31-Oct-2019

Wayfair, Inc. (W)

Q3 2019 Earnings Call

CORPORATE PARTICIPANTS

Jane Gelfand
Head of Investor Relations & Special Projects, Wayfair, Inc.

Niraj S. Shah
Chief Executive Officer, Co-Chairman & Co-Founder, Wayfair, Inc.

Steven K. Conine
Co-Chairman and Co-Founder, Wayfair, Inc.

Michael D. Fleisher
Chief Financial Officer, Wayfair, Inc.

OTHER PARTICIPANTS

Peter Jacob Keith
Analyst, Piper Jaffray & Co.

Brian Nagel
Analyst, Oppenheimer & Co. Inc.

Jonathan Matuszewski
Analyst, Jefferies LLC

MANAGEMENT DISCUSSION SECTION

Operator: Good morning, ladies and gentlemen. My name is Suzanne and I will be your host operator on this call today. At this time I'd like to welcome everyone to the Wayfair Q3 2019 Earnings Release and Conference Call. All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question-and-answer session. [Operator Instructions]

Thank you. At this time I'd like to introduce Jane Gelfand, Head of Investor Relations at Wayfair. Please go ahead.

Jane Gelfand
Head of Investor Relations & Special Projects, Wayfair, Inc.

Good morning, and thank you for joining us. Today, we will review our third quarter 2019 results. With me are Niraj Shah, Co-Founder, Chief Executive Officer and Co-Chairman; Steve Conine, Co-Founder and Co-Chairman; and Michael Fleisher, Chief Financial Officer. We will all be available for Q&A following today's prepared remarks.

I would like to remind you that we will make forward-looking statements during this call regarding future events and financial performance including guidance for the fourth quarter of 2019. We cannot guarantee that any forward-looking statements will be accurate although we believe that we have been reasonable in our expectations and assumptions. Our 10-K for 2018 and our subsequent SEC filings identify certain factors that could cause the company's actual results to differ materially from those projected in any forward-looking statements made today. Except as required by law, we undertake no obligation to publicly update or revise these statements whether as a result of any new information, future events or otherwise.

Also, please note that during this call, we will discuss certain non-GAAP financial measures as we review the company's performance. These non-GAAP financial measures should not be considered replacements for and should be read together with GAAP results. Please refer to the Investor Relations section of our website to obtain a copy of our earnings release, which contains descriptions of our non-GAAP financial measures and reconciliations of non-GAAP measures to the nearest comparable GAAP measures. This call is being recorded and a webcast will be available for replay on our IR website.

I would now like to turn the call over to Niraj.

Niraj S. Shah

Chief Executive Officer, Co-Chairman & Co-Founder, Wayfair, Inc.

Thanks, Jane, and thank you all for joining us this morning. We're pleased to talk about the third quarter results and the many initiatives that continue to propel Wayfair's momentum and our confidence in the future. In Q3, Direct Retail net revenue grew by $607 million or 36% year-over-year. Total net revenue grew by 35% year-over-year. Despite much debate about the health of the U.S. economy and a mixed macro backdrop in Europe, we continue to see strong growth in both the U.S. and International segments, as the structural shift from offline to online marches steadily on.

In the short-term, tariffs are injecting greater than expected volatility into our marketplace as customer consideration cycles are disrupted and larger than normal amounts of substitution occur in response to price changes. We believe this is temporary in nature since our machine learning algorithms will adjust our site experience as customer preferences change, but it does inject near-term volatility.

As Michael will discuss in greater detail, we are optimistic that this noise will subside over the next several months. Meanwhile, we remain as always focused on the longer-term and the investment initiatives we have in place to cement Wayfair's positioning as the e-commerce leader in home goods.

These major initiatives include our logistics infrastructure build-out, International expansion and further penetrating our TAM, across all categories of home goods. Today I'll provide updates on each of these pillars including highlighting the successful approach we're taking in the core plumbing space. But first I'll start with our logistics network.

We currently stand at approximately 15 million square feet globally after having opened our second CastleGate warehouse in the UK this past quarter. This marks the first International CastleGate warehouse that spans over 1 million square feet, which is more similarly sized to the fulfillment centers here in the U.S. and which reflects the high-levels of demand we now have in Europe.

Looking ahead to 2020, we also expect a similar sized warehouse to come online in Germany. The planned rollout of our network continues, just last month we opened a facility in Lathrop in Northern California. Another warehouse in Jacksonville, Florida, to help serve the major population center in the southeast, is expected to open in January of 2020. Lathrop, near San Francisco, is a great example of how we optimize for speed and density. This coastal warehouse was envisioned since we needed to add capacity but at the same time, its location enabled us to reduce inbound shipping costs while unlocking more one and two-day coverage. To put a finer point on it, areas in Northern California and the Pacific Northwest for which Lathrop is now the closest warehouse could see a 50% lift in one and two-day coverage thanks to the opening of this fulfillment center and we know the presence of such delivery speeds lift conversion meaningfully.

We've already built a strong competitive advantage through CastleGate and the Wayfair Delivery Network and are excited by the plans in place to increase their sophistication and agility over the coming quarters. We've built out the coverage that we need in the United States and over the next year are planning to moderate the pace of our logistics expansion as we drive greater utilization and throughput in our existing footprint. Last quarter we highlighted one such move to drive greater efficiency as we shifted to a seven-day staffing model in some of our facilities from a five-day staffing model. These kinds of moves have clear positive long-term implications, though short-term, they may cause a step back in terms of efficiencies as we adjust and take time to grow into the extra capacity that we've unlocked. You'll see more of this over the course of the next year as we seek to optimize the use of our current footprint.

And then, by 2021, to keep up with our growth we expect to once again pick up our pace of square footage expansion in the U.S., in order to expand capacity. All future warehouses we will add deliver similar compounding benefits as I described in the case of Lathrop, that is provide needed extra capacity, faster delivery speeds, and lower costs.

