**Arhaus, Inc.**

**Fourth Quarter and Full Year 2023 Earnings Conference Call**

**March 7, 2024**

## CORPORATE PARTICIPANTS

**Wendy Watson,** *Senior Vice President, Investor Relations*

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

**Dawn Phillipson,** *Chief Financial Officer*

**Jen Porter,** *Chief Marketing Officer and eCommerce Officer*

## CONFERENCE CALL PARTICIPANTS

**Peter Keith,** *Piper Sandler*

**Jonathan Matuszewski,** *Jefferies*

**Peter Benedict,** *Robert W. Baird*

**Steven Forbes,** *Guggenheim Partners*

**Jeremy Hamblin,** *Craig-Hallum*

**Max Rakhlenko,** *TD Cowen*

**Simon Gutman,** *Morgan Stanley*

**Maddie Cech,** *Bank of America*

**Phillip Blee,** *William Blair*

**Cristina Fernandez,** *Telsey Advisory Group*

## PRESENTATION

**Operator**

Good morning, and welcome to the Arhaus Fourth Quarter and Full Year 2023 Earnings Conference Call.

At this time, all participants are in a listen-only mode. A question-and-answer session will follow the formal remarks.

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. Please go ahead.

**Wendy Watson**

Good morning, and thank you for joining Arhaus for the Fourth Quarter and Full Year 2023 Earnings Call.

On with me are John Reed, Co-Founder, Chairman and Chief Executive Officer, who is joining us this morning from Italy, and Dawn Phillipson, Chief Financial Officer. After prepared remarks, they will be joined by Jen Porter, our Chief Marketing and eCommerce 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 for the year ended December 31, 2023 before market open today.

Yesterday, after market close, we filed an 8-K to inform investors that we identified an error in our unaudited condensed consolidated balance sheet as of September 30, 2023, related to certain leasehold and landlord improvements prior to Showroom completion being incorrectly included in prepaid and other current assets, rather than property, furniture and equipment, net. This error resulted in inaccurate cash flows ascribed to the operating and investing activities in the unaudited condensed consolidated statement of cash flows for the nine months ended September 30, 2023. As such, we will restate our financial statements for the third quarter of 2023, and revise the December 31, 2022 comparative balance sheet that will be included in the amended third quarter 10-Q. For more details, please refer to the 8-K.

These documents are available on our Investor Relations website at ir.arhaus.com.

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 most recent Annual Report on Form 10-K and subsequent 10-Q's, 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.

A replay of this call will be available on our website within 24 hours.

Now, I will now turn the call over to John.

**John Reed**

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

We delivered a strong fourth quarter 2023, with net revenue of $344 million, net income of $31 million and Adjusted EBITDA of $51 million, and are very pleased to have exceeded our top and bottom line outlook for the quarter.

Turning to our 2023 performance, it was another exceptional year for Arhaus, fueled by our long-term growth strategies to: one, increase brand awareness; two, expand our Showroom base; three, enhance our omnichannel capabilities and technology; and, four, invest in growth to build scale and enhance long-term margins.

Highlights from our 2023 full year results include:

- net revenue of $1.3 billion, with our Showroom channel up 2% and our eCommerce channel up 17%, on top of growth of 57% and 43% for each of these channels in full year 2022;
- comp growth of 1% and demand comp growth of 8%, both at or above the high end of our outlook for the year, and cycling comp growth of 52% and a demand comp growth of 14% in full year 2022;
- net and comprehensive income of $125 million; and
- Adjusted EBITDA of $203 million.

Given our strong cash generation and balance sheet strength following 2023's outstanding performance, I am pleased to announce our Board of Directors approved a special cash dividend of $0.50 per share, payable on or about April 4, 2024 to shareholders of record at the close of business on March 21, 2024. We are very pleased to be able to return value to our shareholders, while retaining the balance sheet strength that will allow us to continue investing in the Arhaus growth.

Dawn will cover our fourth quarter and full year 2023 financial results in more detail later on in the call, but I want to congratulate our team for delivering these results. I'm astonished by what our team has accomplished in the short time since we went public on November 4, 2021. At that time, we had 77 Showrooms. Today, we have 92 Showrooms, adding almost 20% to our Showroom total, and we expect to add another 9 to 11 this year.

Over the last three years, we believe the U.S. premium home furnishings market has grown 50%, while our growth has been more than three times that of the industry. We've increased our net revenue by 154%, or $780 million, increased our net income by 635%, or $108 million, and increased our Adjusted EBITDA by 193%, or $134 million.

As impressive as this growth, and the execution by our team, has been, it is our future potential that is so significant and has me so excited. Going forward, we expect to continue to grow faster than the market by executing on our strategy.

Starting with Showroom growth, which is the number one way we expand our brand awareness, in 2023, we completed the largest number of Showroom projects in our history, opening eight new Showrooms, two new Design Studios and one new outlet location, along with eight renovations, relocations and expansion projects. Remember, our new Showroom economics are very strong, and we target new traditional Showrooms to generate at least $10 million in revenue by year three, with targeted Adjusted EBITDA margins averaging 32% and average investment payback in two years or less.

In 2024, as I mentioned, we expect another year of record Showroom growth, with plans to equal or exceed the number of 2023 Showroom projects, including four to six new traditional Showrooms, two Design Studios, three outlets, and to renovate, relocate or expand several existing Showrooms.

With wonderful feedback from our clients and the continued word-of-mouth awareness building around our Showrooms, and the incredible product they showcase, we look forward to introducing the Arhaus brand and experience to many more clients over the next several years, especially as we continue to work towards our target of 165 traditional Showrooms.

The number two way we expand brand awareness is through recommendations from friends and family. Our incredible product and the value proposition it offers is at the heart of these recommendations, and we enjoyed persistent demand for our product throughout 2023, driven by the success of many of our newer product collections.

