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Arhaus, Inc.

First Quarter 2022 Earnings Conference Call

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CORPORATE PARTICIPANTS

Wendy Watson, *Senior Vice President, Investor Relations*

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

Dawn Phillipson, *Chief Financial Officer*

Jennifer Porter, *Chief Marketing Officer*

CONFERENCE CALL PARTICIPANTS

Jonathan Matuszewski, *Jefferies*

Curtis Nagle, *Bank of America*

Jackie Sussman, *Morgan Stanley*

Steven Forbes, *Guggenheim Securities*

Cristina Fernández, *Telsey Advisory Group*

Peter Keith, *Piper Sandler*

Daniel Hofkin, *William Blair*

Adrienne Yih, *Barclays*

Peter Benedict, *Robert W. Baird*

PRESENTATION

Operator

Greetings, and welcome to Arhaus' First Quarter 2022 Earnings Conference Call.

At this time, all participants are in a listen-only mode. A question-and-answer session will follow the formal presentation. 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, Investor Relations. Thank you, and over to you.

Wendy Watson

Good morning, and thank you for joining Arhaus' First 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 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, you may return to the queue.

We issued our earnings press release and our 10-Q for the quarter ended March 31, 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 Report on Form 10-K, and subsequent 10-Q, as such factors may be updated from time to time in our other 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 participating in our first quarter call.

We are very pleased with our first quarter 2022 performance. This morning, we reported record quarterly net revenue of $246 million, a 44% increase from Q1 last year, with our retail channel up 46% and our e-commerce channel up 34%. Comp growth was 40%. Net and comprehensive income increased 74% and Adjusted EBITDA increased 22%.

Key operational highlights in the first quarter include:

First, the launch of our spring product assortment, which has performed very well. We are also pleased with the early reads of our Outdoor 2022 catalog, which homes in March.

Our new Arhaus.com website experience continues to connect very well with visitors. Clients are not only spending more time on the site, but they are also engaging with our interactive content, providing a more robust overall brand experience.

We welcomed a new CHRO, Jen Hinkle, who comes to us after 20 years with various divisions of L Brands, most recently as Senior Vice President, Human Resources for Bath and Body Works. Jen is focused on growing and enhancing our talent acquisition and talent management processes.

We are encouraged by current supply chain dynamics. Our inbound supply chain continues to improve and vendors are focused on helping us return to having our top sellers back in stock.

On the outbound side, our teams are working diligently to get product to the clients, as reflected in our better than expected net revenue in the first quarter. While lead times are still longer than historical averages, they are steadily improving from their peak in the second quarter of 2021. We expect the improvement to continue. Additionally, we believe the new distribution capacity coming online later this year from the expansion of our Ohio distribution facility and the opening of our third distribution center in Texas will further positively impact our lead times.

In closing, we are pleased with the trends in our business and with our long runway for growth.

I'll now turn it over to Dawn to discuss our first quarter financial performance and outlook for the remainder of the year.

Dawn Phillipson

Thank you, John, and good morning, everyone.

As John mentioned, we are pleased with our first quarter 2022 results.

For the first quarter, net revenue increased 44% to $246 million. This growth was driven by delivery of orders in the backlog as our supply chain continues to improve, along with increased demand for our products in both Showroom and E-commerce channels. Our first quarter net revenue outperformance, relative to our expectations, was primarily driven by delivering product to our clients more quickly than anticipated.

Comparable growth was 40.3% in the quarter. Demand comparable growth was 8.3% on a one-year basis and 98.6% on two-year stacked basis.

Gross margin increased 39% to $98 million in the quarter, driven by our higher net revenue, partially offset by higher product, transportation and variable rent expenses related to the increase in net revenue, and credit card fees related to demand. Gross margin as a percent of net revenue decreased 140 basis points to 39.7%, reflecting the expected higher product and transportation costs, as well as higher variable rent expense, partially offset by our ability to leverage our fixed showroom occupancy costs over higher net revenue and leverage on credit card fees related to demand.

SG&A expenses increased 27% to $75 million, primarily driven by investments to support the growth of our business, including increased corporate and warehouse expenses as new showrooms open and we expand distribution capacity, as well as public company-related costs. These were partially offset by the non-recurrence of a prior year derivative expense. As a percentage of net revenue, SG&A expenses decreased 410 basis points to 30.4%, with the decrease driven by leverage of fixed costs on the 44% net revenue increase. Excluding the impact of the prior year derivative expense of $11.5 million, SG&A expenses as a percent of net revenue in the first quarter of 2022 would have increased versus the prior year, driven by the higher corporate and warehouse expenses, as well as public company-related costs.

