Arhaus, Inc.

Fourth Quarter 2022 Earnings Call

March 9, 2023

C O R P O R A T E P A R T I C I P A N T S

John Reed, *Chairman, Chief Executive Officer*

Jen Porter, *Chief Marketing and Ecommerce Officer*

Dawn Phillipson, *Chief Financial Officer*

Wendy Watson, *Senior Vice President, Investor Relations*

C O N F E R E N C E C A L L P A R T I C I P A N T S

Curtis Nagle, *Bank of America*

Steven Forbes, *Guggenheim Securities*

Jonathan Matuszewski, *Jefferies*

Peter Keith, *Piper Sandler*

Cristina Fernandez, *Telsey Advisory Group*

Justin Kleber, *Baird*

P R E S E N T A T I O N

Operator

Greetings, ladies and gentlemen, and welcome to Arhaus, Inc. Fourth Quarter and Full Year 2022 Earnings Call.

At this time, all participants are in listen-only mode. A question-and-answer session will follow the prepared remarks. As a reminder, this conference is being recorded.

I would now like to turn the conference over to your host, Wendy Watson, Senior Vice President of Investor Relations.

Wendy Watson

Good morning and thank you for joining the Arhaus fourth quarter and full year 2022 earnings call. On with me today are John Reed, Co-Founder, Chairman and Chief Executive Officer; Jen Porter, Chief Marketing and Ecommerce Officer; and Dawn Phillipson, Chief Financial Officer. John will start with a summary of the main points we made in this morning's press release along with operational details. Jen

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will discuss the status of our marketing initiatives, and Dawn will cover our financial performance and our outlook for 2023. We will then open the call to questions.

During Q&A, please limit to one question and one follow-up. If you have additional questions, please return to the queue.

We issued our earnings press release and our 10-K for the year ended December 31, 2022 before market open today. These documents are available on our Investor Relations website at ir.arhaus.com. A replay of the call will be available on our website within 24 hours.

As a reminder, remarks today concerning future expectations, events, objectives, strategies, trends or results constitute forward-looking statements. Actual results or events may differ materially due to a number of risks and uncertainties. For a summary of these risk factors and additional information, please refer to this morning's press release and the cautionary statements and risk factors described in our annual report on Form 10-K as such factors may be updated from time to time in our filings with the SEC. The forward-looking statements are made as of today's date and except as may be required by the law, the company undertakes no obligation to update or revise these statements.

We will also refer to certain non-GAAP financial measures and this morning's press release includes the relevant non-GAAP reconciliation.

I will now turn the call over to John.

John Reed

Good morning, everyone, and thank you for joining us today.

2022 was another record year for Arhaus as we achieved the milestone of over $1 billion in net revenue, over 50% comp growth for the second consecutive year, and Adjusted EBITDA of well over $200 million. We have exceeded our net revenue and profitability expectations in every quarter since our IPO in November of 2021.

What our team accomplished this year was truly amazing. I need to thank my entire team for not only their hard work but their passion to succeed and to get better every single day. Home furnishings retail is made up of many different disciplines, and I was thrilled to see every department stepped up, performed incredibly well, and focused on delighting our clients. Congratulations, team.

The tenure and strength of our relationship with our vendors has also been a key to our success. Our product development, sourcing and merchandising teams have worked tirelessly to build newness and depth in our product categories that have so clearly resonated with our clients, resulting in 14% demand comps for 2022 on top of 2021's over 45% demand comps.

Turning to some highlights from the 2022 full year results, net revenue of $1.2 billion was a $432 million increase over 2021 with our showroom channel up 57% and our ecomm channel up 43%, comp growth of 52% and demand comp growth of 14%, net and comprehensive income was up $100 million, and Adjusted EBITDA increased by $100 million to $223 million.

Dawn will cover our fourth quarter and full year 2022 in more detail, but we delivered an exceptional quarter of net revenue and earnings with net revenue up 50%, comp growth of 47% and strong 10% demand comp growth, notably lapping an 18% prior year demand comp increase. Net income was up 606% and Adjusted EBITDA up 126% to $74 million.

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Our outstanding finish to 2022 was driven by both strong demand in the fourth quarter and accelerated delivery of our backlog as our new Dallas distribution center outperformed expectations, enabling us to deliver product in our backlog we had expected to deliver in 2023 but moved it into 2022. I'm so proud of our teams' sense of urgency in the fourth quarter that drove them to deliver much more of our product into our clients' homes for the holidays than either we or the clients had expected. Our clients are thrilled, a testament to our client-first strategy. We are excited about the success of our new distribution footprint and the critical support it will provide as we execute our growth strategies and expand our showroom footprint.

Turning to our operational accomplishments in the year, what differentiates Arhaus are the same attributes that are driving our growth and where we prioritize our energies. First, highest quality, exclusively-designed products. Quality in our products has always been our number one focus, and with our recent growth, many of our vendor partners more than doubled their production without compromising quality. Our quality remains as high as ever. We are also differentiated by our inspirational showrooms and our omnichannel approach to our clients' experience and our emphasis on client-first service.

As I mentioned earlier, our product development, sourcing and merchandising teams continue to knock it out of the park, delivering heirloom-quality artisan crafted furniture that is resonating with our clients. We never stopped designing and developing products hand-in-hand with our vendors during the pandemic. This strategy of continuing to develop and introduce new products has set us apart in our industry and drove the strong demand we saw throughout 2022, and we could not be happier with our 2023 product line-up - we think it's the best ever.