We frequently describe traveling the world to seek inspiration, meet with incredible artisans and ensure we continue to delight our clients with beautiful products from across the globe. As Wendy mentioned, I am joining you from Italy today, where members of our Product Development Team and I are working on some really exciting new products.

Last year, I told you I thought 2023 was going to be the best ever new product lineup, and I think we have exceeded even that very high bar with the product introductions and category expansions in 2024. Our Spring and Outdoor catalogs and Showrooms are currently showcasing this product and I encourage all of you to go to the Showrooms and spend some time on Arhaus.com to judge for yourself.

During 2023, we also continued to make some important growth investments to enhance our omni-channel capabilities and technology. We are growing our insights from website engagement and have launched our incredible Storied campaigns online and in print, highlighting artisans from Mexico and Italy. These campaigns not only tell our product stories, but they elevate our brand at a time when we are introducing Arhaus to many new clients across the United States.

This is also a great time to highlight the Volume 2 launch of the Storied Campaign, Bellissimo Segreto, a beautiful secret. As a reminder, we developed the Storied Campaign in response to our clients asking to know more about the talented craftsmen behind our beautiful products. The introductory volume of Storied, *Rooted: A Story Not Common*, highlighted a family of woodworking artisans in Mexico and was released last fall.

The current campaign is a testament to our Italian partnerships, some of which were established decades ago, and all of which have been instrumental to building our brand. We are thrilled to continue this series and look forward to telling the Arhaus story through future volumes.

We are also continuing to make strategic investments to upgrade the technology that supports our business and long-term growth plans, and enhances our capabilities in warehouse management, inventory planning and allocation and manufacturing and delivery efficiencies. Our teams have been working around the clock on these initiatives, and I am excited about our technology roadmap, the long-term advantages and expected margin enhancement it will create for us. These investments and enhancements will continue in 2024, and Dawn will give you more detail on the size and scope of these investments.

These near- and long-term prospects, combined with the team's strong and disciplined execution of our strategic priorities, and buttressed by our debt-free balance sheet, has us well positioned to deliver on our financial and operational goals.

As we look to 2024, and beyond, I'm excited about the opportunities for our business and our brand, both of which, in many ways, are still in their early days, even though I have been at this for close to 40 years. I genuinely feel that there are no collections like our collections, there are no people like our people, and there is no potential like our potential. Arhaus stands out, and Arhaus stands alone.

Our product is designed using the best materials and with an unparalleled focus on quality and comfort. We are curious world travelers, and our mission to design and craft the best furniture and décor leads us to work alongside some of the most talented designers and craftsmen on earth.

Our Showrooms are an authentic expression of who we are. We curate inviting spaces, carefully layered footprints and compelling digital presentations to take every visitor on the journey of their choosing, always letting inspiration lead the way. With our client experience, we aim to build authentic relationships, inspiring and supporting our clients at every step of the journey.

We encourage exploration, customization, and we are never defined by a single style. Instead, we encourage and help our clients to curate the unique style of their homes; and I believe we have the best team in the industry, we are a team of designers, dreamers and doers, as passionate as we are curious.

Finally, I want to personally congratulate our team for a great job in 2023 and thank them for their dedication to Arhaus and our clients. I'm looking forward to what we will continue to build in 2024, and beyond

Now, I'll turn it over to Dawn.

**Dawn Phillipson**

Thank you, John, and good morning.

As John mentioned, we are incredibly proud of our 2023 fourth quarter and full year financial results and our operating performance throughout the year. We delivered a solid fourth quarter that concluded another year of record net revenue and exceeded our expectations for both revenue and earnings.

Key items from our fourth quarter 2023 income statement include:

- Net revenue of $344 million, with a 6.8% comp decline against a comp growth comparison of 47.0% in the fourth quarter last year that reflected strong backlog delivery.

- We were pleased with our demand comp growth in the quarter which was 1.6% on a one-year basis and 91.4% on a four-year stacked basis. Demand comp growth in the quarter was impacted by promotions in November of 2022, that we made a strategic decision not to repeat in November of 2023 to preserve margin.

- Our fourth quarter gross margin decreased $17 million to $141 million, driven primarily by lower net revenue, higher transportation costs and Showroom expenses, partially offset by lower costs related to the reduction in net revenue. Gross margin as a percent of net revenue decreased 330 basis points to 41%, driven primarily by product mix related to the sell-through of SKUs that were price-actioned in June of 2023, as well as increased Showroom costs and transportation investments.

- Fourth quarter SG&A expense increased $7 million to $100 million, primarily driven by strategic investments in the business to support our growth, and increased selling expense related to new Showrooms and higher demand, partially offset by lower warehouse expense.

- Fourth quarter 2023 net income decreased $16 million to $31 million.

- Adjusted EBITDA in the quarter decreased $23 million to $51 million, from $74 million in the fourth quarter of 2022.

- The fourth quarter net revenue of $344 million and Adjusted EBITDA of $51 million resulted in a 15% Adjusted EBITDA margin in the quarter.

For the full year, key income statement items include:

- Net revenue of $1.3 billion, comp growth of 1.4%, and demand comp growth of 7.6% on a one-year basis and 91.4% on a four-year stacked basis. During the year, demand was strong in both Showroom and eCommerce channels, as our products and marketing continue to resonate. Our net revenue growth was driven by both our strong demand and the delivery of approximately $75 million in abnormal backlog in 2023.

- Gross margin as a percent of net revenue decreased 70 basis points to 42%, primarily reflecting higher Showroom expense, transportation investments and credit card fees, which were partially offset by favorable product costs. Product costs improved due to the flowthrough of container cost favorability versus prior year, and promotion management, partially offset by the impact from price-actioned SKU's.

- Full year SG&A expense as a percent of net revenue increased 150 basis points to 29%. The increase was primarily driven by strategic investments to support and drive the growth of our business, including increased expenses as new Showrooms open and we invest in technology, and the donation to The Nature Conservancy. These increases were partially offset by lower warehouse expense and the non-recurrence of costs related to the 2022 opening and setup of our Dallas distribution center.

