Arhaus, Inc.

Third Quarter 2022 Earnings Conference Call

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CORPORATE PARTICIPANTS

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John Reed, *Co-Founder, Chairman and Chief Executive Officer*

Dawn Phillipson, *Chief Financial Officer*

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CONFERENCE CALL PARTICIPANTS

Curtis Nagle, *Bank of America*

Jackie Sussman, *Morgan Stanley*

Jonathan Matuszewski, *Jefferies*

Steven Forbes, *Guggenheim Partners*

Cristina Fernandez, *Telsey Advisory Group*

Peter Keith, *Piper Sandler*

PRESENTATION

Operator

Good morning and welcome to Arhaus' Third Quarter 2022 Earnings Conference Call.

Please note that this call is being recorded and the reproduction of any part of this call is not permitted without written authorization from the Company.

I will now turn the call over to your host Wendy Watson, Senior Vice President of Investor Relations.

Thank you. You may begin.

Wendy Watson

Good morning and thank you for joining Arhaus' Third Quarter 2022 Earnings Call. On with me today are John Reed, Co-Founder, Chairman and Chief Executive 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. Dawn will cover our financial performance and outlook for the remainder of 2022, and then they will be joined by Jen Porter, our Chief Marketing Officer, for the Q&A session.

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-Q for the quarter ended September 30, 2022, before market opened today. Those 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 repost on Form 10-K and subsequent 10-Q, 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 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 reconciliations.

I will now turn the call over to John.

John Reed

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

We are pleased to report another strong quarter with record net revenue and significant year-over-year earnings growth. Our team once again executed extremely well in a very dynamic macro environment, satisfying our clients, supporting our growth strategies, and managing our profitability.

Turning to some highlights for the third quarter results. One, net revenue of $320 million, a 57% increase over Q3 last year, with our retail channel up 61% and our e-commerce channel up 40% in the quarter. Comp growth of 54.3% and demand comp growth of 15.8%. Net and comprehensive income increased 160%, and Adjusted EBITDA increased 87%.

Our net revenue performance for the quarter was better than expected from both demand in quarter and continued delivery of our backlog. Our net income and Adjusted EBITDA were also much better than expected, primarily driven by the strong net revenue and leverage on fixed costs.

Demand comp to growth in the third quarter was a robust 15.8%, significantly exceeding our expectations. In the early part of the fourth quarter, we are continuing to see solid demand with mid-single-digit demand comp growth off a strong prior year Q4 demand comps. This is consistent with our longer-term expectations for comp growth and demand comp growth.

Turning to our operational developments in the quarter. Our product and marketing continues to resonate with our clients. We are pleased with the fall campaign and just launched our new holiday campaign last week.

Regarding supply chain, on the inbound side, we continue to see moderation of the bottlenecks that have impacted our industry since the start of the pandemic, and our lead times are coming down steadily. We are seeing lower freight costs persist, although fuel prices remained volatile.

On the outbound side, as we discussed in the last quarter's call, our Dallas distribution center is now open, and we have started delivering products out of that facility. While we continue to slow ramp the operation to ensure a seamless transition and client experience, we are making great progress. We're also on track with the expansion of the Ohio distribution center, expected to be completed by the end of this year. As a reminder, we believe our new distribution capacity will help alleviate our backlog, reduce our lead times to support our growth over the next seven to 10 years.

Turning to showroom growth. We are opening a new design studio in Park City, Utah, later this month as we expand our testing of that concept, which has been very successful, and we plan to open two more design studios over the next several months. Looking ahead, our real estate pipeline is very robust. We will share our showroom opening plans for 2023 early next year. We continue to target adding five to seven new traditional showrooms annually.

Given our performance over the third quarter of 2022 and the strength of our backlog, we are reaffirming our full year net revenue and comparable growth outlook and raising our full year net income and Adjusted EBITDA outlook that Dawn will cover next.

As we look to the future, we remain confident in our strategy and our focus on delivering long-term growth. In closing, I want to reiterate how pleased we are with our performance in the third quarter, and truly thank our team for stepping up to every challenge. I'm incredibly proud of each and every one of you.

Now, I'll turn it over to Dawn.

Dawn Phillipson

Thank you.