First quarter 2022 net income increased 74% to $16 million. Our first quarter net income outperformance, versus our expectation, was driven by higher than expected net revenue and gross margin. Gross margin was driven by stabilization of freight costs, as well as leverage from our higher net revenue. Adjusted net income in the first quarter of 2022 was $17 million, compared to adjusted net income of $19 million in the first quarter of 2021.

Adjusted EBITDA in the quarter increased 22% to $31 million, from $25 million in the first quarter of 2021. The factors that led to higher than expected net income also contributed to our first quarter Adjusted EBITDA outperformance versus our expectations.

Turning to the balance sheet, as of March 31, 2022, cash and cash equivalents were $149 million and the Company had no long-term debt.

Net merchandise inventory was $247 million, an 18% increase from December 31, 2021, as we built inventories in response to strong ongoing client demand and as the value of our inventory increased due to higher freight and product costs. As I mentioned, while we are reducing our backlog and our comp growth is now outpacing demand comp growth, demand remains strong, and we continue to increase our inventory levels to support this demand, as well as to continue the trajectory of improvement on lead times, as John discussed.

For the quarter ended March 31, 2022, net cash provided by operating activities was $35 million and net cash used in investing activities was $10 million, with landlord contributions of $2 million. As a result, total capital expenditures, net of landlord contributions, were approximately $8 million in the quarter.

As we announced this morning, we are raising our full year 2022 outlook to reflect our first quarter out-performance. Highlights include: full year net revenue of $1.145 billion to $1.185 billion; full year comparable growth in the range of 36% to 46%; net income of $73 million to $83 million; and Adjusted EBITDA of $151 million to $161 million.

This outlook assumes continued inflation in transportation, logistics, container and product costs.

Regarding Adjusted EBITDA margin, we continue to expect year-over-year margins to stabilize by mid-year and expand in the fourth quarter.

Our new distribution capacity is helping alleviate our backlog and we expect this to continue throughout the balance of the year.

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

This concludes our prepared remarks, thank you for your attention, and we would now like to open the call up for questions.

Operator

Thank you. At this time, we will be conducting a question-and-answer session. One moment, please, while we poll for your questions.

Thank you. The first question comes from the line of Jonathan Matuszewski with Jefferies. Please go ahead.

Jonathan Matuszewski

Hey, good morning, nice quarter, and thanks for taking time for the questions. First question was just on 2Q to date trends. The press release indicated demand trends were positive throughout the quarter and remained solid going into 2Q. I'm wondering if you could just frame how the first couple of weeks of 2Q demand comps are shaping up relative to maybe that 8.3% in 1Q. Thanks so much.

Dawn Phillipson

Good morning, Jonathan. Thanks for your question. Demand in the second quarter, we're really pleased with what we're seeing. We have seen—it is positive year-over-year, and we are seeing some acceleration, but we don't guide to demand. I don't want to get into a kind of cadence of giving color on that, apart from just general. So, we are pleased with what we're seeing now.

Jonathan Matuszewski

Got you, that's helpful, and then just a follow-up question. I'm curious if you observed any trends during the quarter in terms of customers by household income. Obviously, a lot of market gyrations in late 1Q and into 2Q. I think half your customers are earning over $200,000 in household income. I wasn't sure if there was any kind of, you know, trend in terms of customers maybe earning double or triple that amount, whether you were seeing any relative under- or over-performance by income quintile in your customer base. Thanks.

Jennifer Porter

Yes, hi, Jonathan. This is Jen Porter. Great question. We don't like to look too detailed in shorter time periods of our customer base, just because, as you know, it can lead to false results or false assumptions. Overall, though, I can say that we really haven't seen any significant shift in our customer mix. We are seeing that average order values are still going up, so customers are still spending more, but nothing specific that we would speak to in terms of customer demo or overall trends there.

Jonathan Matuszewski

Great, thanks, Jen. Best of luck.

Jennifer Porter

Thank you.

Dawn Phillipson

Thank you.

Operator

Thank you. The next question comes from the line of Curtis Nagle with Bank of America. Please go ahead.