- Full year 2023 net income decreased $11 million to $125 million.

- Full year 2023 net revenue of $1.3 billion and Adjusted EBITDA of $203 million resulted in a 16% Adjusted EBITDA margin for the year.

I want to reiterate John's appreciation of the exceptional work of our teams across the Company over the past year, which was instrumental in driving 2023's strong performance and record net revenue.

Turning to this morning's special dividend announcement, one of our competitive strengths is our strong debt-free balance sheet and the financial flexibility it affords us. Following several years of outstanding performance, growth and cash generation, and having ended the year with $223 million in cash, our Board of Directors is pleased to return approximately $70 million in capital to shareholders in the form of a special cash dividend.

We are pleased to note, even with this special dividend, our growth and strategic investments remain unchanged, as we are also in the enviable position of having both a long runway to continue to grow our Showroom footprint and high returns from that growth. Investing in the business to drive profitable growth remains our top priority. We will continue to build on that profitable growth with our planned CapEx investment of $80 million to $100 million in 2024, with the majority allocated to showroom projects.

Next, I'd like to turn to our outlook for 2024. With continued macroeconomic uncertainty and lapping prior year backlog delivery, we have assumed a range for comp growth of negative 4% to negative 2%. As a reminder, we are comping approximately $75 million in abnormal backlog delivery in 2023. While we entered 2024 with a normalized backlog, our comp growth metric will not normalize until 2025.

For the full year 2024, we expect net revenue of $1.33 billion to $1.37 billion dollars, which represents growth of 3% to 6%, comp decline of 4% to 2%, net income of $95 million to $105 million dollars, and

Adjusted EBITDA of $185 million to $200 million dollars. We expect full year Adjusted EBITDA margins to be lower than 2023.

Deleverage will be most significant in the first half of the year and is driven by comping prior year backlog delivery and strategic investments we are making this year. 2024's strategic investments include our robust number of Showroom projects and operational improvements to enhance our capabilities and drive our success long-term. We expect most of the deleverage to come from SG&A, with a lesser amount of deleverage in gross margin.

We expect to invest approximately $10 million to $15 million in corporate strategic investments this year as we work to streamline operations and drive a best-in-class client experience. Strategic investments for the year, in addition to new Showrooms, include a new warehouse management system in our Ohio distribution center, planning and allocation software, and a manufacturing ERP. We will also continue to invest in our in-home delivery experience, as well as other growth initiatives, such as eCommerce and our in-home designer and trade programs.

For the first quarter of 2024, we expect net revenue of $260 million to $270 million dollars, a comp decline of 23% to 20%, net Income of $1 million to $3 million dollars, and Adjusted EBITDA of $11 million to $15 million dollars. As the range indicates, in the first quarter of 2024, we expect net revenue to be down low-teens, compared to the first quarter of 2023. This is primarily due to the implementation of our new warehouse management system in March and weather-related impacts in January.

Quarter-to-date, our demand comp in January declined high-single-digits, as weather impacted traffic, with February accelerating to mid-single-digit demand comp growth.

We expect significant Adjusted EBITDA deleverage in the first quarter. Of the deleverage, approximately a third is coming from gross margin, due to deleverage of fixed costs on the revenue decline and continued delivery of price-actioned SKUs. The balance of the deleverage is in SG&A, due to the revenue decline and as we continue to make strategic investments.

As our full year outlook implies, we expect net revenue growth in the balance of quarters this year. We expect deleverage in both gross margin and SG&A in the first half of the year, with inflection expected in the second half as the P&L impact from the June 2023 price-actioned product is complete and revenue and earnings from new Showrooms positively impact our P&L. We will update you on our second quarter expectations when we report first quarter financial performance in May.

For all other details related to our 2024 outlook, please refer to our press release.

We are also reiterating our long-term growth goals. We expect the investments we are making in the near term will enable us to achieve these goals. Over the long term, we target mid-single-digit comparable sales growth and mid- to high-single-digit Showroom growth, leading to high-single-digit net revenue growth and low-double-digit Adjusted EBITDA growth.

In closing, I want to again acknowledge the hard work and dedication of our teams. Our success in 2023 reflects our focus on, and execution of, our strategy, which remains unchanged. We believe our strong, debt-free balance sheet is a competitive advantage, enabling us to execute on our growth plan and make the necessary investments to build on our share gains in the 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, and we would now like to open the call up for questions.

**Operator**

Thank you. Ladies and gentlemen, we will now be conducting a question-and-answer session. (Operator instructions) Ladies and gentlemen, we will wait for a moment while we poll for questions.

Our first question is from Peter Keith with Piper Sandler. Please go ahead.

**Peter Keith**

Hi, thanks. Good morning, everyone. Great results. I want to ask about the system rollouts, which are interesting. ERP systems can send some fear down analysts' spines, so talk about the risks of the ERP and then future benefits of the other systems that could come in the next two years.

**John Reed**

Good morning, Peter. John here. Dawn's probably got more information on this than I, but we're kind of laying things out in stages. I don't believe we're doing a full ERP system any time soon. We're doing a warehouse system, and then a management planning system, and then a totally separate system for our manufacturing plants that manufacture our upholstery.

Dawn, do you have anything to add to that?

**Dawn Phillipson**

Good morning, Peter. I think we—in the fourth quarter of last year, we deliberately—we hired a consulting agency to help us really evaluate our full systems and business infrastructure, and look at not only what we should be really contemplating for revision and updating, but also the sequencing and cadence of that, for exactly what you're speaking to. We want to make sure that as we are continuing to grow the top line, that we don't compromise the client experience, certainly, and that we don't compromise operational integrity. We're certainly being very thoughtful, very mindful. ERPs, I think, send fear down the spines of everyone, implementers and analysts alike. So, you know, we are trying to be very thoughtful.