In early January 2023, the most recent introduction of new products hit our showrooms and the website and was highlighted in our spring catalog. Later in the call, Jen will discuss the success of that catalog with you, and we are already seeing remarkable client excitement around our new collections and product extensions. We are also very excited about this year's outdoor launch that hits stores just this week. We think it's the best line-up of outdoor product we've ever had and builds on the success we saw with outdoor in 2022.

Moving to showrooms, we continued to invest in showroom growth in 2022. We opened two traditional showrooms in White Plains, New York and Colorado Springs, our new design studio in Park City, Utah, along with one relocation and two showroom renovations.

We are very proud of everything we've put in place over the last two years for adding two new distribution centers, aggressively developing new product collections and categories, and now in 2023 we are happy to announce the largest number of showroom real estate projects in our history. We expect to complete 17 separate projects, including plans to open 12 new showrooms and to renovate and/or expand five additional existing showrooms.

I also have more exciting news regarding our showrooms. As previously discussed, we have been testing a smaller format, called the design studio. We opened our first design studio in Carmel, California 29 months ago. Today, we have six design studios. Tomorrow we are opening our seventh in Asheville, North Carolina. The test has proven to us that the concept works and as the performance of our design studio's format has exceeded our expectations, I'm thrilled to officially announce the design studios will be part of our showroom expansion plans going forward.

Over the long term, we expect to have 100 or more design studios in addition to our plans to have over 165 traditional format showrooms. If you look at a map of our existing showrooms that we include in our investor presentation on our investor website, you can see the incredible white space opportunity we have in front of us with many, many years of growth. The wind is at our backs.

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And rest assured we have a very disciplined real estate strategy, refusing to compromise either location or the financial return criteria in our decisions to open showrooms. Our new showrooms continue to perform incredibly well, and Dawn will share some of the targeted unit economics later in the call.

As a reminder, we target adding an average of five to seven new showrooms annually. We will balance our annual opportunities between traditional showrooms and design studios based on resources and our focus on consistency of excellent client service across our omnichannel footprint.

Regarding supply chain, on the inbound side our average lead times continue to improve and for most products are back to pre-pandemic levels. Container costs are lower year-over-year while U.S. inland transportation rates remain elevated but are stabilized.

On the outbound side, I mentioned the investment we made in 2022 growing our distribution footprint by adding an 800,000 square foot distribution center in Dallas and expanding our Ohio distribution center by 200,000 square feet. We believe our distribution capacities will support our growth for the next seven to 10 years.

During 2022, we also invested in our ecomm and omnichannel capabilities and information technology systems as we transition to scale. These investments and enhancements will continue in 2023.

2023 is off to a strong start with new products, exciting showroom expansion plans through the first two months of the quarter, demand comparable growth are up high single digits. We feel well positioned to deliver on our financial and operational goals indicated in our outlook for 2023 that Dawn will discuss in detail.

I also want to take a moment to welcome Alexis DePree to our Board of Directors. Alexis was appointed a new director at our Board meeting last week and will stand for election to a full term at our annual meeting of shareholders in May. Alexis is the Chief Supply Chain Officer of Nordstrom. She has decades of experience in global supply chain operations at several leading retail organizations. It's an honor to have Alexis join us and enhance the collective skill set of our Board.

Finally, our long term prospects remain very strong. We will continue to execute our strategy and our runway for future growth looks very promising. I want to reiterate that our vision could not be realized without the hard work and successful execution of our team. I want to personally congratulate every one of our team members on a job well done and thank them for their dedication to Arhaus.

Now I'll turn it over to Jen.

Jen Porter

Thank you, John, and good morning, everyone. I am happy to recap our key marketing efforts from 2022 with you and discuss some of our initiatives for 2023.

From our showrooms to our catalogs, social media presence, Arhaus.com and more, every Arhaus touch point is designed to deliver a seamless experience that engages and inspires our clients. We are incredibly proud of recent initiatives within our omnichannel ecosystem, including our powerful campaign photography that was shot on location in Nantucket, Greece and Costa Rica, the more impactful artisan-focused storytelling on our new easier to use ecommerce website, and the experiential collaborations with new partners like The Surf Lodge in Montauk, the Aspen Art Museum, and at the Round Top Antique Show, which have helped to elevate the Arhaus brand's new and existing clients. We look forward to continuing these relationships and introducing even more compelling campaigns and partnerships in 2023.

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One of the biggest highlights from 2022 was the success we saw over the course of the year from our new Arhaus.com experience launched in late December of 2021. We are incredibly pleased with both the full year and Q4 2022 results, seeing increases in traffic, conversion, page views and time on site. We also saw decreases in cart abandonment and strong improvements in our mobile performance.

In 2023, we are looking forward to even more enhancements to the customer experience onsite and our back-end analytics capabilities, which will help us to further drive engagement and conversion across channels. We know that most of our clients engage with us digitally even if their purchase is in one of our showroom locations, so we're really enthused about continuing to build out this channel of discovery and research for our clients.

From a brand perspective, we were really pleased with our key seasonal product launches supported by our spring, outdoor living, and fall 2022 campaigns. All three campaigns drove strong engagement with both our existing client base and brought new clients into the brand through digital and print mediums.

