Corrected Transcript

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Wayfair, Inc. (W)

Q4 2019 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning. My name is Amy, and I will be your conference operator today. At this time, I would like to welcome everyone to the Wayfair Q4 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.

Jane Gelfand, Head of Investor Relations and Special Projects, you may begin your conference.

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

Good morning, and thank you for joining us. Today, we will review our fourth 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 first quarter of 2020. 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 2019 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 good morning, everyone. We're pleased to speak with you all today. This juncture in our history is particularly interesting given we just celebrated five years as a public company and closed out an exciting decade of transformation and progress. Wayfair's journey thus far has been remarkable. But in truth, we're even more enthusiastic about the opportunity ahead. In many ways, we think what has to come will be even more exciting as we solidify our position as the leader in the home category and begin to reap the benefits of our large strategic investment.

To that end, we're using the opportunity of this year end to reach you not just through this conference call, but also through our annual shareholder letter posted on our IR website. We hope that you'll take the time to read the letter since in it we share some longer-term reflections on our history and we talk about our operating philosophy and priorities as we look ahead to the next ten years.

As you know, we manage the business over years, not quarters. And so, I'll focus most of my remarks here on 2019 as a whole and our forward view of 2020. But first, we'll briefly go through our performance for the fiscal fourth quarter. In Q4 2019, we generated $2.5 billion in net revenue, representing 26% growth year-over-year and also year-over-year growth of $519 million. This momentum was broad-based across U.S. and International, and our operating performance in the holiday was strong.

Over the key Cyber 5 period, we saw strong consumer engagement with Black Friday and Cyber Monday, both taking equal share of the holiday with consumers increasingly seeing online as integral to how they shop our category. We grew to 20.3 million active customers with orders from repeat customers up 31% year-over-year. Looking at quarterly profitability, while Q4 adjusted EBITDA at $180 million loss came in as planned, we're looking forward to making significant movement towards adjusted EBITDA profitability in the year ahead, which I'll discuss more about in a moment.

Now, let's look at 2019 as a whole. The year showed clear progress across many fronts, but also shed light on some things that we can optimize as we move forward. We grew net revenue by 35%, a rate that very few companies of our size ever demonstrate. This is a testament to the fact that home has historically been underserved both offline and online and that our core strategy and investments are working and resonating with our customers. We estimate that we captured $0.36 of every $1 of home goods expenditures moving online and solidified our standing as the go-to home goods retailer.

Our aided awareness remained at very high levels in the U.S. and improved by nearly 1,000 basis points in the United Kingdom. Across all of our geographies, we remain focused on the customer by providing her the broad selection across more than 1,000 subcategories of home goods, ranging from mailboxes and area rugs to beds and gazebos; by inspiring her with richer visuals, features and reviews; and by engaging her through a variety of sale events and curated collections and features. We also partnered closely with our suppliers to create new house brands with a growing share of unique products and empowered our suppliers through tools such as Sponsored Products and the evolving Wayfair partner home platform, which is our supplier Extranet.

In 2019, we made considerable progress against our three key strategic initiatives. We added 4 million square feet of logistics space across our fulfillment, middle mile, and last mile networks to end the year at 16 million square feet. Small parcel CastleGate penetration increased 500 basis points to 31%, while large parcel now sits at 21%, and that's up from 14% as of Q1 2019. Compared to the prior year, we also saw a low-single-digit improvement in average ship cost per order, and this is demonstrating the early financial returns on our investments.

As we indicated back in October, we now have the geographic coverage we need to reach the consumer incredibly fast; in fact, regularly more rapidly than our competitors and also faster than our customer often expects as possible in our categories. In 2020, we have an opportunity to drive greater capacity utilization in our existing fulfillment centers and delivery locations. And as we previously stated, with the logistics footprint we now have in place and with the opportunity to drive much higher throughput and utilization, we do not expect significant square footage additions this year.

In Europe, where I recently attended three trade shows, suppliers are now all in. We more than doubled our selection in 2019, and saw rapid market share gains in both the UK and in Germany. When we time index our progress in the UK and Germany versus the trend we established in the U.S. earlier in the decade, we see repeat rates, conversion and household brand awareness tracking along the same trajectory. We're also seeing our unit economics improve with scale even as we continue to invest to grow our customer base. We've also now built out a spectrum of categories and services to represent all things home for our customers.

We've highlighted many of these in past calls and before transitioning to a new earnings call format next quarter, we will revisit vanities again today. It was actually our first earnings call category deep-dive we did in Q1 of 2018. Through this updated example, which you'll see here, we want to give you a sense of how far we've come in just two short years and not just in this category, but across many categories where historically we've been underpenetrated. We're pleased with the foundations we've set in these investment classes and believe we can continue to go after this opportunity in a lean, deliberate manner.

And is often the case, 2019 was also a year not without its challenges. For the first time in many years, consumers experienced price inflation for furniture, decor and most other home good items as the reality of onerous tariffs began to filter through the supply chain. Our suppliers who absorbed much of the initial wave of tariffs in 2018 could not sustain doing so again in 2019. We saw wholesale costs rise, retail pricing become more volatile in our marketplace, and increasing pressure on consumer wallet.

We also spent 2019 absorbing the near doubling of our OpEx head count from roughly 4,000 people to 8,000 people over just two years. The surge on hiring across dozens of old and new initiatives strained our ability to execute with a tight fashion that we know, is a hallmark of our success. Against this backdrop, we saw our back half sales momentum moderate. And while it's true, the revenue dollars we are adding year-over-year remains substantial. We actually believe we can do better than our recent trend.

We've managed through similar episodes before. And we've come out stronger, on the other side. For instance, over the course of 2016, and into 2017, we saw net revenue growth decelerate from nearly 70% year-over-year in the first half of 2016 to 29% by the first quarter of 2017. We then put a series of course corrections in place that led to a rebound to 40-plus percent growth rates, by year-end, and throughout all of 2018.