Curtis Nagle

Great. Just a quick follow-up of Jonathan's first question. I just want to make sure I got my facts straight. You said you saw an acceleration in demand 2Q. Is that off of 8.3%, as in demand counts are trending above 8.3%, and then I have a follow-up after that?

Dawn Phillipson

That's correct, Curtis. Good morning. Our comps are trending above the first quarter rate.

Curtis Nagle

Terrific, great, good to hear. Then, just secondarily, I'm curious how online is trending. I think it was up about 60%, if I've got my facts right, in 4Q. You guys have made a bunch of investments, the brand is growing, plenty of room for increased penetration for you guys. So, yes, how did it perform in the quarter, how should we think about growth going through the year?

Jennifer Porter

Yes, hi, Curtis. This is Jen. We're happy with how e-com performed in Q1. I think that the key thing that we look at, and we've talked about in prior calls, is that all of the investments that we are making in e-com and our digital, we're really focused on the omnichannel experience, so really seeing those drive growth in retail showrooms, as well as online. But, having said that, we are really happy with what we're seeing on e-com.

I know it was only about a month-and-a-half ago when I shared more, so nothing really revolutionary since then, but all of those trends that we were seeing in terms of customer engagement, time on site, increased inbounds rate, are all continuing. We are seeing clients engage really well with some new, more interactive features that we've laid onto the site, as well, so we're really excited about that, and what it means as we just continue to optimize that onsite experience.

Then, we're starting to see some really positive trends in mobile, which I think that is really exciting. And you're looking at that digital experience, seeing improvements in conversion and sales on mobile, as well, so we're really happy with what we're seeing there.

The other thing that I think is important to note just with that e-com experience and how it's driving total brand is we're really thrilled with what it's allowed us to do in terms of the brand and campaign and story-telling. I spoke a lot about us traveling to Greece for that outdoor campaign back on the last call, and what we are really loving about that site experience is that Greece campaign is now translating indoors, as well. So, you're really starting to get just that really holistic overall experience, and we're seeing it resonate very, very well with clients across the entire business.

Curtis Nagle

Terrific, good to hear. Thanks very much.

Jennifer Porter

Thank you.

Operator

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

Jackie Sussman

Hi, this is Jackie Sussman on for Simeon. Thanks so much for taking our questions. It looks like you guys put up another great comp, and it sounds like you guys are expecting another good demand comp. I guess, could you give us some color as to whether or not the acceleration on the three-year stacked basis on the comp was due to more of new orders being placed and new demand versus kind of working through the backlog, any color there; and as a follow-up to that, could you give us a breakdown between traffic and ticket?

Dawn Phillipson

Sure, I will start with that. For demand, demand comp, the backlog does not relate to that demand comp number, so demand comp is all new orders. We are seeing AOV up, as Jen mentioned, related to our in-home designer program, which continues to perform extremely well and increase in penetration. We also implemented price increases last year that will impact the AOV. Units per transaction is increasing nicely year-over-year. Total number of transactions is down slightly versus last year. We did close one showroom in the quarter, but we're watching that metric very closely.

Jackie Sussman

Great, thank you so much, and just a quick follow-up. We know that supply chain has been a headwind to gross margin as you deal with higher costs and we were just wondering, are you past the peak? I mean, we're hearing some potential relief in the freight market. Kind of where are you guys with that, are you still on track, any color there? Thanks.

Dawn Phillipson

Sure. The freight market remains volatile. We have seen stabilization in freight costs over the last few months. We did see an acceleration in costs in April. Nothing that is outside of our expectations for the balance of the year. So, everything we're seeing is factored into our full year guide.

Jackie Sussman

Great, thanks.

Operator

Thank you. The next question comes from the line of Steven Forbes with Guggenheim Securities. Please go ahead.

Steven Forbes

Good morning, John, Dawn, Jen. I just wanted to start with your real estate plans. Dawn, you just mentioned the one closure during the quarter, so I'd love to just hear any color on the decision process there, just given the location of that store, if there's any anticipated business impact, and then just an update on the real estate pipeline for the year, if five to seven is still the correct number to plan.

John Reed

Sure, Steven, I can take that. Yes, we are on track to stay on our plan. We're actually finding more real estate than we think we should open in a year, which is a good thing. Again, as I've mentioned, we're really wide open on the West Coast, so that's going to be one of the concentrations for the next few years, which we think will really resonate with our product out there.

As far as the closure of the store, no, that won't be significant. It was a planned closure. We've opened stores, and are planning on opening more stores around that area, that will more than compensate for any change in that one store's volume.