Looking forward to 2023, we purposely invested more heavily into some of our spring campaign initiatives to drive new client acquisition. We are pleased with the early results of our spring launch and are particularly pleased with the new client acquisition we are seeing from our spring catalog, which hit homes in late December. Our new outdoor living 2023 campaign just hit homes and showrooms this week and we are thrilled by early reads. Whether you are searching for a lush oasis, a harbor cape or seaside cliff to inspire your own personal outdoor sanctuary, our outdoor 2023 product assortment delivers.

Perhaps one of our most exciting opportunities for growth is the large percentage of potential clients who are not yet familiar with our brand. By executing and building on the strategies we've developed over the past 35 years, we will be able to introduce Arhaus and the core values that have always defined us to potential clients in key markets nationwide. It's important to note that many of our major competitors in the U.S. premium home furnishings market today have brand awareness that measures at least twice the level of ours. We are keenly aware of the opportunity that growing our brand awareness and, by extension, our market share and client base presents over the next several years.

We will continue to drive this growth by opening more showrooms, enhancing our capabilities related to omnichannel marketing and technology, and by expanding our product assortment across key categories. We look forward to sharing more information throughout the year.

For now, I'll pass over to Dawn Phillipson.

Dawn Phillipson

Thank you, Jen, and good morning, everyone. As John mentioned, we are incredibly proud of our 2022 fourth quarter and full year results and our operational performance throughout the year.

Key items from our fourth quarter 2022 income statement include: net revenue of $356 million, comp growth of 47% and demand comp growth of 10% on a one-year basis, 27.9% on a two-year stacked basis, and 89.9% on a three-year stacked basis.

During the quarter, we saw strong demand in both our showroom and ecommerce sales channels.

Our net revenue growth was driven by both demand and the acceleration of delivery of our orders in our backlog related to our increased distribution capacity as our supply chain continued to improve, enabling us to substantially outperform our backlog delivery expectations to place product in our clients' homes.

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The accelerated delivery of orders in the fourth quarter represented approximately $40 million in net revenue that we had expected to deliver in 2023.

Our fourth quarter gross margin increased $61 million to $158 million in the quarter driven by our higher net revenue partially offset by higher variable costs related to the increase in net revenue, including product, transportation, and variable rent expense. Gross margin as a percentage of net revenue increased 370 basis points to 44% driven by favorable product costs and leverage on fixed showroom occupancy costs over the higher net revenue that benefited from the accelerated delivery of product in the backlog. This was partially offset by higher variable rent and transportation expense.

Fourth quarter SG&A expense decreased $6 million to $94 million. The decrease was primarily driven by the non-recurrence of derivative expense related to the termination of our former credit facility, lower equity-based compensation expense, the non-recurrence of one-time IPO expenses, and lower variable compensation in our showroom. This was partially offset by increased warehouse and corporate expense to support the growth of the business. SG&A expense as a percentage of net revenue decreased 15.5 percentage points to 26% driven by the items just described, as well as leverage on fixed costs on the $118 million net revenue increase.

Fourth quarter 2022 net income increased $40 million to $47 million. Adjusted net income in the fourth quarter of 2022 increased 175% to $48 million compared to adjusted net income of $17 million in the fourth quarter of 2021.

Adjusted EBITDA in the quarter increased $41 million to $74 million from $33 million in the fourth quarter of '21. Net income and Adjusted EBITDA in the quarter exceeded our internal expectations primarily due to the faster than anticipated delivery of product in the backlog as Dallas outperformed our expectations and enabled us to place more product in our clients' homes.

The fourth quarter net revenue of $356 million and Adjusted EBITDA of $74 million resulted in a 700 basis point increase in Adjusted EBITDA margin to 21%, demonstrating the fixed cost leverage realized on revenue growth and helping drive our record quarterly earnings and margin.

For the full year, key income statement items include: net revenue of $1.2 billion, comp growth of 51.6% and demand comp growth of 13.8% on a one-year basis, 59.1% on a two-year stacked basis, and 83.8% on a three-year stacked basis. During the year, demand was strong in both showroom and ecommerce channels as we strive to provide a seamless experience for the client to transact where and how they prefer. Our net revenue growth was driven by both demand the continued delivery of orders in our backlog related to our increased distribution capacity and improvement in product lead times.

Our full year gross margin increased $195 million to $525 million, driven by our higher net revenue partially offset by higher variable costs related to the increase in net revenue, including product, transportation, and variable rent expense as well as higher credit card fees related to the increased interest rates and demand. Gross margin as a percent of net revenue increased 130 basis points to 43%, reflecting our ability to leverage our fixed showroom occupancy costs over the higher net revenue. We also saw favorable product costs which were partially offset by higher variable costs related to the increased net revenue, including transportation and variable rent expense.

Full year SG&A expense increased $44 million to $340 million. The increase was primarily driven by investments to support the growth of our business, including higher corporate and warehouse expenses as new showrooms open and we expand distribution capacity, as well as public company related costs partially offset by the non-recurrence of both derivative expense related to the termination of our former credit facility and one-time IPO expenses. SG&A expense as a percentage of net revenue decreased 950

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basis points to 28%, driven by the items just described as well as leverage on fixed costs on the $432 million net revenue increase.