Back then, we had hired rapidly and had many new people coming up the productivity curve, at one time. We also found that groups had different hiring standards. And this has led to inconsistent talent levels, across the company. This growth rapidly increased the interdependencies between various roles and initiatives. And this contributed to inefficiencies that caused our execution to suffer. To course-correct then, we took an initiative to streamline our processes and tighten our measurement, even as our objectives remain the same.

After we calibrated the talent levels, drove out inefficiencies and let people mature in their roles, we saw connectivity and effectiveness increased, execution improved, and the resulting substantial improvements for our customers, led to a rebound, in revenue momentum. We then also spent two years creating multiple methods to make sure that the talent we bring in, is all consistently of the highest level. And this has been a great success.

As we underwent our regular biannual business review process in the fall of 2019, our leadership team again, saw signs of inefficiency. We thought we'd put in place the measures to prevent this. But with hindsight, we now see that we did not create enough prioritization and scarcity. While this type of volatility is perhaps a natural outcome for a business of our size, growing at the rates we are, we'll work even harder to smooth out these cycles in the future. The key is that we're mobilizing quickly to address these issues, which probably gives you some more context to the never easy, but necessary decision we made a couple of weeks ago to let go of roughly 3% of our global workforce.

To be clear, our list of promising growth initiatives effectively remains the same. And the gains we expect to see, in the near future, are very large. But to maximize our success, we chose to reorganize a number of groups, in a leaner more efficient and disciplined fashion. While letting go of approximately 550 people is the most visible of the course corrections we are making, the reality is that this doesn't just come down to head count. Across all areas of spend, we see opportunity to be more surgical and focused, and frankly, to harvest some relatively low-hanging fruit. While I'll let Michael share with you the specifics of our guidance, I will just say that over the course of 2020, we expect to better leverage our cost across various lines of the P&L, as a result of these changes, even at our current top-line growth rate.

Let us now take a moment to walk through the opportunities underpinning each P&L line item. When it comes to gross margin, even though it's never a straight line, we continue to expect substantial gains from a few factors. One, gross margin improvement from many of our emerging categories that have grown now to be of meaningful scale. Two, benefits from our logistics infrastructure, as it continues to speed up delivery to our customers, while actually driving down our shipping costs.

Three, reduction in issues and costs associated with items that are damaged or have other incidences. Four, growth in the count of items in our house brands that are not widely available elsewhere. Five, price gains from investments in high-quality merchandising, what we call internally, red carpet merchandising. And six, benefits from ancillary services that our suppliers buy from us to advance their business, such as CastleGate or Sponsored Products with more to come. And this list is not comprehensive, but it should give you a feel as to what underlies our confidence in our long-term gross margin targets. These targets are well within reach and we should make progress towards these goals.

Now, let's switch to ad costs. Ad costs as a percentage of net revenue, which was adversely impacted by mix in 2019. We'll anniversary these headwinds and should show leverage in 2020. And this will be hastened by our decision to include an additional constraint in how we deploy marketing dollars to deliver ad spend leverage. Let me explain. As we saw in 2019, it's possible for all core channels in all brands and all geographies to be spending efficiently within their targeted payback framework, while the consolidated result delevers due to mix effects and the impact of investments in new channels.

While this is acceptable in the long run, part of what we want to reemphasize across Wayfair is that scarcity is an asset and this applies to marketing as well. While we admit that this can run the risk of sub-optimizing growth, it's an additional mechanism to keep the quantitative framework tight and healthy. And so, we're kicking off this process in Q1 by first re-baselining customer acquisition and traffic to ensure that we're getting maximum efficiency within these dual constraints. And Michael will discuss this in greater detail a bit later.

And now, just switching to our SOTG&A line, or our OpEx, this line should increasingly reflect greater discipline in a number of areas, namely a much more moderate approach to hiring and a greater focus on driving efficiency in how we work, but also a closer examination of other expenses. And the natural flow of unutilized rent into utilized rent, which runs through COGS as our operations gain throughput. Somewhat offsetting these efforts will be further scaling of our partnership with Google Cloud, which has worked exceptionally well since we implemented it in 2019 and the benefits of that will manifest over the next couple of years in the form of lower CapEx spend.

What's exciting here is that none of these cutbacks, while they're beneficial to the bottom-line over time, actually constrain our ability to continue to invest against our long-term growth initiatives. Said differently at a $10 billion annual net revenue run rate, the attractive unit economics that we've already achieved in the U.S., and that have been apparent to us internally, will become much more prominent to you as well. I will finish up by saying that we're even more excited today about the vast opportunity ahead of Wayfair and about the many differentiated advantages we have built that allow us to emerge as a leader in home goods retail in both North America and Europe.

We're already at a run rate in excess of $10 billion in net revenue, but have just scratched the surface of our total addressable market. We are one of very few with the scale and resources to have established a world-class logistics footprint, the benefits of which should compound over time and drive a bigger wedge between us and our competition. We already have a loyal and enthusiastic customer base, and yet our penetration and share of wallet still have substantial runway.

And we are well-positioned to capture that share through unparalleled selection, one of the largest 3D asset libraries in the world, and a unique marketing engine built almost entirely on in-house technology and a sophisticated returns-oriented quantitative approach. Perhaps even more importantly, we have a true partnership model with our suppliers that will only get stronger with time as they increasingly take advantage of the platform we have built for them and that we are enhancing every day.

Last, but not least, underpinning all of this is the incredibly talented team of 17,000 employees who are every day focused on making the experience better and better for our customers. This powers all of our success. Together, we have consistently seen that when we are focused and tightly executing, we unlock big wins for our customers that drive our growth. I want to thank all of our valued employees past and present for all of their hard work in helping us make this happen.