We also continue to be pleased with the progress we're making in International. In Canada though the majority of goods we sell cross the U.S. border, the team is focused on achieving market pricing and lower costs by driving higher CastleGate penetration in Mississauga and leveraging our Asian consolidation operations to ship more product directly from Asia to Canada via [ph] full-mix (07:03) containers.

In Europe we've doubled our assortment over the last 12 months and continue to optimize and enhance the site experience for our customers. Just earlier this month, we debuted our first flagship house brand in Europe, called Hykkon, building on the successful curated brand strategy we've established here in the U.S. As we scale in Europe, we're also increasingly focused on tightening end-to-end execution to drive greater cost efficiencies across our entire supply chain.

Now turning our attention to the emerging categories, I'd like to spend some time today telling you about core plumbing. It's one of the categories against which we have deployed investment resources over the last couple of years as we cement our right to compete and win in these important parts of home goods retail. As a result plumbing has grown into a formidable business for Wayfair approaching $300 million in annualized gross revenue and growing both revenue and variable contribution dollars at greater than 50% rate year-over-year.

The market for the core plumbing categories in which we compete is vast, and an estimated $20 billion total addressable size in the U.S. We define core plumbing as spanning faucets and fixtures items such as bathtubs, toilets, bathroom and kitchen sinks and faucets, bidets and shower doors.

Market share in this category has historically been dominated by local showrooms, regional specialty retailers, as well as contractor and DIY-focused national retailers. We estimate online penetration at a relatively low 15%, but show rapid growth at a roughly 20% clip.

At Wayfair, we want to win across all categories, where our customer is making the purchase decision and cares deeply about how the product will look in her home, and core plumbing is no different. Though the installation may at times be pro-assisted, core plumbing product selection is still heavily influenced by style and aesthetic inspiration.

The nuance in retailing these products is that we also have to educate the homeowner in the technical considerations involved, helping us to achieve this is our dedicated core plumbing team of approximately 50 people, who represent a cross-section of category, engineering, marketing, and merchandising functions. They along with a dedicated specialized Customer Service team are all experts at finding ways to resonate with our core customer who may be less familiar with the complex facets of plumbing.

As they take on a project we want customers to turn to Wayfair as the destination to inspire, educate, scope, and fulfill their product needs. In doing so we believe we will not only accelerate the plumbing category transition online, but also help grow the overall market by democratizing access to products formerly in showrooms and materially increasing the ease of shopping.

No single venue for shopping the category today effectively marries depth and breadth of assortment, inspirational content, accessible technical know-how and ease-of-use including fast and reliable shipping. We believe Wayfair can disrupt the current landscape by uniquely tailoring our site experience for core plumbing, while leveraging our strong logistics and customer service offerings.

Our core plumbing catalog is vast with nearly 100,000 SKUs including direct relationships with the key brand name manufacturers in the space such as Kohler, GROHE, American Standard, Moen, and Delta. These customers seeking something specific can easily navigate to and explore well-known brand pages and products that are full of rich visuals and detailed technical specifications to help customers know that they found the right item, but for the majority of our customers, for whom the shopping occasion is unfamiliar and opaque, we're also demystifying the journey by helping them explore and find what they're looking for using imagery and visuals to supplement industry terminology, and proactively offering key descriptive and technical stats in a digestible way, buying guides, trends articles and do-it-yourself tips on our site augment this further.

For instance, using our super browse page for tubs, showcases a well-merchandised assortment of over 9,000 items featuring robust imagery and 3D models that help bring to life the unique characteristics of each product.

Before the customer even clicks on a single product, we offer up important details to help them narrow their selection. For example, the material it is made from, whether there is a faucet or not, drain placement, and soaking depth, all the while explaining the industry jargon such as therapy and installation type, through pictures and quick description.

We also offer a tub buying guide to build the customer's trust and awareness as she embarks on making her selection. With every product class, we understand the common challenges in the shopping journey and tailor the site experience to mitigate them, giving our customers the confidence to buy. Another example of how we do this in core plumbing is by pre-configuring complete plumbing kits and shower systems so that our customers do not have to worry about compatibility or having to shop individually for complementary sets of products. We also highlight required-related items as one shops so that the customer has all the key components they need during installation.

Wayfair prides itself on exceptional customer service including specialized sales support for our customers. We employ more than 500 subject matter experts globally in technical categories such as core plumbing, and with their help, offer customers a comparable assisted sales experience to a showroom, but with a far-wider and more robust selection of products. These representatives support longer consideration purchases and projects without necessarily pushing for a sale, helping to reinforce customer trust in Wayfair and the confidence to make a purchase decision when ready.

As you can imagine, getting the right product, damage free and quickly, is critical in the core plumbing category, particularly for customers who are on tight project timelines. Delays are not just inconvenient and frustrating, but are also expensive for our customer. We are leveraging our logistics infrastructure and close-knit supplier relationships to drive down lead times and forward-position key inventory through CastleGate. Core plumbing sits among the top five categories at Wayfair for one and two-day coverage reflecting both CastleGate forward-positioning and virtual badging.

We also align closely with our supplier partners to improve packaging, product design and shipping practices, to drive down incident rates and improve customer satisfaction. Plumbing is one of the categories where we've invested in growing the team so that we have the resources to go after the immense opportunity that is still ahead. We talked often about how such investments over the last couple of years should yield increasing returns. Core plumbing is an example where the team currently in place is now positioned to considerably scale the already-large business into the future without many incremental resources. Many of our emerging categories are now reaching this stage of increasing productivity and leverage, and we are excited to continue to update you on their progress over the coming years.

I'll now turn the call over to Steve.

Steven K. Conine

Co-Chairman and Co-Founder, Wayfair, Inc.

Thanks, Niraj. Today I want to talk about some of the technology that powers our supply chain and then also share some early observations post the opening of our first physical store location in late August.