Full year 2022 net income increased $100 million to $137 million. Adjusted net income in 2022 increased 71% to $142 million compared to adjusted net income of $83 million in 2021.

Adjusted EBITDA in 2022 increased $100 million to $223 million from $123 million in 2021. Full year 2022 net revenue of $1.2 billion and Adjusted EBITDA of $223 million resulted in an 18% Adjusted EBITDA margin for the year, an increase of 270 basis points year-over-year.

As we have discussed throughout 2022, we consistently exceeded our internal expectations for the delivery of product in our backlog as we brought new distribution capacity online over the past year: our new North Carolina facility in December 2021, our DC in Dallas this past July, and our fourth quarter 2022 DC expansion here in Ohio.

I want to acknowledge and thank our teams across the Company for their exceptional work over the past year delivering product in backlog, helping drive 2022's strong performance and most importantly improving delivery times that allowed our product to more quickly reach our clients' homes.

In 2022, due in part to the success of our expanded footprint, the delivery of our backlog had a significant positive impact both on our net revenue and our earnings as we spread expenses over the higher net revenue.

Turning to the balance sheet and cash flow, as of December 31, 2022, cash and cash equivalents were $145 million and the Company had no long term debt.

Net merchandise inventory was $286 million, up $78 million from December 31, 2021 as we built inventory in response in client demand and as inventory value increased due to higher freight and product costs. A few things that are impacting inventory to keep in mind include freight as a percent of inventory is up nearly 1,000 basis points versus pre-pandemic levels. Our in-stock positions are significantly improved this year; for example, our outdoor collections are approximately 90% in-stock this year versus approximately 40% in-stock last year. As I have mentioned previously, while our inventory dollars are growing due to inflationary conditions, our inventory units are growing at a lesser rate.

Client deposits decreased to $203 million, down $62 million from December 31, 2021 primarily due to the improved delivery of orders in the backlog and lower demand comp growth in 2022.

For the full year ended December 31, 2022, net cash provided by operating activities was $74 million and net cash used in investing activities was $53 million with landlord contributions of $16 million. As a result, total capital expenditures net of landlord contributions were approximately $36 million for the year, below our estimates primarily due to showroom opening delays and lower than expected spend in warehouse expansion.

Turning to our outlook, with the uncertainty of the macro backdrop, we have assumed a wider range of demand comps for full year 2023 and constructed a guidance range that includes a normalized mid single digit demand comp at the high end of our net revenue range and a slightly negative demand comp decline of approximately 1% at the low end of the range.

Due to delivering more product in the backlog to our clients than we expected in the fourth quarter of 2022, we anticipate significantly lower backlog deliveries than previously planned in full year 2023 versus full year 2022, resulting in negative-4% to plus-1% comp growth.

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To help further frame the impact of the backlog on our financial results in 2022 and our 2023 expectations, we thought more detail would be helpful. In 2022, due to the success of our expanded footprint and highly prioritizing delivery of product to our clients, we were able to deliver in approximate round numbers roughly $150 million of product in our backlog, positively impacting both our net revenue and our earnings as we spread expenses over the higher net revenue. As I mentioned previously, the pull forward of backlog into the fourth quarter of 2022 from the first quarter of 2023 represented approximately $40 million of additional net revenue in the fourth quarter versus original expectations.

We generally expect our contribution margin on the backlog flow-through to be in the range of 35% to 45%.

In the first half of 2023, we expect to work through the remaining approximately $100 million balance in our backlog at a similar contribution margin.

Turning to our 2023 earnings outlook, we expect full year Adjusted EBITDA margins to be compressed due to the fixed cost deleverage on lower comps created by the backlog dynamic discussed and growth investments we are making during the year. Growth investments include expenses related to our showroom projects, our much larger distribution center footprint, and systems improvements to enhance our omnichannel and technology capabilities, all of which are key to our long-term strategy and enabling us to build scale across our business.

In particular, the new showroom investments include higher rents, staffing and variable compensation costs tied to the level and cadence of our store openings, many of which will be in more expensive markets. Additionally, new showroom rent typically starts six to 12 months in advance of the showroom opening, and after opening net revenue lags demand in the showroom while commissions are paid on showroom demand. This is expected to have a sizeable impact on our P&L performance this year and will be most noticeable in the second half of the year.

For the full year of 2023, we expect net revenue of $1.24 billion to $1.3 billion, which represents growth of 1% to 6%, comparable growth in the range of negative 4% to positive 1%, net income of $95 million to $110 million, and Adjusted EBITDA of $180 million to $195 million.

We also want to give you some direction derived from the midpoint of our outlook for how to think about our expected performance in the first half and in the second half of 2023 due to the large impact of the backlog delivery pull forward into 2022 and the remaining backlog delivery in the first half of 2023.

Our net revenue outlook reflects the expectation that we will continue delivering our backlog through the first half of 2023. This cadence of backlog delivery is expected to result in net revenue growth in the high teens in the first half of 2023 compared to the first half of 2022. In the second half of 2023, we expect net revenue to be down high single digits as we are lapping substantial backlog delivery in the second half of 2022 that includes the fourth quarter backlog pull forward I mentioned, that we do not expect to repeat in 2023 as demand continues to normalize. We expect the vast majority of our new showroom openings to occur in the second half of the year, with several in the fourth quarter.