We are excited for some of these new systems. As we think about the planning and allocation software, really, that's going to help us just more seamlessly facilitate moving a product through our network, which is going to have not only operational efficiencies, but financial efficiencies, once deployed, so we're really excited for that. There are some other systems that we have not yet started, but have mentioned in the past that were under analysis, like an order management system, which will also do the same thing and help kind of facilitate making sure the product is coming from where it needs to be.

I think, overall, we're taking a very thoughtful, prudent, responsible approach, I would say, to system enhancements and infrastructure changes, but we'll certainly—we're laser-focused on the operational impact, as well.

**Peter Keith**

Okay, thank you, and just, Dawn, a little more financial, technical question. With the warehouse management system rolling out in Q1, I guess it's probably causing a little bit of sales lag, so Q1's sales guide a little bit worse than we thought. Is there a sales shift that you could quantify for us that's going to roll directly into Q2, or maybe also carry into Q3?

**Dawn Phillipson**

We think it's probably about a week. So, simple math, you could kind of just take what a typical quarter looks like and divide by the number of the weeks in the quarter. That being said, we also did see some impact on deliveries in January related to weather. As you think about those drivers who are our there, there's really icy conditions, there's snowy conditions, that are particularly difficult. At times, they will delay those deliveries.

As we're thinking about 2024, the first quarter certainly has kind of the lowest year-over-year impact, or the least favorable year-over-year impact, and then as we look out to the following quarters, we're pretty excited, and we think that as we move through the year, we should see sequential acceleration in the deliveries and net revenue as we move through the year.

**Peter Keith**

Very good. Thank you so much.

**Dawn Phillipson**

Thanks, Peter.

**Operator**

Thank you. Our next question is from the line of Jonathan Matuszewski with Jefferies. Please go ahead.

**Jonathan Matuszewski**

Good morning, and nice results. Thanks for taking my questions. The first one is just underlying assumptions for your 2024 comp guide of down 4% to down 2%. Just help us, give some color, in terms of how you're thinking about large-scale renovations, light refreshes, existing home sales, factors like that, that you've said have the most weighting on demand for your business. That's my first question. Thanks.

**John Reed**

Go ahead, Dawn.

**Dawn Phillipson**

Good morning, Jonhathan. As we're thinking about the macro, there certainly continues to be a lot of uncertainty. We do know that our client continues to renovate, continues to refresh their home, and a light refresh could be something as simple as painting a room. We think there's still plenty of that happening.

Also, as you think about our market share of just the total $100 billon industry, we have a ton of runway, we're less than 2% of market, and so just so much opportunity for us as we continue to open Showrooms, as the Marketing Team continues to really expand the brand awareness, and kind of think outside of the box with some of these different marketing campaigns.

Jen, do you want to talk about the Italy campaign?

**Jen Porter**

Sure. Hi, Jonathan, good morning. Yes, we're really excited. As Dawn mentioned, we're really excited opening up those new Showrooms, but within Marketing, as well, we're really excited about the new opportunities that we have to not only present Arhaus in a similar way to more people, but also new ways that we're presenting Arhaus out to the audiences.

As John mentioned, we kicked off our Storied series with our *Rooted* campaign featuring our Mexican artisans last fall. We just launched our Italy campaign in Spring, with a big rollout in February, and it really does give us a way to tell those stories, share the craftsmanship, share the things that really make Arhaus unique and special. John talks all the time about how proud we are of our product and what we're delivering to the market, and I think we, as a Marketing Team, are just thrilled to really be able to share those stories and let people see into our world. These are things that we are excited about and have been experiencing for decades, but these campaigns really allow us to go into detail and share those stories with a larger audience.

Really, really excited by the responses that we are seeing to those campaigns. We are learning a lot. We are seeing some really great engagements and traffic results, particularly on digital, with those campaigns. As John mentioned, we decided to start telling these stories because of questions and interest we were getting from current clients, and just seeing existing clients, and also future potential clients, really engage with them is really, really exciting, so more to come from that, but really excited about what we'll see through the rest of the year there.

**Jonathan Matuszewski**

That's helpful, thanks for the color there, and then I guess just a follow-up, if we could get an update on anything you're seeing regarding cancellation rates, whether you've seen any deviation there from historical levels. And I guess relatedly, I think last year you called out at one point consumers choosing to postpone their orders and that kind of having an impact on when revenue may have been recognize, or I guess postponed their receipt of deliveries. Are you still seeing that dynamic? Any color there would be helpful.

**John Reed**

Yes, I don't believe—I'm certain we have not seen any increase in cancellation rates, number one. They hold steady, as they have been for the last quite a few years, so that's normal case. We're actually doing a little better than we had been. We're not really seeing people now delaying orders, either. Sometimes you see that, obviously, when people are renovating their homes. As we know, people aren't moving as much as they had been, but people are—at least in our category—renovating quite a bit, and most builders and that have caught up, at least telling the clients an actual date that they can stick to, so things are getting better in that field. We're not seeing people delaying, like we did last year. So, we're not seeing that is going to be a factor at all.

**Jonathan Matuszewski**

Thank you.

**Operator**

Thank you. Our next question is from the line of Peter Benedict with Baird. Please go ahead.

**Peter Benedict**

Oh, hey, guys, thank you. Thanks for taking the question. Good morning. Kind of a question around the top line cadence, how you're thinking about the recovery over the course of the year. You talked a little bit about some of the macro drivers there, but just maybe unpack that a little bit, what you're thinking in terms of just sector demand, and you guys have clearly been doing better than the sector, but just your view there, and help us understand maybe the cadence of that $75 million backlog release that you saw in 2023, just so we understand the comparisons on that. That's my first question.