At the heart of our logistics strategy is to transport a massive number of SKUs from a wide spectrum of suppliers to the right place at the right quantity and also at the lowest-cost possible for our customers, our suppliers and therefore, ourselves. To drive the most efficient product flow into our network, we leverage a piece of software called [ph] BI-Fair (14:42) which is a machine learning-based optimization and supplier collaboration platform. This is the proprietary solution that we built over the last three-years in the absence of compelling third-party options. In close collaboration with our suppliers, [ph] BI-Fair (14:58) allows us to influence the product's journey directly from the manufacturing site all the way to our warehouses. It offers recommended quantities of each product for both CastleGate and drop-ship models, and directs which SKUs should travel to which CastleGate warehouse locations across North America and Europe. With [ph] BI-Fair (15:17), we can also route them as efficiently as possible over land and sea, contemplating every step along the way. [ph] BI-Fair (15:24) effectively ensures availability to the customer while minimizing time, distance traveled, touchpoints and damage involved. That is at the lowest-possible cost to all parties.

What makes the [ph] BI-Fair (15:38) technology both differentiated and challenging is that in order for it to do its job properly, we must optimize not just across our own network, but also across our supplier's networks.

We seek to understand their manufacturing and logistics capabilities, including production quantities, timelines, and locations and then figure out how to best complement them with ours. This is a potent example of what is possible given our unique partnership model with our suppliers. In implementing [ph] BI-Fair, (16:08) we rely on our supplier partners to offer transparency around sourcing and production that they may include in important proprietary information.

In return, they can leverage our analytics insights to maximize their product velocities, while minimizing cost, by engaging with us in the planning processes that [ph] BI-Fair (16:27) facilitates, suppliers are showcasing their trust in us. We, in turn, closely guard that confidence and aim to drive our business in ways that always benefit them while also advantaging our customers.

If you think about the quantity and diversity of the SKUs we service all of the places they originate in and travel to, the various means we have to get them there and what other products they might travel with, the [ph] BI-Fair (16:51) exercise has to run through hundreds of thousands, if not millions of decisions to arrive at the optimized recommendation for our suppliers. This is complex math which was developed and is supported in-house by a cross-functional team of engineers, data scientists and operations experts. It also continues to evolve as our network grows.

For instance one can see how Asia consolidation, our initiative to optimally pool products across our various suppliers close to where it is sourced will be integrated into [ph] BI-Fair (17:21) suggestions. This is a natural extension of the effort to forward-locate and manage product flow at the lowest-cost. [ph] BI-Fair (17:29) is a core enabler of greater speed and lower-cost for the full spectrum of suppliers. It is agile enough to consider those suppliers who have finely-tuned logistics networks of their own or in combination with other offerings, such as ocean freight, drayage and domestic freight pickup, [ph] BI-Fair (17:47) can also take the headache out of logistics and transportation planning for other suppliers who prefer to concentrate solely on designing and producing the best possible goods.

Similarly, while [ph] BI-Fair (17:59) is a key input into the inventory planning conversations we are continuously having with our key suppliers today, over time, it will be available as a self-service solution. Given the sheer quantity of product we sell, and the many supplier partners participating in CastleGate, keeping everything in-stock in the right place at a low-cost is no small task. The proprietary solution we have developed in [ph] BI-Fair (18:22) is another great example of the partner-focused, data-driven, tech-centric approach on which we pride ourselves. Now as you may know, we opened our first full-service physical retail store on August 21, in Natick, Massachusetts just a few miles from our headquarters in Boston. Our journey into the physical retail began with two holiday pop-up stores at the end of 2018 in Massachusetts and New Jersey. After a successful run, we expanded to four additional pop-ups across models in Pennsylvania, Virginia, Illinois and North Carolina this past summer.

Learnings from each of these experiences informed how we went to market with our first permanent location. Our Natick store is relatively small at 3,700 square feet of retail space, and the mix of products we offer ranges from small items one can buy and carry-out to showroom items one can experience in the store then purchase online. The vignettes on display inspire our shoppers to go on to the site and explore the many other product options available to them. In the store there's also an experiential component via our Home Bar, which offers complementary design consultations as well as Augmented Reality, virtual reality and design tools to showcase the future of home goods retail and how it can interact with their personalized space.

We can't emphasize enough that the store is a dynamic exercise. We designed the space to be flexible, and are already iterating on how it might look and what we might offer to align better with our customer's needs and expectations.

That said our initial observations have been encouraging. While it is too early to highlight any numbers, I will share that traffic and interest levels have exceeded our expectations. A high proportion of our Natick customers are first time Wayfair shoppers, who subsequently discover our online marketplace. We are also seeing customers come back to the store multiple times and shop across the product catalog, making purchases ranging from furnishings for the living room and bedroom to wall art, decorative accents and housewares.

As we experiment with the physical store format and assess ROIs, we will judge its success on the basis of it representing a different form of marketing channel not a widespread distribution channel as this is not our aspiration. As always, we remain focused on attractive, payback metrics and building a sustainable profitable business over the long-term and that extends to offline and online outlets. With that I'll pass the call on to Michael to discuss our Q3 financials and forward-looking expectations.

Michael D. Fleisher

Chief Financial Officer, Wayfair, Inc.

Thanks, Steve, and good morning. Before we discuss the details of our third quarter financial performance and expectations for the end of the fiscal year I want to take a step back and provide a bit more context on how our business is managing through the latest tariff-related volatility. Since the beginning of the year more than 90% of our suppliers who are subject to China tariffs have raised wholesale prices, which have resulted in higher retail prices. As retail prices on the site fluctuate, we observe that our customer's consideration cycle gets disrupted and is effectively lengthened. This has always been true. Changing prices up or down lengthens customer decision-making.

Traffic to our site remains healthy and average order values steady, but customers are taking more time to consider their options across the site before purchasing. In many cases our most popular, highly-rated products with extensive review counts and great imagery are now slightly more expensive than extremely similar products that have lower review counts, often not burdened with a tariff. Customers require more time to build confidence that the price they are being asked to pay is right and to actively assess alternate product.

As products shift in popularity, the sort order changes. In turn, we have seen suppliers then revert and lower their pricing in order to optimize their share in the marketplace which then, again, contributes to customer experiences being altered and so on. All of this creates short-term dissonance for the customer which we expect will go away as the marketplace inevitably rebalances.