Regarding our Adjusted EBITDA outlook, in the first half of 2023 we expect Adjusted EBITDA margins to be up approximately 100 basis points compared to the first half of 2022, primarily from leverage on the higher net revenue. In the second half of 2023, we expect Adjusted EBITDA margin to drop approximately 700 to 800 basis points compared to the second half of 2022 primarily from reduced leverage on net revenue declines related to lapping the backlog deliveries in the second half of 2022 and from our growth investments, particularly higher rent or staffing and higher variable compensation from the large number of expected showroom openings and activity, higher year-over-year warehouse expense, and

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investments in technology systems and omnichannel enhancements that will support our growth. As we always do, we expect to carefully manage expenses even as we continue to invest in this growth.

As John mentioned, in 2023 we are very excited about our robust showroom expansion plans of 12 new showrooms as three showroom openings planned for 2022 shifted into this year. We also have five renovations, relocations and expansions planned; accordingly, our full year expectation for capital expenditures net of landlord contributions ranges from $75 million to $85 million.

Importantly, we believe we have a very strong new showroom economic model. Our new showrooms ramp quickly and generate strong returns on investment. When evaluating new traditional showrooms that average approximately 17,000 square feet, we target minimum net revenue per new showroom of $10 million and an average showroom contribution margin of approximately 32%, each by year three of operations, and with a targeted payback on investment in less than two years. With our smaller new design studio format showrooms that average approximately 5,000 square feet, we target a lower net revenue per new showroom and a higher average showroom contribution margin of approximately 35%, each by year three of operation, also with a targeted payback on investment in under two years.

For all other details related to our 2023 outlook, please refer to our press release.

We also want to reiterate our long-term growth targets. These are forward-looking goals expressed as a compound annual growth rate. Over the long term, we target mid single digit comparable sales growth, mid to high single digit showroom growth, high single digit total revenue growth, and low double digit Adjusted EBITDA growth.

In closing, our operational and financial performance in 2022 substantially exceeded our expectations and we are focused on the long-term investments we are making as we transition to scale, including a robust showroom opening plan supported by great economic returns in both our traditional and design studio formats, along with ecommerce capability, IT and systems investments, and omnichannel enhancements.

We believe our strong debt-free balance sheet enables us to execute on our strategic growth plan and make the necessary investments to build on our share gains in this highly fragmented $100 billion premium home furniture market. We believe we are well positioned to meet the needs of our clients in any economic environment and remain keenly focused on driving value for all stakeholders.

Thank you for your attention and we would now like to open the call up for questions.

Operator

Thank you.

The first question comes from Curtis Nagle of Bank of America.

Curtis Nagle

Good morning. Just wanted to focus a little bit on the ’23 sales guidance - it came in a decent bit below the Street. Appreciate the commentary on the backlog, right. Anything else going on there in terms of just incorporating a weaker view on the consumer? If it’s just really due to the backlog, why not have communicated that earlier just for the purpose of basic expectation management? Then I have a follow-up after that.

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Dawn Phillipson

Hi Curt, good morning. We're pleased with how we performed in the fourth quarter and extremely proud of how Dallas performed in particular and was able to really drive product into the clients' homes in time for the holiday - great client response to that, so pleased with how the facilities performed.

I think we're being prudently cautious for this year when we're thinking about the demand in that we don't know what's going to happen in the back half. It's the same kind of commentary that I think every retailer has said really for the last couple of years, so we're pleased with how we're performing quarter to date. The first two months of the quarter, demand comps were up high single digits, so really proud of both the marketing materials that went out early January and the client response to our new product introductions as well, so pleased with how things are performing there and just taking what we think is a prudent approach to what we think the consumer might do this year.

Curtis Nagle

Okay. Focusing on the store growth, great to hear that we're now—we've set some targets for the design galleries. Could you give us some parameters in terms of sales productivity, just given that this is now expressly part of the model, and I may have misheard this but are we still targeting five to seven new stores a year? I thought that was just for the galleries, so if the design galleries are now in there, I would have thought it would have been a little higher but maybe I misheard.

Dawn Phillipson

No, you heard correctly. We are really pleased with how the design studios have performed and we feel it's the right time to move out of the test mode and think about where the right locations are for these new design studios going forward. But, I think similar to how we approach overall financial spend and being prudent with our cash position and investments, historically prior to today, we had said that five to seven, the annual target was the traditional showrooms, but now we believe holistically looking at every market available to us, we believe five to seven is the right cadence of openings for us, go-forward on an annual basis, so think that the opportunity now is to look and make sure that we are expanding into the right markets and the right locations, so we'll continue to stick to the five to seven per year and just allocate between traditional and design studios as we evaluate each particular location.

Curtis Nagle

Are we still targeting 150 galleries long term?

John Reed

That is correct, yes.

Curtis Nagle

Okay. Thanks, John, appreciate it.

John Reed

You bet.

Operator

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Thank you. The next question comes from Steven Forbes of Guggenheim Securities.

Steven Forbes

Good morning, John, Dawn, Jen. Congrats on a great year.

Maybe just to expand on Dawn's comments around the back half margin commentary, I think math would—that 700 to 800 basis point give-back would push the margin structure in the low double digit range, which I think is in line with where the IPO model was for 2023, so is that the right baseline to think about building off of as we look into 2024 and beyond, that 12%-plus Adjusted EBITDA margin profile?