And I'll now turn the call over to Steve to update you on vanities.

Steven K. Conine

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

Thanks, Niraj. In fiscal 2020, we have something new in mind for the format for this section of the call. Over the past few years, we have typically used this time to highlight some of our investment categories and in-house technologies. For the next few quarters, we'll invite some of our senior leaders to talk to you firsthand about their part of the business. This will afford you a deeper dive into pivotal parts of Wayfair such as marketing, category management, merchandising, Europe, supply chain and numerous others, as well as the ability to ask our leaders questions. We're excited to make this transition next quarter.

But before doing so, it's appropriate to come full circle and briefly highlight a category we featured before to give you a sense of how far we've come and how much we have overcome at a micro level in a relatively short two years. We wish we could give you this update for every single one of the categories we've discussed in the past, but we think vanities, which we'll talk about today, is a great representation of the strides we've made across the spectrum of home goods categories which we've seeded.

We originally provided an introduction to vanities in early 2018. At that point, it had just over $100 million run rate in annual gross revenue. A small team was shepherding the business and was tasked with navigating a challenging category to bring it online. Vanities were burdened by long lead times, high shipping costs and high damage rates, all of which hampered the customer experience and constrained margin. In the beginning, it was also lacking robust selection and merchandising, which made it difficult to build the confidence our customers needed to buy vanities online.

It was our team's objective to address each of these issues and create an elevated customer experience from browsing to delivery. Over the course of the last two years, we focused on strengthening selection across price tiers bringing on entirely new suppliers and solidifying our relationships with others. Our objective early on was to build a wide assortment that would satisfy the variant needs and tastes of our customers, who typically only saw very limited selection in any bricks and mortar location. We also added the ability to customize finishes and materials wherever possible to make our choice more unique and personal.

To that end, over the last two years, we were able to onboard 40 new suppliers for the category and meaningfully increase the SKU count. When we last provided an update, we offered over 10,000 different vanities, which featured almost 50,000 product reviews across the catalog. This has grown to 15,000 vanities with over 100,000 reviews today. The average number of product images for a given SKU expanded from four to nine as our merchandising efforts bore fruit.

Another clear opportunity for us, two years ago, was optimizing the delivery experience in this damage-prone category while increasing delivery speed. Since then, we studied the end-to-end journey for vanities to identify where and why damage may occur, and then work closely with our suppliers to mitigate these instances. In practice, this meant developing specialized plans for unloading, storing, packing and transporting vanities. We fit our warehouses with custom racking, specifically designed for vanities; palletized product to absorb any jewels along the shipping journey; created unique packaging to accommodate different materials and shapes in partnership with our suppliers.

Together, we also introduced a robust quality control and communication process to diagnose any issues and then work out solutions to avoid them in the future. As a result, our efforts have reduced incident rates in vanities by a one-third over two years, savings us and our suppliers millions of dollars each quarter. These benefits also helped drive increased CastleGate penetration for vanities, which grew from 15% to 40% over the last two years. Strategically taking control of the inventory and forward positioning in our network has allowed us to more than quintuple our two-to-three day coverage for the category.

As we have scaled across the organization, we have become sophisticated in our ability to withstand and mitigate headwinds across various parts of our business. In vanities, this comes to life in the context of not just tariffs, but also anti-dumping duties that hit the industry in 2019. Together, these amount to more than 200% wholesale cost inflation, on average, for China-sourced vanities. Translating, to much higher potential retail pricing for which consumers have very little appetite.

To avoid this, suppliers are shifting their supply chains to other countries, in relatively quick response, and are facing rising out-of-stocks, as they make these transitions. It can take our suppliers upwards of six months to move production. With the majority of vanities sold online in the U.S. being sourced from China, this has led to a significantly curbed supply of vanities, and supply chain issues in the category.

While the industry's shock will take a few quarters to work through our agile teams, mobilized rapidly, to mitigate our exposure to tariff and anti-dumping duty-impacted vanities. In a matter of weeks, we were able to further diversify our supplier base, while also leaning into a number of existing suppliers that manufacture outside of China. Today, the situation is flipped. A large majority of the vanities we now sell are manufactured outside of China. Meanwhile, we were able to help our China-facing suppliers, by offering them the ability to store and forward position their products within CastleGate, as they transition manufacturing locations.

The size and scale of our logistics footprint was a clear advantage here, as we are one of the few able to offer suppliers the space they needed at a turbulent time. Partnering with our suppliers like this has meant that we have been able to maximize product availability and preserve our rapid growth rates in the category. These fundamental wins have translated to clear financial results. The business now measures approximately $250 million in gross revenue globally, and is still growing strongly. Variable contribution margins for the category have expanded more than 500 basis points. This financial progress and milestones achieved have exceeded expectations. Particularly when taking into account, all the unexpected challenges, we have had to adapt for along the way.

As we evolve the format of the conference calls, I want to take a moment to thank our category teams for all of the hard work that has led to the kind of successful outcomes that we highlighted today. Vanities is just one of many such examples across Wayfair. We pride ourselves on being entrepreneurial and collaborative with the desire to move quickly, iterate if necessary, and to scale when we spot success. And these teams embody that to a t. We know you'll continue to see evidence of this, as we further solidify our market presence across the many categories they represent.

With that, I'd like to pass the call on to Michael to discuss our Q4 financials and forward-looking expectations.

Michael D. Fleisher

Chief Financial Officer, Wayfair, Inc.