Tariffs are having a secondary effect as well. As you know our marketplace model is unique in that we do not own the vast majority of inventory we sell. This is almost always a substantial, multi-facetted advantage, with perhaps the sole exception being in periods of widespread cost increases, like we are seeing now. As suppliers communicate pricing decisions to us, our pricing algorithms seek to maintain a balance between factoring in our higher wholesale costs and keeping us market-priced. In practice, this also translates to a lot of dynamism on the site and means that for a short period of time, inventory carrying retailers may have a slight cost advantage. This should dissipate over the next couple of quarters as the market rebalances, pre-tariff inventory is depleted and all retailers incur higher wholesale costs reflective of tariffs.

The reality is that our business, as a value-added platform for the home goods industry, will continue to be advantaged as data around the new reality builds, and the algorithms and behaviors all stabilize. Our marketplace will also rebalance the most popular items accounting for customer preference of which price is only one of many drivers. Though this whole process may take a couple of quarters to play out, we will, as always, remain steadfastly focused on the longer-term initiatives that continue to widen our competitive moat and will not shift our investment course in reaction to this near-term volatility.

Now let's turn to the details of the Q3 results and Q4 guidance. Our press release and investor presentation which include GAAP to non-GAAP reconciliations are complements to this discussion and may be found on our investor site. In Q3, our Direct Retail net revenue grew 36% year-over-year to $2.3 billion. In other words, we added approximately $610 million in sales year-over-year. In the U.S., Direct Retail net revenue increased to $1.961 billion, up 34% or $500 million year-over-year. Direct Retail net revenue in the International segment increased 46% year-over-year to $339 million.

Excluding foreign currency translation headwinds, Direct Retail net revenue growth in International was up 50% year-over-year in constant-currency terms. Our KPIs remained healthy. LTM active customers totaled 19.1 million this quarter up 38% year-over-year reflecting successful customer acquisition and healthy engagement and repeat behavior. LTM net revenue per active customer reached a new high of $449 and LTM orders per active customer were about flat sequentially at 1.85.

In North America, LTM net revenue per active customer increased sequentially but we experienced a slight moderation in average order frequency reflecting the longer consideration cycles that I referenced earlier. In Europe where tariffs are not a factor, we did not see the same dynamic.

In the quarter, orders from repeat customers represented 67% of the consolidated mix. As we move down the P&L, I'll be referencing the remaining financials on a non-GAAP basis, excluding the impact of equity-based compensation and related taxes which totaled $65 million in Q3 2019.

Our gross profit for the quarter was $541 million or 23.5% of net revenue. Gross margins expanded 40 basis points year-over-year. Though gross margins were in-line with our guidance for 23% to 24%, this was admittedly a bit lower than the past few quarters and primarily reflects some of the short-term tariff-related pressures in the U.S.

Advertising spend was $282 million or 12.2% of net revenue in Q3. This is approximately 35 basis points higher year-over-year. This is due to continued negative mix shift as our International business which operates at higher-levels of advertising as a percent of sales outpaces U.S. growth rates, and continued ad spend to add new customers in the U.S. within our ROI payback threshold.

We are highly payback driven in our marketing spend decisions, and that is no different as we scale in Europe than our approach in the U.S. As you analyze our results you'll also see that the average cost of customer acquisition or CAC has risen modestly in the quarter, so I want to remind you that we are focused on acquiring high-quality customers who will not necessarily transact in the same quarter we engage with them. We continue to target an average 12-month payback period on the variable contribution dollars these customers will bring in relative to the cost of acquisition, as we have done since Wayfair's inception.

Fundamentally, we expect advertising costs to drop as a percent of net revenue as the repeat customer base grows faster than the new customer base, given that repeat customers run at approximately a 7% ad cost as a percent of net revenue. This has been our long-term trend over the last five years and we expect it will continue over time.

Our non-GAAP selling operations technology and G&A expenses in Q3 totaled $365 million. As a reminder, much of this line item is attributable to compensation costs. And the third quarter, as expected, was a heavier hiring quarter due to the timing of campus recruiting. In total we added approximately 1,500 employees in the third quarter with roughly 800 of these in variable cost areas of our business. Where we are mostly in-sourcing work previously done by third-party logistics partners, and keeping our customer service teams staffed to our scale. The balance, or about 700 employees, is accounted for on the OpEx line, and represents employees in work areas such as engineering, marketing and merchandising.

Our campus recruits made up more than half of these 700 net new employees. We have added really talented new people, from highly-respected undergraduate, MBA, engineering and data science programs; a testament to the strong employer brand we have built on undergrad and graduate campuses.

Now turning to profitability. Adjusted EBITDA for Q3 was negative $144 million or negative 6.3% of net revenue. Adjusted EBITDA for the U.S. business was negative $63 million or negative 3.2% segment EBITDA margin, and adjusted EBITDA for the International business was negative $81 million. Our level of investments in International was consistent with our expectations but the U.S. losses were slightly greater than anticipated. Non-GAAP free cash flow for the quarter was negative $181 million based on negative $76 million in net cash from operating activities and $104 million from capital expenditures. CapEx was 4.5% of net revenue in Q3 and we expect Q4 CapEx to run approximately 4% to 5% of net revenue.

As of September 30, 2019, we had approximately $1.3 billion of cash, cash equivalents and short and long-term investments. Let's now turn to guidance for Q4 2019.

Thus far into the quarter, our Direct Retail gross revenue growth year-over-year is trending at just under 30% so our growth has moderated some relative to the first-half. As we are closely monitoring our business drivers, we see underlying fundamentals as broadly healthy. We also feel very well-positioned for the holiday period that is right in front of us. As you know, our guidance philosophy marries quarter-to-date performance, full-quarter expectations, and a healthy dose of prudence. As a result, we are setting our guidance for overall revenue growth below our current quarter-to-date performance as we typically do.