Dawn Phillipson

While we're not prepared to guide to '24 and beyond, we did put those long-term targets out there earlier today in the Adjusted EBITDA growth. The second half is really compressed - we have some incremental investments that we're really excited about to drive the business and really help the business continue to scale, but in a really efficient way. Things like a warehouse management system, improvements in our planning software, our manufacturing ERP, things like that, we're really excited about. We're also looking at different ways to communicate with clients from a scheduling perspective, so I think ideally in a perfect world, we'd always leverage, right - that's always going to be our goal, so more to come on '24, I think is in the future, but excited for '23 and all the new things that we have planned for this year to really help drive the top line and improve the efficiency of the organization.

Steven Forbes

Then maybe a reversal of Curtis' question on demand - I look at the demand guidance really positively for this out year here in 2023, so I don't know if you could maybe just take a step back high level, talk about what you're seeing in terms of engagement and conversion on website engagement, utilization of the designers in the stores, average order value strength, because I think the demand comp guidance you gave, I think is probably above underlying expectations here and really a highlight, right, as we think about 2023.

John Reed

Yes, big picture, we're thrilled with what we're doing. When we look at all the news out there, we try to study some of our competitors, we think we're blowing it away - we know we are. With all the negative stuff out there, we're doing fantastic, and as we look in the future, we've got 12 new stores being opened. Once we get those opened and so forth, that's more than double, I think, any year we've ever done, or pretty darn close to it. Once we get that open, I think our future is looking incredible and we're very, very excited about it.

Yes, we think we're doing well. Jen can maybe fill in on some more of the facts on ecomm and so forth.

Jen Porter

Yes, hi Steve, good morning. Just to echo what John said, we're really happy with what we're seeing, and obviously we pay very close attention to the market, we watch what our peers are doing, we read all the same news you guys do, but we're seeing really great responses. As John mentioned on the call, clients are responding really well to the product, they're responding really well to our campaigns. We've gotten a little bit more aggressive in some of our marketing tactics, as I mentioned, going after new client acquisition to set us up strong going into 2023 here, and we're really pleased with the results we're seeing there.

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Customer behavior is looking good to us and we're very pleased with that, obviously. We are happy with what we're seeing across the existing client base, new clients. We're seeing particularly strong results within our existing client base, which is really nice to see, the product is really hitting. Online, as I mentioned earlier on the call, we're really happy with all of those metrics we're seeing. Traffic is up, sales up, conversion's up, time on site is up, decreases in cart abandonment, really great mobile performance as well, and I think the big thing that we are focused on is really leaning into our business and doing more of what's working for us, continuing to learn every day.

I've spoken a lot in the past about we really think that we're just at the beginning of a lot of these journeys with the new site just launching at the end of 2021. We are so pleased with what we saw in 2022, but we're learning new things every day and are really excited about additional optimizations and launches for this year, within our marketing channels, learning and optimizing those every day, being able to increase investment.

Again, just to remind everyone, back before the IPO, we really were just starting to get more aggressive in our marketing tactics (inaudible) and outreach, proactive outreach, so looking at that optimization and strength combined with the new showrooms, combined with how great the product is working, we're just really excited.

Steven Forbes

Appreciate the color, thanks.

Operator

Thank you. The next question comes from Jonathan Matuszewski of Jefferies.

Jonathan Matuszewski

Great, good morning. Nice quarter, and thanks for taking my questions.

My first one is on the quarter-to-date high single demand comp mention. Could you comment on your promotional posture during the first two months of the year relative to the comparable period last year and relative to 4Q? Thanks.

John Reed

You bet. Yes, it's been the same - we've stayed on track, doing the same marketing, same promotions we've been doing for many years, quite honestly, and haven't done any more, haven't done any less. It seems to be working, responding very well. Our clients love our products and of course if they can get it for a little bit cheaper, they'd love that; if not, they tend to buy it as well, so we've been thrilled with that.

But to answer your question, we've not changed our discounting or promotions at all.

Jonathan Matuszewski

Got you, that's helpful. My follow-up question - there's been some softening in luxury home markets around the U.S. in terms of pricing and turnover as of late. I recognize your business has historically been more tied to movements in the stock market versus the housing market, but are you seeing any regional differences in markets where luxury housing is cooling more than others? Overall, you're putting up really strong numbers, so just curious about any regional differences. Thanks so much.

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Dawn Phillipson

Hey Jonathan. No, we're not seeing any significant regional differences. We're really pleased with how we're performing and in particular in some of those luxury markets, we're outperforming kind of balance of chain, so excited to continue seeing where the design studios can go from that perspective as well as traditional footprint, so nothing major to note there.

Jonathan Matuszewski

Great, best of luck.

Dawn Phillipson

Thank you.

Operator

The next question comes from Peter Keith of Piper Sandler.

Peter Keith

Hey, thanks. Good morning everyone. Congrats on wrapping up a great year.

Dawn, thanks for the puts and takes around the guidance. We're still kind of working through the numbers here, but I wanted to dig into the second half year EBITDA margin declines - I think you said it was down high single digit basis points, or I guess percentage, however you want to say it.