Thanks, Steve, and good morning, everyone. I will provide some highlights of the key financial results for the fourth quarter of 2019, with more detailed information available in our earnings release, and in our investor presentation on our IR site. In Q4, our net revenue grew 26% year-over-year to $2.533 billion. In other words, we added approximately $519 million in sales relative to Q4 2018. Given we have historically referenced our other net revenue line, and that it has now become immaterial, we will be transitioning our commentary and forward-looking guidance to focus on total net revenue only.

However, since we provided Q4 guidance on a Direct Retail net revenue basis in October, I'll now detail our Direct Retail results for Q4, before transitioning to our new format, with the Q1 guide. Q4 total Direct Retail net revenue was $2.526 billion, representing roughly 27% growth year-over-year. In the U.S. segment, Direct Retail net revenue increased to $2.132 billion, up 25% or $423 million year-over-year. Direct Retail net revenue in the International segment increased 37% year-over-year to $394 million.

Currency movements year-over-year were neutral to International Direct Retail net revenue in Q4. Our KPIs remained healthy. As Niraj mentioned, LTM active customers totaled 20.3 million this quarter, up 34% year-over-year, reflecting both solid new customer acquisition and strong repeat behavior. In the quarter, orders from repeat customers represented 69% of the consolidated mix. LTM net revenue per active customer and LTM orders per active customer were roughly flat year-over-year at $448 and 1.86, respectively.

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 $67 million in the fourth quarter. Our gross profit for the quarter was $579 million or 22.9% of net revenue. As we outlined back in October, we expected some potential headwinds to gross margin due in part to tariff-related volatility, which ended up playing out as gross margin came in just a bit lower than we planned. This was due to a combination of different product category and brand mix, and tariff-related headwinds, which should dissipate as the whole industry arrives at more equal footing on wholesale costs.

Advertising spend was $311 million or 12.3% of net revenue in Q4. This represents about 75 basis points of deleverage year-over-year and was consistent with our expectations and guidance. As was the case last quarter, there was continued negative mix shift due to us ramping spending in newer brands like Perigold as well as in International. There were also some channel mix impacts as we experimented with some newer media formats.

As Niraj said, while each of these practices may be economically smart on its own, we also want to make sure the combination of how marketing dollars are spent across the company leads to improved leverage. To do so, we have to first pull back new customer acquisition on a channel-by-channel basis and re-baseline to the most efficient spend. And from there, layer back on as we optimize between still attractive payback economics and our intent to drive year-over-year leverage in ad spend as a percent of net revenue at the overall company level. This began in early 2020 and is ongoing as we speak, and is a headwind to our current growth rate. Our non-GAAP selling, operations, technology and G&A expenses in Q4 totaled $409 million. As you know, much of this line is linked to compensation costs, and reflected the surge on hiring that we have had over recent quarters.

In 2019, we grew OpEx head count by over 1,500 people or 24% year-over-year to roughly 8,000 OpEx employees. Headcount costs grew at a faster clip than that in Q4, given the heavy mix of engineering hires this past year as well as inflation in other compensation areas. Google Cloud costs, which were not in the year-ago period and unutilized rent increases year-over-year also contributed. As Niraj noted, we are taking a surgical look at other expenses also flowing through SOTG&A. These costs will take some time to address and optimize, but we've already identified clear opportunities to be more efficient throughout the business.

Adjusted EBITDA for Q4 was negative $180 million or negative 7.1% of net revenue. Adjusted EBITDA for the U.S. business was negative $88 million or negative 4.1% segment EBITDA margin and adjusted EBITDA for the International business was negative $92 million. Each of these were in line with what we planned and discussed with you last quarter. But as previously mentioned, these are not where we would like them to be, and as such, we are aggressively working to improve them.

As of the end of 2019, we had approximately $1.1 billion of cash, cash equivalents and short and long-term investments. Non-GAAP free cash flow for the quarter was negative $159 million based on negative $36 million in net cash from operating activities and $122 million in capital expenditures. CapEx was 4.8% of net revenue in Q4. We expect this number to remain elevated in Q1 at 5% to 5.5% of sales as we fully racked existing fulfillment centers to maximize their capacity. However, we do expect CapEx as a percent of sales to moderate as the year progresses. Recall also that Q1 tends to be our biggest cash outflow period, a dynamic that will be more pronounced this year due to later Cyber 5 timing than usual this past quarter.

Before turning to first quarter guidance, I want to recognize that our practice of guiding only for the current quarter leaves open natural questions about the full year and beyond. Niraj talked at length about our increased focus on driving towards improved P&L leverage and some of the concrete actions we're taking as a result. To be clear, Wayfair's strategy is already a proven winner. We are just sharpening our execution and our cost focus. Over time, we expect our efforts to translate to improving profitability and free cash flow trends, but the associated benefits are not instantaneous and it will take some time for them to begin to flow through. You will see them begin to build over the course of 2020, and the changes we are putting in place will lead to more consistent, positive adjusted EBITDA in the U.S. at some point in 2021.

Let us now talk about our expectations for the first quarter, and please keep in mind that we are transitioning to guiding only on a net revenue basis. Quarter-to-date, our net revenue growth year-over-year is trending at just under 20%. We believe the tariff-related disruptions to our customer experience that we described back in October are waning, but some self-inflicted factors still weigh on our revenue growth momentum. The first of these is deliberate as the process of re-baselining ad spend and the associated impact on-site traffic we just discussed. The second are the inefficiencies that Niraj discussed that have impacted our execution, which we are now tightening. We believe both of these impacts are transitory.

Our guidance philosophy factors in quarter-to-date performance, full quarter expectations, and a bit of prudence in a highly dynamic mass market business where the customer has to show up every day. As a result, we project Q1 net revenue in a $2.235 billion to $2.275 billion range, or approximately 15% to 17% growth year-over-year. We forecast U.S. net revenue growth in the range of 14% to 16% year-on-year and expect International net revenues to be up 22% to 25% year-over-year. As was the case in Q4, we do not expect currency translation impacts to be a major factor in Q1.