**John Reed**

Yes, good morning, Peter. Dawn, you can help me with this one. But, what we're seeing is—as we've been saying all along, last year was strong, very strong, our new products are just resonating so well, and I think we're just dead-on with what people want these days, and it's very unique products. We think we're way ahead of the curve from our competition on products. So, we think people are responding. As we've opened up so many new stores, every day we're getting more and more new clients coming in, finding out who we are, because we're a relatively unknown brand, especially on the West Coast, and they're resonating. It's amazing how people walking in, who really don't know our brand, and are purchasing from us, because they just fall in love with our product, fall in love with our Showrooms, and fall in love with our designers, who are just fantastic. That part is great, and I'm seeing the lineup of new products, and so forth, strong, and that's what we're all about, selling great products, and the more we have better products and the more people know about us, the better we're going to be, and we'll just continue to grow.

Dawn, do you want to add on to the other part of that?

**Dawn Phillipson**

Sure. I think, just to reiterate what John was saying, we feel so great about the new product introductions, the marketing materials. The new Showrooms that were opened in the fourth quarter of last year, we're so excited about how those are performing, and the clients' engagement within those locations.

As we think about demand in the first quarter, January was a bit soft, February accelerated nicely, so I think, as we're thinking about the demand cadence, that will impact a little bit in the first quarter, but really feeling great about all of our offerings and how we're engaging with clients.

Switching to think about net revenue, as we move through the year, we do expect sequential acceleration, so every quarter, we expect net revenue to improve a bit, and that's really going to be driven by new Showrooms that opened not only in the fourth quarter of this year, but Showrooms in 2024 are slated the heaviest in Q2 and Q3, so we should see some nice benefit in the back half from those openings, as well.

As we think about backlog in 2023, it's relatively evenly split between first half and second half. It's slightly heavier weighted towards the second half.

**Peter Benedict**

That's helpful, thank you, and then just maybe on the—turn the sourcing side of things. Transportation was a benefit for you guys in 2023. Just curious what you have kind of assumed in your plan for '24. Remind us kind of the geographic exposure you guys have in terms of where your product is coming from, and just any thoughts on all the activity in the Red Sea and what that might be doing to your inbound rates on ocean freight. Thank you.

**John Reed**

Yes, we have—keep in mind almost half of our product is made in the United States, which we've always made our upholstery in the United States, and some other products are being made here, so that takes almost half the business off the table. The other strong parts, where we're strong is in Mexico, we buy a fair amount of product, and in Europe, we buy a fair amount of product, especially Italy. None of that is affected by the Red Sea at all. Some of the Asian things were, but we just have rerouted them. We're not seeing significant cost increases with that, so we're not—right or wrong, we're not worried about the Red Sea part of the business. Again, it's maybe 20% of our business that may go through there, if that, so it's not going to be significant.

**Dawn Phillipson**

Yes, just to layer on there, I think, over the last few years, we have seen some slight adjustments in products coming domestic versus international. The number is a little bit lower coming from domestic these days, it's closer to probably 30%, versus the 50% when we IPOed. But, to John's point, we have layered in some slight increases in the back half of this year for freight costs related to Red Sea, just from a guide perspective. We're cautiously optimistic that we won't see significant increases in the costs, but think it's prudent, just based off of what we know today and what we're seeing, to have something factored in there.

Then, just to reiterate John's point, we are seeing a few-week delay in certain containers, but we're managing that really well upfront with the clients, and so far haven't seen any kind of client kind of issue or ordering issue related to the Red Sea delays.

**Peter Benedict**

That was super-helpful. Thanks so much, guys. Good luck.

**Dawn Phillipson**

Thank you.

**Operator**

Thank you. Our next question is from the line of Steven Forbes with Guggenheim Partners. Please go ahead.

**Steven Forbes**

Good morning, John, Dawn, Jen. I was wondering if you could expand on what's driving the acceleration in demand trends during February. Is it simply the weather compare month-over-month, or is the core accelerating, and any early reads on how the consumer is engaging with the new outdoor collections, noting it may be early, but, John, you sound super-excited about the product, so really would love to hear your sort of early thoughts on how the consumer engagement is?

**John Reed**

Sure. First of all, February versus January, it was really the first two weeks of January that we were affected just—I mean, you guys heard the news. I mean, the news scared the hell out of basically everybody in the country, except California and Florida, I think, and rightly so, there was some nasty weather there. Once we got through the first two weeks, we actually saw positive trends for the last two weeks of January, and then, of course, into February. So, it was kind of a blip with the weather and we're not giving that any worry whatsoever. Our product is strong, it's resonating very, very strongly.

As far as the outdoor products, we just launched our new and, by far, best catalog. Hopefully, you've all received it. If not, let us know and we'll get one in the mail to you. But, it is, by far, the best product ever. We've put together—assembled a new Outdoor Team about three years ago, three-and-a-half years ago, and they are really running at full speed in 2024. So, we've got great product, the results so far have been incredible on it. It, literally, kind of just like hit days ago, but the response we're hearing from the stores, from our clients is fantastic. We've got some very fresh things, things nobody else in the world are doing, and it's great style, incredible quality at a fantastic price. So, we think outdoor is going to be strong this year.

**Peter Benedict**

Thanks for that, and maybe just a quick follow-up. Capital structure extremely strong, balance sheet, free cash flow profile, you announced a special dividend, but maybe sort of give us some preliminary thoughts on the 2025 pipeline. I guess, is there an opportunity here to accelerate store growth? Are you thinking about potentially accelerating store growth, or how are you sort of thinking about the right rate of store growth, or square footage growth, over the coming years?

**John Reed**

Right, right. Well, as you know, we've been saying we did quite a bit of new store growth, renovations last year, and also this year. Going into '25, and beyond, we're shooting to go back to our very well-planned, very strategic growth plan, which is five to seven full-size stores a year, and a couple more of the design centers, as we see fit. So, no, we're not looking to expand beyond what we've been planning all along, and we're going to stick with our strategic plan.

**Peter Benedict**

Thank you.