I understand sales are down a lot. At the same time, at the back half of the year, I was thinking your freight costs are going to be substantially lower, so that should be a gross margin benefit. You're lapping the Dallas DC opening, so you should start leveraging those DC costs. Can you just frame up some of the puts and takes around that back half of the year, particularly in the context of notable EBITDA margin declines?

Dawn Phillipson

Yes, so you hit a couple of the main points. Revenue is certainly going to be down. Not implying anything wrong in the business - still feel really great about the demand, it's just the function of the backlog in '22 and then in '23 and the timing of when that flows through is certainly going to impact year-over-year comparisons in the second half.

We feel good about where container costs are - they're still slightly elevated from pre-pandemic levels but have come down nicely. As you know, that will take some time to flow through the P&L just based on our inventory position and what we have on hand today at those higher container cost levels. Inbound fuel is still elevated, so the cost to get the product from the port to the distribution centers is included as well in that landed cost of inventory, so that still remains elevated.

But as we really think about some of the other puts and takes, it's investments in marketing, so continuing to make sure that we stay top of mind with clients, continuing to focus on new product introductions and all the relevant items that go with that. We're also investing in IT capabilities, which I mentioned, so those can be pricey but extremely important to continue to help us be able to build scale in the Company and

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then to drive efficiencies, so near term investments to drive that medium, longer term growth and productivity.

Then lastly, I think the new showroom openings is important to keep in mind, so we typically take possession of those about six to 12 months prior to opening, so we have all the associated costs, the rent costs associated with opening those locations, and as we're thinking about this year, a lot of those locations are on the west coast, which are more expensive than locations in the midwest or on the east coast, so we have incremental expenses associated with those. Then as we think about the weighting of when those showrooms are going to open, it's primarily back half, so we'll have—as we're staffing up and kind of getting those locations ready and relevant marketing for those locations, there's just more expenses associated with that.

Those are kind of the biggest call-outs I would say for the margin compression.

Peter Keith

Fair enough, and just to follow up on that, the lower container cost does take some time to flow through inventory. When does that start to decline for you year-on-year and become a gross margin tailwind?

Dawn Phillipson

Yes, we should see favorability this year at some point, certainly skewed more towards the back half, I would say, but a lot of it is contingent upon product mix and sell through. I'd also say our—we were less impacted than perhaps other folks in the retail space given that half of our product is sourced domestically and the rest of it is really geographically dispersed, so if you're thinking about us relative to maybe some other retailers, we do have a different impact. Just like we weren't hit as hard over the last couple years, the associated relief of that will also not be quite as exciting, I guess I'd say, but should be more in the back half.

Peter Keith

Okay, fair enough. Then maybe more for John and Jen, you talked about leaning into marketing and going after a lot of new customers. You flashed a brand awareness metric at the time of the IPO of 34% for the premium home furnishings market. That's probably now two or three years old. Have you updated any brand awareness study to see if that's been improving?

Jen Porter

Yes, I can take that. We actually did. We updated that study at the end of last year, re-looking at those brand awareness metrics, and we were really pleased with the report, how we performed comparatively in the market.

What's exciting for us, though, is looking at the opportunity go forward, is that that brand awareness split between us and those main peers out in the market still remains very significant, so a lot of them are still more than twice where we are, so we're pleased with the progress we've made over the last two years but I think even more thrilled about the continued opportunity we have over the next few years.

Peter Keith

Does it maybe move higher than 34%?

Jen Porter

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It's hard to compare direct stats like to like, looking at the percentage numbers. In terms of comparative performance, we believe we improved versus the market, but don't want to really speak to specific numbers.

Peter Keith

Okay, fair enough. Thank you so much for the insights.

John Reed

Yes, just to add to that, we're clearly adding a lot of new clients every month, which we've been thrilled with. Obviously that's how you grow your business. To Jen's point, we did some marketing in December-January to new clients, and we were just thrilled at the response rate, by far larger than we had thought, which means we're getting new customers and more and more people are becoming aware of us. But you know, the future looks incredible because, again, our awareness is only half of some of the big guys out there, and every point we get to add to that is an enormous amount of clients, so even as we add a point or two, or three or four or five every year, we see our future just being incredible as people become aware of us and as they do, they're thrilled with us. They love our product, they love our stores, our showrooms. They love our teams, our designers, and of course they love the quality of the product, and once they do that, they're hooked for life as one of our clients and they tell their friends. We think that's a huge, huge part of why we're growing, why the future looks so good, and why we're performing so well.

Peter Keith

Yes, I fully agree with all that, John, so that's why I wanted to dig into it. Appreciate the comments.

John Reed

Thank you.

Operator

Thank you. The next question comes from Cristina Fernandez of Telsey Advisory Group.

Christina Fernandez

Yes, good morning, and thank you for taking my questions. Congratulations on a good year.

I wanted to ask about what you're seeing on product pricing on the orders you're placing with your manufacturers and how does that impact just pricing in general for your products to consumers in 2023.

John Reed

Yes, pricing has been very, very stable now for, I would say at least the last six, eight months or so. We're truly not seeing price increases. Costs of lumber and so forth have settled down and, as you know, the freight costs have come down, but jus the pure manufacturing costs have been very, very steady. In some cases, we've been able to get them down a little bit as our manufacturing partners have gotten a little smarter on manufacturing and so forth and buying larger orders of, say, wood and raw materials so they get a discount if they buy more, and then they're sitting on some of that inventory. But we've been flowing them orders and projections for a year, so they're able to do that and invest in the materials, so all

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good. I've seen no—no one's raising prices currently, which is good, a lot better than last year, the last two years, which were crazy.