We forecast Q1 gross margins to improve sequentially and return once again to 23% to 24% territory as pre-tariff inventory plays less of a factor in driving market pricing relative to late 2019. Meanwhile, our internal work to unlock benefits across many of the gross margin-oriented initiatives that Niraj described, continues and will flow through over time.

We expect advertising, as a percent of net revenue, to reverse the trend of the last year, plus, in 1Q and show modest leverage year-over-year, reflecting a finer balance between bottom-up decision-making at the individual channel level and our company-wide goals. OpEx head count will end Q1 approximately 500 people fewer than the 8,034 at the end of Q4. We are anticipating that OpEx head count through the rest of the year will remain flat to down, with a normal seasonal pattern, taking into account campus hiring, which largely acts to backfill natural attrition.

Though it will take a couple of quarters, for the year-over-year dollar growth in OpEx to moderate, we do expect OpEx dollars to be about flat sequentially in the first quarter, versus Q4 2019. This will be the first time in several years that this will be the case. As you think about the moving parts in 1Q OpEx, keep in mind that the run rate impact of 2019 hiring will continue to be felt, including in the payroll tax step-up that occurs this quarter. But the full economic benefits of the recent reduction of force will not fully show up until Q2. Google Cloud costs will also remain incremental year-over-year in Q1, as we will only anniversary the initial ramp in Google Cloud spend starting in the back half of 2020.

All in, we forecast first quarter adjusted EBITDA margins in a negative 7.3% to negative 7.8% range, with U.S. adjusted EBITDA margins between negative 4.2% to negative 4.7% and International investments translating to an $85 million to $95 million loss. In Q1, our adjusted EBITDA guidance does not include severance costs associated with the recent reduction in force of approximately $4 million to $5 million. For modeling purposes, for Q1, please also assume equity-based compensation and related tax expense of approximately $66 million to $68 million, average weighted shares outstanding of 94 million, and depreciation and amortization of approximately $64 million to $66 million.

Now, before I turn the call back to Niraj, let me address a question that is no doubt on your minds. The spread of the coronavirus and how impactful it might prove, if at all, is something we are keenly focused on. Our current guidance does not factor in any significant potential disruption due to the virus. We believe our marketplace model, where we offer vast selection to our customers, is an important mitigating factor for us.

So, just over half of our suppliers' product is now manufactured in China. For any given item, we typically have additional selection coming from various countries of origin, creating options for substitution. Also because our industry has lived with tariffs for some time, most of our suppliers are well down the path of creating sourcing alternatives already. All of that said, we're staying tightly aligned in our planning and coordination with our suppliers, as we look to navigate this very fluid situation together. We know how to deal with external shocks effectively with the anti-dumping duties on vanities is just one recent and relevant example, where we were able to use our assets to benefit our suppliers and our customers, and mitigate a major potential disruption. We will stay close to the situation as it evolves.

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. Steve and I are very excited about the year ahead. All of Wayfair is focused on improving what we offer to our customers, so that we can continue to capitalize on the secular tailwind from offline to online in our category. That includes refocusing parts of our organization on the most significant highest ROI projects, while minimizing the work and expense that is less impactful. These efforts will enhance the customers' experience, strengthen our supplier partnerships, and further propel us down the path to profitability without compromising our ability to invest behind the initiatives that really matter.

We thank you all for listening and now we're ready to answer some of your questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. At this time, we will be conducting our question-and-answer session. [Operator Instructions] Your first question comes from the line of Peter Keith with Piper Sandler. Peter, your line is open.

Peter Jacob Keith
Analyst, Piper Sandler & Co.
Q

Hey. Good morning, everyone.

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

Hey, Peter.

Peter Jacob Keith
Analyst, Piper Sandler & Co.
Q

I wanted to just kind of tie together a few of the comments you made around leveraging the P&L at the current growth rates in your path to get to positive EBITDA in the U.S. by 2021. What type of growth rate would that be? Are we looking at the Q4 growth rate of 26%, or are we positioning it now so the high teens growth rate continues for the next couple of quarters?

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

Hey, Peter, It's Michael. We were assuming the current growth rate, Q1, quarter-to-date, that I described.

Peter Jacob Keith
Analyst, Piper Sandler & Co.
Q

Okay. Thank you. And then I think on – Niraj, on the ad spend adjustment, it's good that you guys are looking at the spending more efficiently. I will tell you I think there's going to be a lot of skepticism on pulling back on ad spending and then the subsequent revenue deceleration, which does seem to be happening now. So, can you give us any timeframe on when you think sort of this adjustment, sort of normalizes within the model, and will allow for the revenues to reaccelerate?

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

Yeah, sure Peter. Thanks for the question. So, I guess, let me kind of try to tie it back together for you just to make sure you understand exactly what we're trying to describe. So, what we're trying to describe is so if you look back over the 20 years we've been in business, we've had these periods of time where as we grow quickly, we either particularly around ramping head count really fast, but generally to growing very fast, we end up feeling like we've become inefficient. And then often what we do is we try to basically focus on driving efficiency by not hiring new people, making sure the people we have get up the curve, making sure the initiatives are the right initiatives so on and so forth.

As we've gotten bigger, we've gotten very focused on making sure we do that in a less jarring way where we used to kind of purposely ramp head count really fast and purposely go through an absorption cycle. We've really tried to slow that down. And the 2016-2017 period would be like the best example when we were still reasonably large and we did that and we realized man that's not the right way to do it, so a lot of what we put in place for things that basically prevent that.