As John described, our business continues to be resilient and we were pleased with our operational and financial performance in the third quarter. Key items from our third quarter 2022 income statement include net revenue of $320 million, comp growth of 54.3%; and demand comp growth of 15.8% on a one-year basis, 44.1% on a two-year stacked basis, and 87.8% on a three-year stacked basis.

During the quarter, we saw strong demand in both showroom and e-commerce channels. Our net revenue growth was driven by both demand and the continued delivery of orders in our backlog related to our increased distribution capacity and continued improvement in product lead time.

Our third quarter gross margin increased 61% to $136 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, as well as higher credit card fees related to increased interest rates and demand.

Gross Margin as a percent of net revenue increased a better than expected 90 basis points to 43%, reflecting our ability to leverage our fixed showroom occupancy costs over the higher net revenue, partially offset by higher variable rent and transportation expense.

Third quarter SG&A expense increased 31% to $89 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. We expect incremental expense from our expanded distribution center footprint in the near term to be approximately $40 million on an annualized basis. SG&A expense as a percentage of net revenue decreased by 170 basis points to 28%, driven by leverage on fixed costs on the 57% net revenue increase and the non-recurrence of prior year IPO expenses.

Third quarter 2022 net income increased 160% to $37 million. Adjusted net income in the third quarter of 2022 increased a better than expected 97% to $38 million compared to adjusted net income of $20 million in the third quarter of 2021, driven by higher net revenue.

Adjusted EBITDA in the quarter increased 87% to $57 million from $30 million in the third quarter of 2021. Net income and Adjusted EBITDA in the quarter exceeded our internal expectations, primarily due to continued container and product cost stabilization, positive impact from price increases which offset higher fuel costs, and lower than expected warehouse expenses.

I want to again thank our team for working diligently to control expenses and drive operational efficiencies in what is still a highly inflationary environment.

Turning to the balance sheet and cash flow. As of September 30, 2022, cash and cash equivalents were $146 million, and the Company had no long-term debt. Net merchandise inventory was $293 million, up 40% from December 31, 2021, and up 72% year-over-year as we continue to build inventory in response to client demand and as inventory value increased due to higher freight and product costs. As I mentioned last quarter, while our inventory dollars are growing due to inflationary conditions, our inventory units are growing at a lesser rate. We remain comfortable with our inventory levels.

For the nine months ended September 30, 2022, net cash provided by operating activities was $58 million, and net cash used in investing activities was $37 million with landlord contributions of $11 million. As a result, total capital expenditures, net of landlord contributions, were approximately $26 million in the first nine months of 2022.

Finally, as we announced this morning, we are affirming our full year net revenue and comparable growth outlook for 2022 and we are raising our full year net income and Adjusted EBITDA outlook. We now expect full year net revenue of $1.173 billion to $1.193 billion, full year comparable growth in the range of 43% to 48%, net income of $109 million to $115 million dollars, and Adjusted EBITDA of $185 million to $192 million. This implies fourth quarter net revenue of $300 million to $320 million, comp growth of 24% to 32%, net income of $19 million to $25 million, and Adjusted EBITDA of $36.5 million to $43.5 million.

Our outlook reflects the expectation that we will continue delivering our backlog through the balance of 2022 and into mid-2023 and carefully manage our expenses, even as we continue to invest in growth, including distribution, marketing, and product development. Our outlook continues to assume year-over-year inflation in product and transportation costs.

We have further lowered our full year expectation for capital expenditures, net of landlord contribution, to range from $40 million to $50 million due to lower than expected capital expenditures for the Dallas distribution center and delays in new show room construction and permitting.

For all other details related to our updated 2022 outlook, please refer to our press release.

In closing, we were pleased with our third quarter performance, and despite an ever-changing macro environment, we believe our strong debt free balance sheet, coupled with a strategic growth plan to build on our share gains in the highly fragmented $60 billion premium home furniture market, position us to weather any economic cycle and emerge in an even stronger position, poised to deliver on our longer-term growth plans and drive value for all stakeholders.

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

Operator

Thank you. Our first question is from Curtis Nagle with Bank of America. Please proceed.

Curtis Nagle

Good morning. Thanks very much for taking the question.