**John Reed**

You're welcome.

**Operator**

Thank you. Our next question is from Jeremy Hamblin with Craig-Hallum Capital Group. Please go ahead.

**Jeremy Hamblin**

Thanks. Congrats on the strong results. I just want to come back to the last point here on the Showroom growth and just see if we could clarify the—or make sure that we're interpreting the right way the mid- to high-single-digit Showroom growth on a long-term basis, that you had mentioned, Dawn. Are we thinking about that on a percentage basis or are we talking about still five to seven Showrooms per year FY'25, and beyond?

**John Reed**

Go ahead, Dawn.

**Dawn Phillipson**

Thanks. Yes, I think, on a percentage basis, it makes sense in the near term, the five to seven feels like the right number adding on. That's five to seven traditional with incremental Design Studios on top of that.

**Jeremy Hamblin**

I see. Okay, that's helpful. Then, in terms of just looking at your gross margin profile, I think you said that you expect to see some nice improvement on that in the second half of '24, and it seems, based on where your sales levels are falling, maybe fewer pricing actions dragging on mix on a go-forward basis. Are you planning for kind of a solid step-up in your gross margin profile, as well, as we get into the out years?

**Dawn Phillipson**

We don't typically guide to gross margin and we haven't put out kind of medium/long-term goals for the gross margin, but I will say is that we feel very good about our product costs. In June of 2023, we did take some price actions, really, to kind of make sure that our inventory was right-sized, primarily, and so we'll clear through those in the first half of this year, from a delivery perspective. The second half P&L will benefit having been through that. But, as we think about longer term, we are investing in our in-home delivery experience, which that rolls through gross margin, and we'll kind of continue to invest in that, as we really focus on making sure that client experience is where we want it to be. I think, over time, we'll see how that kind of plays out, and we have a relatively dynamic strategy.

I think, as we continue to scale the top line and really drive some of these growth initiatives that we have around our in-home designer program, our trade program, new Showroom expansion, we would expect to see leverage over time, over long term, on that revenue, right? So, the goal is always to scale those fixed costs. It doesn't mean it won't be—it may not be linear, like I said, as we continue to reinvest strategically in some of these areas where we feel we can continue to elevate and really provide that luxury, premium experience. But, yes, we remain laser-focused on driving margins and fixed costs leverage across the board.

**Jeremy Hamblin**

If I could just sneak in a follow-up on the pricing actions. What would you characterize the impact on kind of Q4 gross margins and in the first half of '24, just from kind of the pricing actions and the impact on mix and gross margin?

**Dawn Phillipson**

Yes, we haven't really disclosed from the P&L flowthrough, because a bit of that is contingent upon just timing, but what we did say was that we took about a mid-single-digit price decrease, when you're looking at it across the full assortment. We are really pleased to say that those prices have largely normalized back to kind of where we think they should be in the go-forward assortment, so feeling good about our price position going forward.

**Jeremy Hamblin**

Great, thanks for taking the questions. Best wishes.

**Dawn Phillipson**

Thank you.

**John Reed**

Thank you.

**Operator**

Thank you. Our next question is from the line of Max Rakhlenko with TD Cowen. Please go ahead.

**Max Rakhlenko**

Great, thanks a lot. First, I know it's early, but how do you think about the new unit economics in the West Coast galleries? What could those look like compared to what you've outlined for your legacy markets? How much more robust is the revenue side in some of those bigger galleries, as costs are higher, as well, and, then, if there's any differences in paybacks that we should be thinking about?

**John Reed**

Yes, I mean, I don't have any specifics, but we do know that with the new stores we've already opened on the West Coast in the last year, and the ones upcoming, we feel they're going to be very strong, the current ones are already very strong, and the economics, the sales should be stronger than, say, a store in Akron, Ohio, where we have a store. There's more people, more people with money, and our product really, really resonates in the West Coast, I mean, they're absolutely loving it. So, we feel very confident about it.

Dawn, I don't know if you have specific numbers, or anything, (inaudible).

**Dawn Phillipson**

Yes, no, I mean, I don't think we'd want to disclose kind of geographically, but what John says certainly holds true. You would expect a larger location in California to perform better than maybe a smaller Midwest market. But, we still remain focused on kind of the average Adjusted EBITDA contribution for a Showroom at 32%, and then the top line is a minimum of $10 million. Some of those locations may significantly outperform, some may come in a little bit under, but we remain laser-focused on the payback, which is under—making sure that we have payback within two years. So, feeling good about our overall strategy. Dallas, opening up that Dallas distribution center really unlocked the West Coast for us, so excited to continue to develop that geographic region.

**Max Rakhlenko**

Got it, and, actually, I was going to ask a question on the Dallas DC, but how is that going, how are those efficiencies, is that DC now where you need it to be or is it still ramping, and, then, what could the stem-mile savings look like, as, over time, you'll be depending less and less on some of those Midwest facilities as you deliver out to the Western markets.

**Dawn Phillipson**

Yes. So, Dallas is performing. It continues to, I would say, underperform where we expected it to be at this point in time, primarily because of inventory allocation, which, as we mentioned a little bit ago, we are expecting to get the allocation software up and running kind of early next year, so we won't fully be able to unlock the Dallas productivity until we have the allocation software and order management system in place. Those are kind of two pieces. In the interim, we are shuttling product back and forth, as necessary, to kind of try to get that inventory allocation in line with where we'd like it to be. Importantly, we remain laser-focused on making sure the client receives their product on time and that the experience is seamless for them. We're excited to get these systems deployed to unlock the stem savings. Certainly, I remain focused on that. I know the team is, as well. But, there's a couple of big platforms that we need to implement in order to really unlock it. More to come in 2025, I would say, on what the stem savings could look like.

**Max Rakhlenko**

Great, thanks a lot, and best regards.

**John Reed**

Thank you.

**Operator**

Thank you. Our next question is from the line of Simeon Gutman with Morgan Stanley. Please go ahead.