When we look back now, in the last couple of years, we can see that we grew head count at a tremendously fast rate. And one of the reasons was that we were optimizing each thing for its own unit economics and making sure it was customer-oriented, but in aggregate, what happens, the sheer amount of things caused a lot of demands on the system. So specifically now in ad spend, what does that mean? On ad spend, when you optimize each channel, you can still get an outcome that deleverage you, that doesn't keep you as efficient as you want where you're really driving the unit economics because of the gains of the repeat customer coming back and driving it through technology innovation, creative efficiency, as much as you would if you further constrained it.

So, what we're doing here is we said hey instead of solely having an optimization requirement at the channel level around payback, let's also just say, hey let's make some hard trade-offs so that we're also getting overall leverage. So in fact, the channels or the brands that are growing would delever you, let's say, hey, what we want to do is we want that brand to show leverage, let's force an additional constraint. What that does is it drives that innovation. It's the concept of scarcity we mentioned where scarcity is not just head count scarcity, but in the case of marketing, it would be scarcity in terms of choosing where you lean in and where you need to drive innovation to unlock more traffic.

Well so to get there, what we talked about with re-baselining is saying, hey, when you add an additional constraint and so, you're not operating within that additional constraint, what do you need to do? Well, you need to pull back in certain areas. So, that's what we're choosing to do, and then pulling back in certain areas, what it does is it basically limits you in terms of how much traffic you're going to buy. But then to unlock it, you move to those types of innovative things like I mentioned around targeting, around creative optimization, or new measurement methods or what have you, things that we've always done, but it heightens the focus on those.

So, in terms of your question around timeframe, the way to think about it is, in the fall, we decided we wanted to drive efficiency in a lot of areas of the business. One of those is how we organize our folks and where we put people and where we didn't. So that was part of the reorganization where we ended up letting go some folks. But one of those was what I just described in marketing. So, when you look at this quarter, this quarter has pretty acute headwinds because we are purposely re-baselining the traffic, which means we have – the way you do that is you have a more arduous constraint than you normally would, which, in other words, to hit the constraint, you pull traffic down. It's very hard to pull it down entirely surgically.

So, what happens is you pull it down, generally past the point of efficiency even with that additional constraint and then you can expand it and then you sequentially grow from there. So, I would say your timeframe, we're in the midst of it right now. And as you roll months into the future and you go out a couple of quarters, it's well behind you. So, it's an active thing right now.

Peter Jacob Keith
Analyst, Piper Sandler & Co.

Q

Okay. I appreciate all the feedback, and good luck, guys.

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

A

Thanks, Peter.

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

A

Thanks.

Operator: Your next question comes from the line of Heath Terry with Goldman Sachs. Heath, your line is open.

Heath P. Terry
Analyst, Goldman Sachs & Co. LLC

Q

Great. Thanks. Just to dig a little bit deeper into the marketing question, can you give us a sense in terms of how you would disaggregate the pieces of this? How much of this is higher costs of traffic? Meaning that, that traffic is becoming more expensive potentially because the category is becoming more competitive versus lower conversion rates within that traffic? I know you talked about the product itself becoming more expensive, which assuming I would imagine is having an impact on conversion. If you could just sort of breakdown what's driving this, and ultimately, what you think is within your control?

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

A

Yeah, yeah. Yeah. So, what I would say is the primary driver is neither of those two. The primary driver is if you basically pick a target amount of leverage you want to see, you're basically constraining your spend, and that's what's driving you down. So, in other words, if you look at conversion, our conversion is actually – you've seen headwinds as you said from tariffs but then we've seen tailwinds from a lot of things we've worked on for the customer experience. So, the conversion overall net is flattish. We actually expect conversion to expand, and so some of the things that we feel like we haven't executed as well as we could have. As we roll through this year, we think we'll actually drive conversion up. But conversion right now is flattish when you look at it year-over-year. So, you're not seeing it net down.

On your point about costs, on the competitive side, we're not really seeing that either. And the marketing cost, there's generally been market inflation. We've offset that with some of the targeting and other optimization we do. That continues to be the story there. I just went to a kind of tradeshows because the tradeshows are basically in the first quarter of the year across a whole bunch of our categories in North America and in Europe. And what we're even seeing from our suppliers is that they're not seeing a competitive field really changing. And we're still generally their number one customer in e-commerce and really far up their customer ranks. So, the biggest thing is we've effectively imposed a view that we want to drive more leverage on the ad cost. So, that would manifest as ad cost a percentage of revenue.

So, as you roll in over time, you would see that number going down, faster than it would just naturally drift down, through just the repeat base, if we then, spend in each channel, for payback. And because we want to drive it down faster, which we think, will be productive for us, because of the innovation outcome out of scarcity that effectively is, us proactively pulling back. So, hopefully that answers your question there.

Heath P. Terry
Analyst, Goldman Sachs & Co. LLC

Q

That helps. I did also want to dig deeper into your comments around China and around coronavirus. One, you mentioned that you're now just over half of your – and I believe, it was inventory, maybe it was sales coming from China.

I believe you had said in the past, that that was closer to the industry, at around 60%. If you were to look at the trajectory of that, where do you see that going? And then, you've mentioned a couple of times now the time that you spent at trade shows, even if it's just anecdotal any color that you can provide on, supply chain disruptions that those partners of yours at those trade shows are seeing or expect to see, understanding that at least right now, you're not expecting it to have an impact on your ability to sell to customers?

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

A

Yeah. Sure. So, yes, historically China would have been closer to 60%, which is more or less the industry average in our categories, and then, based on the tariffs that really in our categories kicked in in 2018.

We're started seeing suppliers proactively in a lot of categories setting up sourcing or manufacturing operations in other countries. And so, because of that, over the ensuing 1.5 years, it's come down into the low 50s.

And I think that's a trend, that's going to continue to play out. Because I think, folks are moving not just because of the tariffs in China, but because they now sort of perceive being in China, as kind of – they don't want to have that sole country risk, what if the tariffs went from 25% to 35%, so on, so forth. So they want to have a broader geographic base.