We especially think this approach makes sense in a period when visibility is somewhat compromised by tariff-related uncertainty and the fact that as I like to remind you every quarter, we are in a mass-market consumer business where the customer has to show up every day. We forecast Direct Retail net revenue of $2.475 billion to $2.515 billion representing approximately $480 million to $520 million of Direct Retail dollar growth year-over-year or a growth rate of approximately 24% to 26%.

For the U.S. business, we forecast Direct Retail net revenue growth in the range of 23% to 25% year-over-year and expect International Direct Retail net revenues to be up 27% to 30% year-over-year. On a constant-currency basis, we're forecasting International growth between 30% and 33% year-on-year. Recall that Canada represents the majority of our International revenue and tariffs are a factor here as well, given our current sourcing structure. We forecast other net revenue to be in the range of $5 million to $10 million for total net revenue of $2.48 billion to $2.525 billion for the fourth quarter. We expect Q4 gross margins to once again land in the 23% to 24% territory.

So we continue to see multiple upward drivers to get us beyond this range over the mid and longer-term, we expect to contend with some of the same dynamics as we saw in Q3 as it relates to tariff-related trade-offs and normal quarter-to-quarter variability as our supply chain optimization progresses. We also anticipate about 50 basis points to 100 basis points of deleverage year-over-year in advertising as a percent of net revenue. That said our advertising decisions will ultimately be determined by our marketing team in a bottoms-up approach as they monitor channel-specific opportunities, vis-a-vis our 12 month payback threshold in real-time, and assess whether to increase or decrease their spend in specific markets and channels based on the returns they are seeing.

Moving on to the core components of selling, operations, technology and G&A expense, or OpEx, our hiring plans contemplate that our pace of net employee additions will moderate back to first-half levels. As an organization, we are focused on driving towards operating expense leverage and though it may take a few quarters to play out, those efforts start to take root with a more normalized hiring pace quarter-over-quarter.

Unutilized rent is expected to remain in the $15 million to $20 million range in line with the third quarter. At the consolidated level we forecast fourth quarter adjusted EBITDA margins in a negative 7% to negative 7.5% range with the U.S. adjusted EBITDA margins in negative 4.25% to negative 4.75% territory and International investments translating to an $85 million to $95 million loss.

For modeling purposes for Q4, please also assume equity-based compensation and related tax expense of approximately $69 million to $71 million, average weighted shares outstanding of 93.3 million, and depreciation and amortization of approximately $60 million to $62 million.

In Q3, we demonstrated that shorter-term headwinds from tariffs or otherwise, are something we can effectively manage. So these may take several more months to work through, we remain more focused on the long-term drivers to our success, partnering with our supplier partners to provide customers with a massive selection across all classes of home goods, exceptional customer service, and an easy, fast, and seamless delivery experience. Our continued momentum not only reflects the structural move from brick-and-mortar retail to an e-commerce world but also the unique competitive advantages we have cultivated to capture a disproportionate share of the dollars moving online.

So we are privileged to have a healthy balance sheet to allow us to continue to invest in our business for the long-term, we are also confident that Wayfair's compelling unit economics and ROI orientation will become increasingly evident across all lines of the P&L over time.

I'd now like to turn the call back to Niraj before we take your questions.

Niraj S. Shah

Chief Executive Officer, Co-Chairman & Co-Founder, Wayfair, Inc.

Thanks, Michael. Though our momentum remains impressive despite tariff-infused volatility, it is moments like this that underscore the value of our long-term orientation. Our team of over 16,000 employees is appropriately focused on our customers, the long and substantial runway for growth still ahead, and the many initiatives underway to capture a disproportionate share of that opportunity. As we approach the holidays we're truly excited by the impressive lineup and service we have planned for our customers and we are committed to always being customer-focused, execution oriented and to think long-term in nature.

We'll now go to Q&A so that we may answer your questions.

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] Our first question comes from the line of Peter Keith of Piper Jaffray. Your line is open.

Peter Jacob Keith
Analyst, Piper Jaffray & Co.

Q

Hi, thanks, good morning, everyone. I did want to dig a little bit more into some of the tariff dynamics, so you first talked about it with July seeing some price increases, so we're now four months into maybe a price increase environment. On that note, you do sound a little bit more confident about working through the temporary disruption so the two questions I have on this topic would be first off, when have you seen a majority of the price increases? Has that been more recently or was it more front-end loaded towards July, and secondly, when you look at consumer behavior, how long do you think this disruption or pause dynamic lasts so we can get a better sense of when your sales growth might start to reaccelerate? Thank you.

Niraj S. Shah
Chief Executive Officer, Co-Chairman & Co-Founder, Wayfair, Inc.

A

Thanks, Peter. Yeah, so let me try to answer those two, and I do think they are obviously highly inter-linked. So, the tariffs, the bulk of our goods were in the tranche, where 10% – the first 10% happened last year and then the 10% went to 25% this summer and then we have a smaller amount of goods where they went from 0% to 10% in that – the summer timeframe. Really it focused on the part that went from 10% to 25%, what we found was that the 10% largely was absorbed so the price increases that came through last year were really minor, or non-existent. When the 10% went to 25%, that's really what created a lot of volatility and so basically, what's happened is that there's no clean date when people started passing through price increases, and what you find is actually folks did all kinds of different things.

Some folks decided to try to hold price either for a while or permanently. Some folks held price because they are in the middle of resourcing the goods elsewhere, but then the goods may have gone out-of-stock for a while, while they are trying to bring new supply sources online, but then the thing that took us by surprise, and the thing that I think we underestimated was that there was a repetitive cycle of volatility and what I mean by that is that some suppliers, they'd raise their price and then they would see the volume drop-off be steeper than expected because of the nature of our marketplace, which basically allows them to compete with other suppliers for the consumer, they would then cut their price. But when they cut their price, it still creates a new cycle of volatility and in that case it's positive for them, but it disrupts the buying cycle again for the consumer as they consider this other item that which became better priced and vice versa.