Just wanted to talk about setup, I guess, for the next year. You guys are way outperforming the industry in terms of demand, products resonating, that's in the face of all sorts of macro uncertainty. What do you think the positive—what keeps positive demand comp going? Is it just the moment that you have now—one of the biggest headwinds? And do you think you can keep up that mid-single digit demand comp growth in line with 4Q (phon) your long-term targets for next year?

John Reed

Good morning, Curtis. John here. John Reed.

Yes, we are sticking with our original plan, which was, during COVID we focused on working on new great products, rolling out collections. They've now gotten recently into the stores. We've gotten the inventory behind them, and it seems like our product is resonating with our customers. That's what retail is about. If you have the right product at the right price that your customers want, they're going to buy. So, we're going to stay focused on that, and we think we'll be okay going into '23.

Curtis Nagle

Okay. Understood. Then just as a follow up—yes, just a similar question around just how to think about transportation costs for next year. Still elevated, I guess, fuel surcharges are still an issue, but contracts reset and freight costs have gone down. I think shipping too. Should that not be a tailwind for gross margins into next year?

Dawn Phillipson

Good morning, Curtis. This is Dawn.

We'll provide a little further context on 2023 when we report the fourth quarter, but I would just remind you that container costs, while they are coming down this year, will take some time to flow through our P&L, just given the timing, and we use our inventories at landed costs, which includes those container costs.

More to come when we report the fourth quarter, but we feel like we have a decent handle on what that'll look like next year.

Curtis Nagle

Okay. Thank you.

Operator

Our next question is from Simeon Gutman with Morgan Stanley. Please proceed.

Jackie Sussman

Hi. This is Jackie Sussman on for Simeon. Thanks for taking our question.

Just quickly on the kind of discounting and promotional environment, what are you guys seeing? And can you please talk about your assumptions, I guess, for the fourth quarter and the beginning of ’23?

Jen Porter

Yes. Hi, Jackie. This is Jen.

As I've been saying, we're definitely seeing promotional activity pick up within the market. Looking at our strategy through Q3, we were in line with where we were last year, which is much lower promotional activity versus 2019, and we continue to feel very strong with the results of that, as you heard today.

Going into the peak November holiday sales period, we're definitely seeing promotional activity pick up even further within the market, and we are a bit more promotional than we were last year, which is really a proactive effort to pull forward some of that promotional activity earlier in the month, in line with the trends that we're seeing with other retailers.

Looking forward, we aren't really seeing this as a shift in our promotional strategy for long-term basis; this is more of a reaction to what's happening in this peak holiday sales period. So, we are going to be monitoring very closely, obviously, as we move forward. But right now, our plan is to stay in line promotionally with where we've been year-to-date as we look forward into next year.

One thing I will note is just the promotion that we did turn on and have been running, we've seen a really nice reaction to that, which we think in part is we have been so quiet all year, and as John mentioned, we have the product, we have all cylinders firing on that side. So, it's really nice for us to see that we do have this great lever if we ever need it in the future. But for now, looking into next year, we still feel really good about focusing on getting the product into the stores, having our marketing hit, and paying our attention there.

Jackie Sussman

Got it. That's really helpful. Just quickly, one more on the completion of the 54.3% comp, is there any color you can give as to price versus underlying transaction growth in the quarter? Were underlying transactions positive? And how did that compare maybe to ’19 levels?

Dawn Phillipson

Jackie, this is Dawn.

Fifty-four percent is on a delivered basis. As we think about the components of the demand comp in the third quarter, that's where we would talk more about average order number of transactions. Both of those were up really nicely, unit per transaction was also up really nicely. So, still seeing some nice strength from the consumer base as it pertains to our product offerings in the market in the third quarter, so we're really pleased.

Jackie Sussman

Got it. Thanks, and congrats on the good quarter.

Operator

Our next question is from Jonathan Matuszewski with Jefferies. Please proceed.

Jonathan Matuszewski

Hi. Good morning, and great quarter.

First question is on market share. You guys comped 54% this quarter. The premium furniture market is not growing near that pace. So, just wanted to get your updated thoughts on where do you think that share is coming from? Is there evidence of elevated challenges that some of your smaller players that you think is driving market share gains? Or do you think it's more of a function of certain larger competitors moving more upmarket? Just wanted your updated thoughts there. That's my first question.

Thanks.

John Reed

Good morning, Jonathan. I can start this up. If Jen wants to pitch in.