Now, 50% is still a lot of product coming from China. And so, when you talk about the coronavirus, there's no question that that creates supply side disruptions. The benefit of being a big customer of our suppliers is that, we do a lot of joint inventory planning.

And so one of the things, we've been doing frankly is just, identifying what inventory do they have in country, what inventory do they not, which products are – do they have a reliable supply line still right now, whereas which products are going to have, kind of a multi-month disruption, in terms of quantities coming in. And so, what we've been trying to do is, down at the category and class level, how are we going to make sure we have enough selections. And so, when you talk about some items, that are maybe seasonal, in the outdoor season, through the spring and the summer.

Those would be goods, where you'd have a lot of disruption, if they're not already in the country, for example. And so, what we've been doing is, trying to make sure that we believe, in aggregate, we're going to have enough selection.

And the reality is we're pretty advantaged, right? Because we more or less work with everyone in the industry, we have a huge amount of selection on site. So given supplier having significant supply disruption, generally just creates opportunities for other of our suppliers.

But there's no question that this is going to hit the industry by and large in a meaningful way. And so I think, those who don't have deep relations with their suppliers, and don't have the reach to do that advanced planning, they're going to – some of these things are going to hit them with surprise.

Heath P. Terry
Analyst, Goldman Sachs & Co. LLC

Q

Great, thanks so much. I appreciate the color.

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

A

Sure. Thank you.

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

Jonathan Matuszewski
Analyst, Jefferies LLC

Q

Yeah, thanks for taking my questions. I guess, just the first one on the recent corporate workforce reduction. I realize it's a sensitive subject, but if you could just comment on kind of what inning you feel you're in there, as it relates to eliminating some of the inefficiencies and redundancies? And I guess just any further commentary in terms of guardrails in place to maybe prevent some of that excess hiring in the future? And then maybe just kind of touch on I think it did impact some of the international regions, which are obviously experiencing some really nice growth. So just kind of thinking there? That's my first question.

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

A

Sure, Jonathan. Thanks. So in terms of the reduction in force and tackling the inefficiencies, so on, so forth. The way to think about that there is what we realized in the fall around inefficiencies manifested in a few different ways. One was basically that in certain groups they've grown to a point where instead of just focusing on – let's make it up, the three key priorities. Priorities four and five and six were getting kind of equal share of attention and focus. And so that was distracting from items one through three.

But then the other issue was that by that group having six initiatives and each initiative needs something say on average from three other groups and say that other group then needs to support all these other different groups that have maybe 50% or 70% more initiatives than the priority ones. Those interactions then caused inefficiency in the prioritization and the order of operations of getting things done, particularly when you talk a lot of this advancement being through us building scalable technology platforms.

So what we've done is we've already gotten through the phase of identifying what we want to focus on. And the whole reduction in force was really around organizing teams around the priorities, which unfortunately meant in some cases it wasn't at the caliber of the people we brought on was the problem. The reality was that we didn't necessarily have a role for them, when we said, we're only going to focus on A, B, C & D and we're not going to do E here. We're not going to do E & F here. And so that's behind us.

So the good news is was everyone focused on the right priority things, well, when do you see the gains from that? Well, that takes a little while to roll through. So I think that's the process we're in now. The execution is much tighter while the gains are going to come in the future.

In terms of how you think about guardrails, I'd say one of the things we realized going back a couple years ago is that we need to organize in a way that as we were getting bigger allowed us to independently track each initiative in a way that was measurable and focused and understand what that team was working on and how it was going, and that needed to be done by a broader base of senior leaders in the company. And so, we put that process in. We have these reviews every – twice a year, every six months, and we did the – we started them over a year ago. And so we've been doing them for a while.

And starting with the cycle we did in this past fall we basically started using that to drive prioritization and drive a lot of investment decisions. And so that process has been quite productive. So I think, as you think about how you roll forward, I think, what we did years ago around making sure hiring high-caliber folks was a key piece. I think, what we then started a couple of years ago of how we monitor progress in these areas is really important with last year with those biannual reviews being a key thing. I think, now though the piece of the puzzle we've added around making sure we keep scarcity, I think, is the last piece of the puzzle. And what that lets us do frankly is the realization we came to is that at the $10 billion in scale we are, with the unit economics having expanded the way they have, the reality is we're at a point where we can actually fund all the investments we want and still be profitable. It's no longer a trade-off. Because what happens is when frankly by just keeping each area unconstrained what we did is we actually grew them past the point where they could efficiently execute. So, the reality is the additional expense, the additional team size, and the additional initiatives, they actually undermined our ability to get our gains. And so that is both an exciting realization, but frankly what we're also retooling around. And so I think going forward this notion of scarcity is kind of another guardrail.

The last thing I'd just comment on, you made a comment about international. And, so I just want to – I just want to clarify because I think at least the way I perceive that's not exactly the way I would phrase it.

We did do this process of orienting every area of the company around this notion of priorities and around in effect on the marketing side, hey, let's rebase [indiscernible] (52:38) let's do that for every brand. Let's make sure we're really driving that innovation. And so that did affect our International businesses, Canada and Europe.

But the reality is Europe, for example, which is really an area where we have such a small part of the TAM. It's doing incredibly well. And so, we actually have a very strong investment posture there. The international segment is weighed down by Canada and some of the things around FX and the fact that the tariffs would – we still ship so much of the goods northbound over the border paying this extra cost.

And as we're ramping our CastleGate facility bring this directly in from Asia. We're starting to dent that, but the International segment is actually something we're very excited about. And so international was not disproportionately hit or is not something we're not investing in going forward or what have you. It's actually an area we're very excited about.