**Simeon Gutman**

Hi, good morning, everyone. Hey, John, I wanted to ask you about newness. You've touched on it a bit in prepared, and even in some of the Q&A. Putting your design hat on and looking across your product, and it's okay if you're biased, but I am curious about trends, where your product stands in terms of style and price points—I heard you made some price adjustments—just thinking about where it sits, and I know you also said we're not a one-design-fits-all. Can you talk about any specific trends, even within your product assortment, that's growing faster than others?

**John Reed**

Sure. Yes, I'd love to. Like I said before, I think we're hitting on all cylinders on our products. It's obviously the fun part of the business, as consumers are looking for new looks, fresh looks for their homes, and we've gotten into a lot of products, especially in the wood categories, that are brand new, and upholstery categories, where things have gotten softer, gotten rounder, curvier. Woods have changed, they've warmed up a lot. They've gone away from the dark grays, and so forth, that were so hot a few years ago. We saw those trends a few years ago and we've been all over it. So, yes, when we walk through our store and seeing our sales, the new product is really what's getting our clients excited, and so we continue to look at and work on large collections that we're going to launch, and quite a few more in 2024.

As far as the new products, as well, the margins are very strong on those, we're setting them where we want to be. I don't want to be, and I tell my buyers, and so forth, that let's not be greedy margin, let's get our margin where we can have a healthy business long term and we're very profitable, but don't get so greedy that we're going to cut half the clients out. We think our prices, the way we buy things direct from the manufacturers, right from the factories, right into our warehouse, and from there right to the consumer, you can't get a better business model of giving clients the best value, us getting our great margins, but not being totally greedy on them, and it works. Customers are happy, they come back, they tell their friends, and our business keeps growing.

So, yes, the trends are great. Again, things have gotten softer, curvier. Anything we're doing in those types of shapes are doing very well, and I foresee that to continue, certainly, into 2024 and '25.

**Simeon Gutman**

Then, maybe one follow-up …

**John Reed**

Does that help?

**Simeon Gutman**

Yes, that was great, thank you. My follow-up, I think is more for Dawn. It's got two parts. They're connected to some of the WMS and the disruption in the first quarter. The demand comps, I think, were running positive at the end of last year, and correct me if I'm wrong. I'm thinking about the anatomy of getting to this minus 20%, or so, that you're expecting for the first quarter, even with a negative high-single-digit in January; meaning, is it just comparison-based, why is there not enough throughput from the prior demand comps to get you to a better outcome? Then, just related to his, you have this ERP rollout. Can you talk about that in terms of benefits and any risks that could pose, or was the WMS the biggest hurdle, in terms of systems investments, that could have created some type of disruption to your business? Thank you.

**Dawn Phillipson**

Sure. I would remind you that the demand comp, that's a clean calculation year-over-year. From a comp basis, that is not a clean calculation year-over-year, because the base of 2023 has backlog in it. There's still going to be a divergence between the demand and the comp number as we move through 2024, because of the backlog in '23. Once we clear 2024, and we hit 2025, those two will be more in tandem. So, there is still some disparity there.

With regard to the ERP, I would just remind everyone it is our manufacturing ERP, so it is not kind of the—it's not the retail ERP, so it has a lesser impact on the overall organization when it comes to—you know, it's not impacting deliveries, it's not impacting kind of the retail organization's day-to-day. Some great benefits. We're going to have some increased visibility to costing, which is going to really give better visibility to the teams, the Product Teams as they're costing product, and just some other operational benefits to the actual Manufacturing Team. So, no significant risk to the overall organization, I would say. We're closely monitoring it, managing it, but it's not meaningful from—no meaningful risks that we're anticipating.

**Simeon Gutman**

Okay, thanks, everyone. Good luck.

**John Reed**

Thank you.

**Operator**

Thank you. Our next question is from the line of Robby Ohmes with Bank of America. Please go ahead.

**Maddie Cech**

Hi. This is Madie Cech on for Robby Ohmes. Thanks for taking our questions. I think you called out that Showroom openings should be heaviest in 2Q, 3Q, and I just wanted to ask specifically on the outlets. You expect three openings this year. It's still a pretty small part of the overall Showroom count, but how is demand in response to these outlets, how do the economics compare to the traditional Showrooms, and how are you deciding where to put these?

**John Reed**

Sure. As we've more than doubled our business in the last couple years, we just haven't kept up with the outlet growth, so this is really just balancing out what we needed to keep up with the outlet product. The outlet product is sold at a substantial discount, so, certainly, the economics are not as strong as a traditional store, but if you look at it as a percent of sales, we're actually not adding anywhere near what we need to add, compared to how much our sales growth has happened, which means we're actually doing a better job delivering things, less people are returning things, and so forth. We think we're in good shape once we get these three open, just to steady things out, so we can move on.

Then, as far as locations, I believe one's in Colorado, one's in Pittsburgh and one's in Kentucky, and all three are opening, I think, the second quarter, I believe.

**Maddie Cech**

Thank you, that's really helpful.

**John Reed**

You're welcome.

**Maddie Cech**

Then, just my last question is about maybe promotions. You dialed back on promotions, which helped margins in November. What are some of your assumptions for the promotional environment in 1Q and the rest of the year, maybe just high level?

**John Reed**

Yes, I mean, high level, we haven't really changed our strategy from what it has been. We've certainly run some promotions at certain times of the year. We're not looking to change that dramatically at this point. We have plenty of levers to turn on if we need to, but right now it's going to be as is, as it has been the last year or so. We do some promotions, we'll do whatever is coming up next, Memorial Weekend, things like that, but that's already happened, hasn't it—or, no, it's coming up. But, anyway, on and off, we'll do some promotions, but everything is typical of what we have been doing.

Is that about right, Jen?