Then we have a lot of other suppliers, who are trying to pass-through a price increase, or pass-through price increase and then waited a while, passed through another one, so they try to trickle it in, but each time they trickled some in, it created some volatility. So, what's happened is if you sort of look at what's happened over time, there's a lot of disruption of the cycles, some up, some down, so on and so forth, and that's sort of what we underestimated was just the amount of changes and the fact that they would be ongoing.

In terms of timing, we do view it as all transitory and a lot of the metrics we have which show how the business is performing around loyal customers coming back, and then the repeat metrics and the early repeat 3 and 7 day-type repeat metrics and we have a whole body of data we're always looking at. Basically show that the customer – we think we're having great momentum with the customer, and they are coming back, and so we think this is transitory and we feel like over a couple quarters it's going to pass and we're kind of in the middle of it. So, from a timeframe perspective, it's very hard to be literal on an exact date per se, but we see it passing through and we feel pretty comfortable about that. And so don't think of the consumer behavior as a pause per se, but just think of it as disruption kind of just keeps kind of throwing small delays into things and that that cycle hasn't ended yet, but as we work through it that will be what causes the growth to kind of tick-up.

Peter Jacob Keith
Analyst, Piper Jaffray & Co.

Q

Okay. Thank you for that color, and then just secondly, we've had some conversations with investors around advertising and the rising customer acquisition cost. There's likely some influence of that rising CAC from the lower sales growth, but it did start to elevate in Q1 and Q2 before the tariffs kicked in. Could you give us just a little bit of color on what might be driving that CAC on an aggregated basis? If it has to do with some of the International or is there a leaning in on new customers? Any additional color would help us, thank you.

Niraj S. Shah
Chief Executive Officer, Co-Chairman & Co-Founder, Wayfair, Inc.

A

Yeah, sure, so let me just first, by trying to just clarify with that CAC calculation. The CAC calculation, if we try to help illustrate how repeat is much less expensive than new, and we'd sort of give you a way to kind of calculate that out, but at the end of the day, that CAC number, you get to $58 is still not the actual CAC we're paying for new customers in the quarter. It's simply all of the ad costs, basically the actual ad cost we're spending for new customers, we get those new customers over time. So, when you use the new customer in the quarter it doesn't tie out with the money spent for new customers in the quarter, and the reason that matters, you mentioned internationally, basically what you have is you have different – there are different geographies on different points of time in the curve, Germany as an example. We just started the brand marketing campaigns for Germany earlier this year, so that's a cost that will look very expensive relative to new customer adds in Germany in the beginning and then as you run through time it'll start looking very efficient.

We also have brands like Perigold, and Perigold is about 2 to 2.5, 3 years in, but it's now hitting – it's starting to really scale and there's a significant amount of money being spent on it, but again it would look quite expensive if you took the Perigold ad spend for new customers and looked at it specific to new customers, because that type of brand-building expense in the beginning is quite expensive.

So that challenge of these different brands, different geographies at different points in maturation create a lot of mix and even within a brand you have different channels and certain channels that get you higher-quality customers may have a 400 day payback that we'll manage against, a more transactional channel we might have a 60 day or 30 day payback we got to manage against, and that manages out to that timeframe that we kind of tell you pays back in under a year which is true, but the reality is there's still mix shift within it and so what you're seeing is the mix shift this year, if you think about Germany, you think about Perigold, you see it going against the overall CAC calculation.

When you get into next year, when I look at the estimates of what I think mix will look like, I think, as you go well through next year you're going to start seeing leverage again. You'll say, oh, CAC is getting less expensive. Again that won't necessarily be true then either. It'll really be the mix effect. The CAC is being managed very tightly within each brand and within each channel, so that's true now when you see it going up and it'll be true later when you see it going down and then one thing because we kind of anticipated there might be a question on this I just pulled up some numbers.

If you actually look at in the quarter, we spent $282 million on advertising, when you add up all of the geographies, all the brands, the brand marketing, the more transactional, the online, the Direct Mail everything. And the $282 million is when you break it out, new versus repeat, you see we added just under 3 million new customers in the quarter. You basically see that you get that $58, and it's like $172 million, $173 million of spend on new customers.

In order to get the CAC to kind of just not – to basically be flattish, out of the $282 million, if you spent $16 million less, you would have had it, you'd have it play out like that. $16 million out of $282 million, we could have pulled $16 million out and not impacted revenue in the quarter, but what would happen is you would have given up getting customers that turned out to be very valuable customers that are paying back very nicely and not building up the brands in terms of awareness at the same rate that we know is financially productive, and so that's why we don't manage to the CAC number. It's more an outcome, an output of the way we manage, and that's why I'm kind of telling you now as you see that leverage roll through next year to be honest it won't be from doing anything different. It's again this is the mix will start to work for us.

Peter Jacob Keith
Analyst, Piper Jaffray & Co.
Q

Okay thank you very much, Niraj. It's very helpful, and good luck with the holiday season.

Niraj S. Shah
Chief Executive Officer, Co-Chairman & Co-Founder, Wayfair, Inc.
A

All right. Thank you, Peter.

Steven K. Conine
Co-Chairman and Co-Founder, Wayfair, Inc.
A

Thanks, Peter.

Operator: Our next question comes from the line of Brian Nagel of Oppenheimer. Your line is open.

Michael D. Fleisher
Chief Financial Officer, Wayfair, Inc.
A

Hi, good morning.

Steven K. Conine
Co-Chairman and Co-Founder, Wayfair, Inc.
A

Good morning.

Niraj S. Shah
Chief Executive Officer, Co-Chairman & Co-Founder, Wayfair, Inc.
A

Good morning.

Brian Nagel
Analyst, Oppenheimer & Co. Inc.
Q

I too want to just dive a little deeper into the tariff issue, and I guess a question maybe for Michael. The deceleration in sales growth now from through what you gave us in the fourth quarter is rather significant, and I hear what you're saying with regard to tariffs. Looking at all the data you have, is there something you can give us that helps to explain further that this really is a tariff issue and there's not something else awry with regard to how consumers react on your website?

Michael D. Fleisher
Chief Financial Officer, Wayfair, Inc.