Jonathan Matuszewski
Analyst, Jefferies LLC

Q

Great. I appreciate all that color. And then just a quick follow-up. Obviously all the color on the tweaked philosophy regarding advertising ahead has been helpful. I know you mentioned some media, marketing channel mix experimentation I believe this past quarter. Just elaborate on that a little bit whether you plan to use less expensive mediums ahead? Whether that's leaning in more on the app or other kind of methods? And then – and obviously maybe just tie that in with the announcement regarding the first brand ambassador in the U.S. and how that's informing kind of just the overall marketing mix strategy ahead? Thanks so much.

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

A

Yeah, sure. So, I would say there's no real change in the philosophy of mix of saying, oh, we're moving away from more expensive channels. We're moving away from more transactional channels. I think we view them all as part of like the total, that we view the – using all those different sort of arrows in the quiver is the more arrows in the quiver allow us to optimize the mix even better.

And one of the things we've done over the last two years is kind of continue to advance our own attribution model in a way that takes into account more and more of the channels in a way that captures interplay. So that's actually been quite an exciting thing.

You mentioned the brand ambassador I mean Kelly Clarkson we think is a perfect brand ambassador for Wayfair. And so you're going to see her featured in a lot of our channels and television is obviously one of our major channels. So, we're actually quite excited about everything we're doing.

I think the thing to kind of convey on the ad cost is just we think you can on one hand experiment, innovate and push forward, and you can do that while still being relatively tight around the scarcity concept and around the constraints you provide the team with which just puts more pressure to find breakthroughs.

And we've historically had a – for 20 years now, we've been creating a lot of breakthroughs and we've mentioned on past calls how Facebook has featured us as one of their most sophisticated advertisers, how Google has done the same, or Pinterest, how we've been their partners on alphas and betas and the deep partnership we have with Discovery-Scripps.

And so I think that role is something we're very excited about. We continue to invest into the ad tech platforms we have, as that's a team we've grown substantially. We have a big investment strategy there. And so, I'd try to disconnect those two concepts.

So one, we're still staying very ambitious. We're looking to use a lot of technology innovation and a lot of creative innovation to scale the advertising. And yet we're comfortable at the same time saying, we're going to constrain the team's ability to invest thus driving more of a necessity on them, to drive innovation to unlock larger and larger tranches of money for them to spend. And we think those two are mutually compatible.

Jonathan Matuszewski
Analyst, Jefferies LLC

Q

Excellent that's helpful.

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

A

Thanks, Jonathan.

Operator: Your next question comes from the line of Oliver Wintermantel with Evercore ISI. Oliver, your line is open.

Oliver Wintermantel
Analyst, Evercore Group LLC

Q

Yeah, thanks very much. I had a question regarding cash flow. In 2019, it looks like the use of cash accelerated, too. And I was just wondering, maybe a two-part question there.

What do you think your annual use of cash rate will be going forward? And then, we had, the last three-years, we had convertibles. Maybe a little bit of the – how your new strategy in reducing the costs have an impact on the cash flow statement going forward? Thank you.

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

Hi, Oli. Let me just touch on one thing, and then I'll turn it over to Michael, for some of the more detailed parts of your question. We definitely – free cash flow is a key metric for us.

I think, what you'll find, we talked a lot about how we think the EBITDA can expand as we roll forward based on a bunch of the decisions we've made and the way we see things playing out, as we roll forward through time.

And the way we expect revenue growth to pick up the way we expect the leverage to come from things like OpEx and ad costs and what have you. Obviously, as that plays out, that which impacts EBITDA, will then actually impact free cash flow, because a lot of the CapEx historically has been from building out the logistics network and some things that we've invested heavily in, and are going to continue to provide gains.

And of course, we'll grow them over time too, but there should be leverage there. So, while we only guide the quarter, we do want to make sure you kind of have a view of the trajectory. Let me let Michael answer your specific questions within the guidance you gave.

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

So Oli, a couple of thoughts here. One is I think, we – obviously, all of the things that Niraj has been talking about, both, and we both talked about in the top track and then now in the Q&A, would be positive, right?

It would be – we'd have incremental positive flow through to future cash flow. We obviously also are increasingly tight on our CapEx spend, particularly noting that this year, we're not going to open any new buildings. But we're still spending CapEx to rack out our existing buildings.

But over the – if you think about – if you're thinking about it in a year-long timeframe, a 2020 timeframe, I think that's going to be a benefit. And so I think you should you can anticipate. I'm not going to guide forward. But 2020 cash flow will be a lower use of cash, markedly lower use of cash than 2019 was.

The one thing I would just note there is that, in Q1, historically, you'll know our seasonal pattern is that we have a larger outflow of cash in Q1 than any other quarter, just because of the timing of holiday sales in the back end of December, where they sit in a float.

And then on the question on the convertible debt, I think at this point, we feel like with $1.1 billion of cash on the balance sheet as of December 31. We feel really good about where we're at. And particularly with the plan we have going forward, all of what we've been talking about today.

So I don't think, we feel like we have a burning need to raise additional capital. That said, in the past, we've always taken advantage of the markets, particularly the convertible debt market, which has been very good. And so I think we'll continue to keep an eye on that.

If there's opportunities to put more capital on the balance sheet, we'll take advantage of it. And we obviously have a sort of a longer-term eye out to our 2022 notes, right, that will come due in 2022.

Not something we're thinking about today, but something that we're certainly -- is in the planning horizon.

Oliver Wintermantel
Analyst, Evercore Group LLC

Q

Got it. Thanks very much. Good luck.

[00B7ZK-E Mark Nelson

A

Thanks, Oli.

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

A

I think, we're out of time.

Operator: Ladies and gentlemen, this concludes today's conference. On behalf of Wayfair, thank you for participating. You may now disconnect.