Christina Fernandez

Yes, and as a follow-up, with the 100 additional potential store target for the next two years, does that change your infrastructure needs or can you accommodate those additional stores with the expansion in distribution manufacturing you made last year? I guess, how does that impact your infrastructure needs over the next couple of years?

John Reed

Yes, over the next couple years, we're good. We've got plenty of space, plenty of capacity whether it's a full blown showroom or a design studio. Logistically, they're really the same. The folks buy our product, we deliver it to their homes, and it comes out of one of three warehouses, so it's—we've got plenty of space. We're going to do a new study as we have thought of opening and growing quicker than maybe we had thought of two years ago. We'll keep studying that to make sure we have enough space so we won't be caught with a shortage in the future.

Christina Fernandez

Thank you.

Operator

Thank you. The next question comes from Peter Benedict of Baird.

Justin Kleber

Hey, good morning everyone. It's actually Justin Kleber on for Pete. Thanks for taking the questions, and congrats on all the real estate projects in the pipeline.

If I could just play devil's advocate, though, for a moment, given what is likely to be a more difficult macro backdrop this year and potentially into 2024, why do you think now is the right time to be ramping store growth, and then maybe Dawn, what are some of the expense levers you can pull in order to protect the margin structure of the business if the top line backdrop does further deteriorate here?

John Reed

First of all, every one of our stores is profitable. As we open new ones, we fully intend them to be profitable, so they're definitely not a drag on the income. It does nothing more than give us more leverage on fixed expenses as we add volume, so we see—we don't see any reason not to grow and to grow as aggressively as we can, and in a smart way. We think opening stores—and again a lot of these stores, get the stores open, get the sale, get it delivered, we are talking towards the end of this year but into next year, we think it's going to be fantastic. If there is economic issues next year, we're fine with that. We know we're going to make money in these new stores and we don't worry about that one bit.

Dawn Phillipson

Hey Justin, just to follow up on that, of the 12 locations we have opening this year in '23, three of those shifted from 2022, so I wouldn't say that we have an overly aggressive cadence. It's slightly above the five to seven that we're articulated over the last several quarters, but we're really excited about the

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locations that were presented to us this year and because of those particular locations and—we run various scenarios on those, whether it's potential recessionary or well performing locations, so these locations, we're really excited about to open, so we thought it was prudent and made sense to stretch from that five to seven, upwards to nine this year, so we feel really good about that.

Then in the—with regards to your financial question, in the long term we view every expense as variable, so we certainly have levers. As we always do, we are continually running downside scenarios and various scenarios if the macro softens, and we feel confident right now that, based on what we know, based on what we're seeing, that we have strategies that will enable us to be successful this year.

We do have demand as a really nice leading indicator, which we've talked about before. We have a couple months of visibility that when that demand starts to soften, before it ever hits the P&L, we have different levers we can take, whether that's—anything from additional marketing touch points to potential promotions, and I'm not saying we're being more promotional but certainly remains a lever, so.

We evaluate in real time. I think we're a really dynamic Company and a dynamic Management Team, and we'll continue to do that just as we have historically.

John Reed

We certainly have taken into account that the luxury home business or building is slowing as we read, and may continue to, but the way that we look at it is we're going to be in a position to really capture a lot of that client's business when we do pull out of this, because we're going to have our locations open and our showrooms open and our designers there. To me, it's kind of silly to wait until it gets through this cycle and then say, oh, let's go open a store. A store takes two or three years to open, so you're lagging three years, so we're going to be three years ahead of the competition, the way I'm looking at it, which is a huge plus for us.

Justin Kleber

Yes, that makes sense. Thanks for all that color, John and Dawn.

Just to follow up on the new store economics, Dawn, you mentioned year three AUV, I think you said $10 million for the traditional showrooms. Can you just remind us how you model the maturation of a new store from year one to year three, just so we can think about the same store sales waterfall looking out over the next few years as these new stores start to ramp up the maturation curve?

Dawn Phillipson

Sure. I said it was a minimum net revenue target of $10 million for the traditional showroom, so some of those are far in excess, some are closer to the 10. We come out of the gate really strong on the demand side, so it ramps very quickly, really pleased with consumer response in the markets that we enter. As you know, there's a timing lag between when we take the demand and when we deliver, which has been a little bit exacerbated in the last couple of years just given the supply chain constraints, but in a normalized world we ramp pretty quickly, so—yes, excited to get these showrooms open and start seeing them perform.

Justin Kleber

Got it. All right, guys, well congrats on the year and best of luck in 2023. Thank you for taking the questions.

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John Reed

Thank you very much.

Dawn Phillipson

Thank you.

Operator

Thank you. Ladies and gentlemen, that concludes our question-and-answer session. I would now like to turn the conference over to Wendy Watson for closing remarks.

Wendy Watson

Thank you, everybody, for your participation in our call and your interest in Arhaus. We look forward to speaking to you again next quarter.

Operator

Thank you. Ladies and gentlemen, that concludes today's conference call. Thank you for joining us. You may now disconnect your lines.

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