A

Hey, Brian. I don't think we can give you sort of a more specific set of data points, other than sort of the health of all of the sort of built-in KPIs and as we look at – look, we're obviously looking at a set of data constantly as to what customers are doing on the site, what their conversion rate looks like, how much time they're spending, how many times they come back, all right, all of the sort of the actual sort of functioning of what those customers are doing every day, and I will say one other piece on this is that we know from well before tariffs that we've done a lot of work to try and understand what price changing – what price changes on the site, how they impact customers, and one of the most interesting pieces of work I think we've done over a long period of time is that if you change prices up or down, right, it impacts the customer purchase cycle, so you would think logically that if you lowered prices customers would be, it wouldn't slow their conversion, but even a lowering price slows their conversion because it makes the customer question am I getting the best price, is this sort of exactly the – do I need to go look elsewhere, or do I need to look at other products, and so I think that that notion of sort of price changing and sort of constant price changing impacts customers is something we've seen in the past as well.

Niraj S. Shah
Chief Executive Officer, Co-Chairman & Co-Founder, Wayfair, Inc.

A

And Brian, this is Niraj just to chime in. One of the things I'd say is we obviously look at our own data. We also try to make sure we're well attuned to what's happening in the market and what we're seeing is our selection in merchandising advantage relative to competitors is actually expanding, not contracting. I was at High Point just a couple weeks ago and I talked to dozens of our suppliers and what we're hearing from what they are seeing on the demand side both in their total business and then specifically in the online component is that their view is actually that we're doing quite well. So I think, there's a little bit of volatility that it's not just us but online platforms that have the same dynamic, which is really where the volume is are going to have the same kind of volatility and what we're seeing if you look at our kind of into our customer data, that's why we feel pretty comfortable with where we're headed, but I'd echo Michael. There's no kind of clean external data point that makes it super easy for you to see that aggregated up.

Brian Nagel
Analyst, Oppenheimer & Co. Inc.

Q

Well, it's helpful. Let me ask this question then. So you mentioned in your prepared comments that a large portion of the products you sell are [ph] separate with (47:52) tariffs. You also mentioned and we've seen in our work too that traffic to your site has remained quite good. So if you look at products and I understand this might be getting a little narrow in focus, but if you look at products maybe the select products where tariffs are not a factor and prices have not had to increase, has the sales velocity on those products stayed the same?

Niraj S. Shah
Chief Executive Officer, Co-Chairman & Co-Founder, Wayfair, Inc.

A

Yeah, so the goods we sell roughly 60% of them are made in China, and something like 80% are made in Asia, and that 60%, there's certain classes of goods like lighting that are almost entirely made in China, but there's a lot of classes of goods like lower-end upholstery, or even upholstery all the way through low to high-end, but really low-end upholstery is where I was going to focus, where there's a significant production component domestically in the United States, as well as a significant component that's imported from China. So there's quite a mix and then the vast majority of our goods were in the ones that went from 10% to 25%. There's a small portion of our business that's in the 0% to 10% in terms of what happened this past summer. So, when you look across for class of goods, I mean, you can look at ones where you have a mix that's domestic and China, look at ones that are just China. There's very few that are zero China, but you can kind of look across them.

What we're seeing is you kind of see what you'd expect them. Basically there's disruption in most places. It's different forms of disruption. Certain classes of goods it's generally inflationary because they are all coming out of China, but different suppliers are choosing to pass-through the increases in different ways, and some are absorbing them. So, you still see a lot of mix shift volatility and then you have other ones where the natural mix shift would be the Chinese production which had the tariff going up in cost relative to the domestic production, which is not changing, but then you find as a result some of the Chinese producers basically find a way to absorb that cost because they don't want to disadvantage themselves so again you have this mix of volatility.

So, we're seeing that kind of across-the-board. There's not – and so it's playing out the way you'd expect. It's not like clean like, oh, look, you know, outdoor furniture is not in China and indoor furniture is in China. There's no real set of classes like that.

Brian Nagel
Analyst, Oppenheimer & Co. Inc.
Q

Got it. Well, thank you for the detail. I'll pass it along to the next question.

Michael D. Fleisher
Chief Financial Officer, Wayfair, Inc.
A

Thanks, Brian.

Operator: Our next question comes from the line of Jonathan Matuszewski of Jefferies. Your line is open.

Jonathan Matuszewski
Analyst, Jefferies LLC
Q

Yeah, thanks for taking my question. I guess I'd just start off with have you seen any material issues as it relates to some of the production shifts from your suppliers looking to avoid China tariffs? So is there any link between some of the Supply Chain shifts of your vendors moving production impacting any customer satisfaction or anything like that? Thanks.

Niraj S. Shah
Chief Executive Officer, Co-Chairman & Co-Founder, Wayfair, Inc.
A

Yeah, thanks, so there's a significant impact from production shifts. It's less about customer satisfaction. I think, in general the Quality Control processes are good to make sure that production quality is high before significant – before they really start exporting the volume. But the impact is actually what you'd expect given that that's true, which is folks want to move production quickly and they aim to do it without being out-of-stock for a very long period of time and then inevitably what happens is it takes longer to get the new production up and running at the volumes they need. So what happens is they end up out-of-stock, so you take a good selling item, that supplier decides they're going to resource it in a new geography, and they think that they can either do it without being out-of-stock, or with only being out-of-stock for a very short period of time and then this zero out-of-stock turns into three or six months of out-of-stock, and so on and so forth. So, what happens is you have a good-selling item, it's now out-of-stock. It starts to get cannibalized by a different item that's in-stock, that could also happen if one price goes up relative to the other. That other item then gets momentum, then this other item comes back in-stock and then it's trying to claw its way back up. So that disruption cycle on the consumer side, which is a lot about substitution basically gets driven not just by price changes, but by stock availability, and that stock availability has actually been a real challenge.

Jonathan Matuszewski
Analyst, Jefferies LLC

Q

Got you, that's helpful and then just a quick follow-up on the same topic. It sounds like different suppliers have been doing different things with pricing. It's probably tough to say at this point, but just from your vantage point what do you see most suppliers doing on a net basis with pricing over the next few months?