**Jen Porter**

Yes, no, I would agree with that, and, Maddie, hi, good morning. What I would add—and this is something that we spoke to on the last call, as well—to John's point, our strategy to promotions hasn't changed. What we have been doing, though, is really focusing on messaging promotions. We spoke about really focusing in on how we assort our sales section on our website, for example, how we speak to promotions, really paying close attention to those elements. But, I'd echo John's point about the overall promotional approach has not changed.

**Maddie Cech**

That's super-helpful. Thank you.

**Operator**

Thank you. Our next question is from the line of Phillip Blee with William Blair. Please go ahead.

**Phillip Blee**

Hi, good morning, and thanks for taking my question. You guys have done a lot of remodels and relocations over the past few years, and plan to continue in 2024, and you've elevated your store experience, which is clearly having a nice tailwind on demand. Can you talk about how many of your Showrooms are still in maybe a legacy format, and what kind of lift do you see following a remodel or relo? Thank you.

**John Reed**

Yes, Dawn, I don't have specific numbers, but I think we're about halfway to where we want to be. Does that sound about right, Dawn?

**Dawn Phillipson**

Yes, I think so.

**John Reed**

We're trying to do—again, we don't have a set schedule, because a lot of stuff has to do with leases, landlords, you know, do we want to move the store, do we want to renovate it, do we move it down the street, across the hall, whatever, so we don't have a set thing, but we are absolutely committed to remodel existing stores that are doing well, in good areas, that we know we want to stay at, and it definitely helps, we do see a lift in sales. It's a long-term investment. The last thing we want to do is get stale, like you've all seen many retailers gotten, to a point where it's too late to remodel, because there's too many of them to remodel and you just can't do them. So, we're staying ahead of that curve big time, we think better than anybody, certainly any of our competitors that I see, and remodeling, staying fresh, staying appropriate, and it really, really helps. I mean, our clients come in. Again, we're driven by a female clients and they get so inspired—well, both females and males, they get so inspired when they walk into our stores. They say, "Oh my gosh! What did you do the store? This is how I want my home to look." It's very refreshing. And it sets us up for the future. I mean, that's the biggest thing. It sets us up for a great, great, great future for many years to come.

**Phillip Blee**

Okay, great, that's very helpful. Then, Dawn, maybe a question on inventory. It was down 11% at the end of the year on a dollars basis. Can you maybe talk about how much is freight and price-actioned versus unit-driven, and then how you feel about your positioning heading into 2024, particularly around some of the newness, and, then, should we expect more muted inventory growth through the first half of the year? Thank you.

**Dawn Phillipson**

We feel great, that the price actions that we took in June of 2023 really positioned us pretty well as we exited 2023. There's still a little bit to clear through and have delivered in the first half, which we talked about. I think we feel that freight has largely—container costs have largely normalized in the inventory, relative to kind of the spikes that we saw in '21 and '22, so feeling good about kind of where the inventory is sitting as we continue to clear through those price-actioned SKUs in the first half of this year, and then really excited for the newness that is going to be launched—or that was launched earlier this year, and that we have a fall launch, as well. I would say that the team is taking a very responsible approach with buying into that newness.

We spoke last quarter around how that backlog is normalizing slightly higher than it was pre-pandemic, right, as we think about how do we buy into newness and can we make sure that we're getting a really solid read on the business before making meaningful purchases into that product, and we know that clients are willing to wait a little bit longer lead time for that newness, because it's exciting, it's different, it's unique. So, I feel good about where we'll be positioned in the next quarter and the buy plan for the year.

**Phillip Blee**

Great, thank you. Best of luck.

**Dawn Phillipson**

Thank you.

**Operator**

Thank you. Our next question is from the line of Cristina Fernandez with Telsey Advisory Group. Please go ahead.

**Cristina Fernandez**

Good morning, and congratulations on a good quarter. I wanted to ask about the special dividend and the decision to pay that, should we think of this as one-time, and then going forward, how would you consider dividends, perhaps a regular dividend or share buyback?

**John Reed**

Sure, I can start. This is a one-time thing, we have no plans to continue on a consistent basis. We've got a lot of (audio interference) done great the last couple of years. We've very well planned out how much cash we're going to need this year, next year, the year after, and we felt we could this. In the future, very happy to be able to do it one-time.

Dawn, I don't know if you have anything to add to that.

**Dawn Phillipson**

Yes, I would just reiterate that the Board was really pleased to be able to return capital to shareholders. We have a really strong balance sheet, we have a great cash position. The special dividend, which we are considering to be one-time in nature, we don't have plans to do anything additional in the future at this point in time, but, interestingly enough, we're in a very fortunate position to be able to do a dividend, a special dividend, and still continue to invest very heavily in the business when it comes to new Showroom expansion and some of these other strategic investments in the back office functions. So, really, really pleased with the performance that we've seen within the Company and our ability to return this value to shareholders.

**Cristina Fernandez**

Thank you, and then my other question was on the price-actioned SKUs. I know you can't comment on the timing of the deliveries, but where are you as far as taking the orders on those SKUs? Have you kind of gotten through most of what you wanted to do, or are there still more to go here in 2024?

**Dawn Phillipson**

We've cleared through the majority of it from the demand perspective, the order-taking perspective. There's still a little bit left, it's not—I wouldn't say it's meaningful. We're excited to get these kind of products delivered in clients' homes and then start to see some nice product cost and gross margin expansion sequentially in the back half.

**Cristina Fernandez**

Thank you, and best of luck for this year.

**Dawn Phillipson**

Thank you.

**Operator**

Thank you. Ladies and gentlemen, as there are no further questions, I will now hand the conference over to Wendy Watson for her closing comments. Wendy?

**Wendy Watson**

Thank you, everybody, for participating in our call today, and we look forward to talking to you again next quarter.

**John Reed**

Thanks, everybody.

**Operator**

Thank you. The conference of Arhaus has now concluded. Thank you for your participation. You may disconnect your lines.