But I guess my answer is, we really don't focus on what our competitors are doing. I mean, we certainly know what they're doing, but we focus on our business and executing everything that is planned in our business right. We seem to be hitting on all cylinders. Everything's working, from getting the product in here, to getting it delivered, to having the right product that customers, obviously, want at fantastic value, incredible quality. I don't have any clue what you know smaller people are doing or the big guys are doing, but we know what we're doing is working, and we're going to keep doing it.

Jonathan Matuszewski

Got it. That's helpful. I guess just my follow-up. Dawn, on the 4Q comp guide, would be great just to get any sense of kind of the macro and housing assumptions underlying that forecast in terms of what you guys are expecting to drive the midpoint of the 4Q guide.

Thanks so much.

Dawn Phillipson

Sure. Keep in mind that 4Q guide is on the delivered side versus the demand side, so just want to clarify there. We continue to see that we don't have an incredibly strong correlation with the housing market. It is a factor, but it's not the driving factor. Stock volatility continues to be kind of what we've seen historically as a driving factor of the demand comp.

That being said, we're really pleased with what we're seeing from the consumer response, like we said, in the third quarter and fourth quarter, to date as well as continuing just to invest in our marketing programs, which we know are resonating really well with clients, and making sure that the product is on point. Just continuing to execute on those key core strategies that we have and not deviating.

Jonathan Matuszewski

Got it. Best of luck.

Dawn Phillipson

Thank you.

Operator

Our next question is from Steven Forbes with Guggenheim Partners. Please proceed.

Steven Forbes

Good morning, John, Dawn, and Jen.

I just wanted to follow-up on a couple of questions before, and I think it was John, around the company's performance. I don't know if you can sort of comment, John, high level sort of what you're seeing in your customer demographic profile that may help explain the outperformance, if there's any changes in AOV trends or the typical trade area that store pulls from?

I think we're just looking at the performance here and trying to find sort of an explanation for what's driving the strength. I think this acceleration in the multi-year stack of comp is certainly a standout, so I don't know if you have any sort of high-level thoughts on what you're seeing in your customer data that would help explain it.

Jen Porter

Yes. Hi, Steve. This is Jen.

Looking at the customer data, we're continuing to see our customers really act and demo-wise be the same as they have been. We're paying very close attention to that, we're digging in—honestly, we're as curious as you are looking there. But we have really strong customer demo files. So, looking at new versus existing, we're continuing seeing that look really nice, with that value still being around that 50/50 mark, as spoken before. In terms of sort of the net worth, income, demos, age, all of that, we're seeing that staying consistent with where we've been for the last few years, so we're definitely paying very close attention.

As we've spoken to, our clients are out there, they're seeing what they want, they're liking the product, and they're willing and able to pay for it. So, we're continuing to focus on getting that message out. If we see anything in the future, we'll definitely share with you. But for now, nothing noteworthy to report.

Steven Forbes

Maybe just a quick follow-up for Dawn. It looks like the fourth quarter EBITDA margin is being guided down year-over-year, I don't know if you can just help us better understand the anticipated margin pressures. It seems like it might be in the product margin side with promotions, but anything specifically to call out in expenses and/or gross we should note?

Dawn Phillipson

Yes, we don't guide on a quarterly basis. I think the additional context that's going to be really helpful for you to think about is the Dallas distribution center. It's a very expensive, very large facility that is adding to our expense structure year-over-year. We feel pretty good about our strategies to execute top line out of that facility.

I'd also say we talked last quarter about the marketing investments, and we're being really thoughtful about kind of getting in front of any macro softening that might be occurring, which, as you can see from our numbers in the third quarter, we feel pretty good about how those came in, but there'll be a bit more marketing investment in the fourth quarter, just preemptively staying top of mind to clients. So, those are probably the two components I would call out for you to think about.

Steven Forbes

Thank you. Best of luck.

Dawn Phillipson

Thank you.

Operator

Our next question is from Cristina Fernandez with Telsey Advisory Group. Please proceed.

Cristina Fernandez

Good morning, and congratulations on a good quarter.

I wanted to see if you could talk about inventory. With inventory building across the industry and the demand environment being a little bit more uncertain, how are you thinking about inventory flow going forward? Should we expect the inventory to increase from here, or level off?