Niraj S. Shah
Chief Executive Officer, Co-Chairman & Co-Founder, Wayfair, Inc.

A

You know, what we've seen is that the first 10% more or less could get absorbed, and it's a 10% going to 25% on the supplier's cost. And so you think about our retail and we buy it wholesale. The wholesale then of course is the revenue line for that supplier and then they've got their cost, so it's 25% on what might be 40% of our revenue dollars, so it's [indiscernible] (52:40) because the transportation doesn't have the tariff, so you end up with sort of if they pass it all through it's something like mid-to-high single-digit percentage of our revenue line of type of cost impact. What you're finding is that 10% to 25%, there really is not a lot of places to absorb that by and large, so the bulk of that's getting passed through.

You're finding a lot of suppliers though saying, hey, you know, I might do some now and some after holiday, or I'm going to absorb it while I resource this item out of China, which for certain items where the raw material supply chain and the tooling in China is not quite as critical they are moving that. And so you're seeing a mix of folks, but I'd say the kind of costing increases where you are seeing them are in that kind of mid-single-digit-type range and then you have a subset of suppliers who are opting not to pass that through or to pass-through just 1% or 2% because they think they can either absorb it or defray it through resourcing or through other methods.

Jonathan Matuszewski
Analyst, Jefferies LLC

Q

Great, thank you.

Niraj S. Shah
Chief Executive Officer, Co-Chairman & Co-Founder, Wayfair, Inc.

A

Thank, Jonathan.

Operator: And your next question comes from the line of [ph] Kunal Walmsley (53:45) of Deutsche Bank. Your line is open.

Q

Hi, thanks for taking the question. A couple if I may one with regard to the logistics side. In terms of you talked about deriving operation efficiencies, how should we kind of view your potential spend on CastleGate and the other warehouses? And then second, we've been seeing a lot of TV advertising as far as Amazon is concerned. How are you seeing competitive landscape both online as well as offline, and are you seeing any impact on the customer behavior? Thanks.

Niraj S. Shah
Chief Executive Officer, Co-Chairman & Co-Founder, Wayfair, Inc.

A

Yeah, thanks, great. Let me first talk about logistics and how we see cost levering as we get into 2020. So on logistics one of the things we tried to highlight in the prepared remarks is that we've been pretty aggressive building out our CastleGate footprint and so obviously we opened a very large building in the UK. That's going to serve us quite well for a while. We have one that'll open in Germany next year. When you switch over to North America, and North America between what we just opened recently in Savannah, and Lathrop, and what we have opening in January in Jacksonville, that capacity along with the buildings we have and some of the things we can do to drive more utilization of those existing buildings we think give us really the capacity to get the yield in 2020 to really scale CastleGate and yet not need additional buildings past that really in 2020. So, we're going to – we'll continue to hone that plan, but really we think it'll take till 2021 before we'll be seeing significant amount of additional capacity, and at that point it will be because of capacity reasons meaning that our utilization in our network will be much higher than it is today. And so that unutilized rent will also get defrayed, so one of the things we see as we go through 2020 I mentioned it earlier that my expectation of mix you'll see ad cost lever as we get into 2020 and increase as we go through the year. We talked a lot about OpEx on the head count side how we added a lot of head count last year and as we anniversary it this year because we've been hiring at a much lower rate on the OpEx side this year, and we expect that to continue. So, as we get into -- you're going to see that hiring rate continue to moderate and when we get into the back-half of next year, you'll see OpEx lever even with the fact that we've moved into Google Cloud, because the thing that's slowing the levering is the fact that while head count has moderated starting at the beginning of this year, we are adding OpEx because of Google Cloud which is no longer CapEx and even with that OpEx, we think as we get into the second-half of next year we'll see that lever. And so you see it, on logistics, I mentioned that unutilized rent, so you're going to see a lot of that – those things start to play through, and the benefit of logistics as we get into a phase where we're only adding for capacity is that the unutilized rent will start to be a lot less because when you add a building for capacity you can fill it much quicker, it's not for building footprint so that's sort of what we expect there.

On the TV advertising, your second question, on Amazon, and then you said online and offline competitors how do you think about those. I mean, obviously we keep an eye on everybody and what we've seen is that while whether it be Amazon or Home Depot or Walmart, everyone sort of viewed home as a kind of open opportunity. What we see is that in home, we actually are seeing our traction with the consumer, our awareness and our preference continue to tick-up with consumers in the research we do, and the competition a lot of those folks have amongst one another are primarily focused on consumables, so think of dish soap or double A batteries, and what we're seeing is there's pretty frenetic competition in those categories. The nice thing from our perspective, we don't compete in those categories and we've always thought the two categories are fundamentally different, one is fashion, and one is home, and we don't focus on fashion, we focus on home.

Those two are very different, consumers want unique items, they want to find that special item, the aesthetic matters, there's the complexity in understanding what the item is and that's what we really cater to. The delivery and logistics is complex and unique, and so we keep an eye on everybody, but we're not seeing the competitive field really take any ground. It doesn't mean that we get all the share, but you could see even with the note that revenues decelerate a little bit. If you look at the math of the share taking we're still taking pretty significant share of the dollars that are moving online and frankly, we expect that to actually grow over time. So, when you zoom real in, you could say, oh, yeah, you took $600 million this quarter, and it's not great compared to last the year. Well, last quarter we had the biggest Way Day ever, this quarter $600 million, yeah, sure we like to be better? Yeah, we'd like it to be better. Zoom out a little, you're going to see that number keep ticking up over time and that's what we expect to see happen.

Q

Thank you.

Operator: And then...

Niraj S. Shah

Chief Executive Officer, Co-Chairman & Co-Founder, Wayfair, Inc.

All right. I – oh, someone just mentioned we're going to wrap-up, so I just want to thank everyone for joining us today and thanks for your interest in Wayfair.

Operator: And this concludes today's conference call. You may now disconnect.