Dawn Phillipson

Yes, so we feel pretty great about our inventory position today. Keep in mind that the inventory dollars are factoring in those higher transportation costs on the inbound side, as well as some higher product costs that we've seen from vendor price increases over the last 18 months or so. But on a unit basis, we're pretty confident with where we're at.

I'd also say we have a pretty nice pipeline of backlog orders to deliver, which should give us good visibility into where we need the inventory levels to be for really the next eight months or so. So, we feel confident in our inventory strategy, and we feel good about where the inventory is positioned today.

Cristina Fernandez

Going back to the demand in the quarter, any more color you can share about how the quarter progress and any product categories that outperform relative to the overall company?

John Reed

Yes, I think it's been pretty steady. We didn't see any pop in any categories or anything. It's the core products, and again the products that resonated with our customers are the ones that are selling. It's been pretty steady all year for that matter, on what the best sellers are, what our clients are buying. We're seeing a nice lift in some of the categories that are add-ons to the core products, in other words, rugs, lighting, so forth, which gives us a great additional sale, because as people are buying, say a sectional, if we can add on the lights, the rugs, it can literally almost double the average sale. So, we've done a really nice job, our team has, on and expanding those categories, and we've seen some great growth in those categories. As well as the outdoor category, we've seen some nice growth on throughout the summer. That of course, is winding down now, but it'll be picking back up soon, right after the first of the year again.

Dawn Phillipson

Cristina, just on the dispersion of the comp within the quarter, we saw some moderation in September, but it was still up really nicely year-over-year. So, nothing really notable there but very, very pleased with how the quarter performed and how it trended throughout the quarter as well.

Cristina Fernandez

Thank you.

Operator

Our final question is from Peter Keith with Piper Sandler. Please proceed.

Peter Keith

Hi. Thanks. Good morning, everyone. I hopped on the call a little bit late, so I apologize if these are repetitive.

I want to just think about pricing going forward. There's a lot of discussion in the furniture industry around excess inventory and if markdowns prices coming down over the next six to 12 months. Obviously, you guys are a bit of a different animal out there. But how do you think about your pricing going forward as you've taken pricing here a couple of times over the last 18 months, do you anticipate maintaining price, or do you think there's probably some moderation in your overall pricing?

John Reed

Good morning, Peter.

Yes, certainly, as everybody has, we've seen costs increase over the last 18 months or so. We've adjusted our prices. We kind of see us holding steady as where we're at right now. We have seen a nice decrease in container costs and current product coming in, but as Dawn said, a lot of the product we own—and we do have a good amount of product, not excessive by any means, but the right amount of product so we can service our customers and clients on a timely basis. So, we're happy with our inventory levels.

We’re able to service our customers a lot quicker than we were. I do see out there in some of the industry that some people are still way out on inventory; and other people have access, so they're trying to clear that out. We're in good shape. We don't have excess so we're not trying to clear anything out. We see pricing holding steady. Once we clear out the inventory that we own at the higher container cost, we'll look to even adjust our prices a little bit if we can to sell more units. But that's down the road.

Peter Keith

Okay. Very helpful. Lastly, just on the unit growth outlook. A lot of other growth-oriented retailers talked about opening delays from permitting, HVAC. What are you guys seeing out there right now as you’re planning the opening for 2023?

John Reed

Yes, we’ve had a couple of stores for 2021 that are falling into the beginning of 2023. I think we have good handle on it now; we just have to plan longer, because we know things like parts for HVAC and so forth are going to take six months to get in and so forth. So, we've got a great team that's building our stores. They're all over it. They're way out in front of it. We think that they said we're committing to—we think we're going to be able to hit pretty well. They're longer than, of course, we'd like or anything, but the dates we are committed to, we feel confident we'll get them open at those dates. My real estate team might kill me for saying that, but that's about what we're seeing right now.

Peter Keith

Okay. Sounds good. Well, best of luck to the real estate team and everyone out there. Thank you.

John Reed

Thank you, Peter.

Operator

We have reached the end of our question-and-answer session. I would like to turn the conference back over to Wendy for closing remarks.

Wendy Watson

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

John Reed

Thank you.

Dawn Phillipson

Thank you.

Operator

This does conclude today's conference. You may disconnect your lines at this time, and thank you for your participation.