So, that, again, has been a strategic plan of ours and we think we're on track to do what we're planning on doing, and, yes, everything's looking great on the real estate side. We're marching forward, and we're not backing off on opening stores, by any means.

Dawn Phillipson

Steve, just to follow up on that—this is Dawn—much like the rest of companies who are trying to build out, we are seeing similar logistical concerns around permitting and timing, so more to come on that, nothing that will impact our long-term strategic plan with regards to real estate, but may have movement just within a month or two here. We'll keep you updated on that.

Steven Forbes

Thank you. Then, just a quick follow-up. I think it was John who mentioned that your vendors are working really hard to get your best sellers in stock. With that comment, any planned changes to the product introduction pipeline this year, as we think about the breadth of assortment, in general, or should we expect sort of no change here and no issues as you plan for the fall?

John Reed

Our stance on product has been, going into COVID and coming out of COVID, is we have been aggressively working on new collections, new products, and the ones that have already rolled out are seeming to work extremely well, so we're staying—marching orders are we're going to continue to roll out new collections, new products going into the summer here, going into the fall, and into the first part of next year. So, we're happy with that.

I mean, our vendors are just doing fantastic. You guys know, as well as any of us, that China has some blips in shutting down and trying to contain COVID, but other than that—and that's more of an annoying delay than anything—but other than that, our vendors are manufacturing at full force. We've got teams, as we speak, in different parts of the world right now working on new products, and we're going to keep going forward with that plan.

Steven Forbes

Thank you.

John Reed

You bet, you're welcome.

Operator

Thank you. The next question comes from the line of Cristina Fernández with Telsey Advisory Group. Please go ahead.

Cristina Fernández

Hey, good morning. John, I wanted to see if you can expand on the merchandising. It looks like that's helping with demand. Is there any way you can frame for us how much newness is there this year versus last year, or versus a normal year? It seems like it's a little bit more, but any color there would be helpful.

John Reed

Yes, it's a little bit more, and it's finally now coming to fruition. Because, as you can imagine, working on product can take a year or more, by the time you design things, have samples made, get samples approved, and so forth, and then getting it into the manufacturing process. We have seen an increase in some of the new collections and items, but nothing major. Our goal is to roll out approximately 20% newness every year in different categories. Obviously, some categories, we do more; some categories, we do less. I think I mentioned last time we focused on outdoor products this year as a major collection, and expansion. That's going to continue throughout this year into next year, as well. But, we're seeing nice, you know, really nice response to collections, between bedroom and upholstery, dining, you name it, all the core product categories that our clients are furnishing their homes. So, we continue to roll it out. It's not going to be a double or triple normal year, but we're pacing ourselves so we can just keep going, and we think that's going to work and we're excited about it, very, very excited about our new products.

Cristina Fernández

Great, and then a second question. Given where you're seeing costs, it seems like they've been stable for you, are there any additional price increases planned this year?

John Reed

Nothing planned right now. We think we've got prices at the right price and we've offset most of the expenses. Barring freight costs doubling again, which none of us can imagine doing, we're kind of stay-as-is. As our partners get price increases, and so forth, on things, we take a look at them on an individual basis. We did adjust prices a little bit in April this year, so last month, we did like a mid-single-digit price increase across the board. For the most part, it went on every SKU, but it came out to be an average of about a mid-single-digit increase. That's been accepted, we don't see anything back from our clients, and I haven't heard anything from the store folks who we stay in touch with weekly. So, we're going to stick with that right now.

Cristina Fernández

Thank you.

Operator

Thank you. The next question comes from the line of Peter Keith with Piper Sandler. Please go ahead.

Peter Keith

Hey, thanks, good morning, and great results, guys. Just to follow up on the pricing, I know you took pricing in Q4, could you just help us think about the flowthrough of that pricing? Did you see some in Q1, will it start to show up in Q2? How should we think about the timing of those Q4 price increases?

Then, separately, now that pricing in the market for premium home furnishings has moved up quite a bit in recent months, how do you feel about your price-to-value equation relative to some of your peers out there?

Dawn Phillipson

Good morning, Peter. This is Dawn. I'll start with the flowthrough and then pass it over to John for your second question.

The flowthrough for the fourth quarter price increases, we should see start coming through in Q2, Q3 of this year. We did take some mid-single-digit price increases last summer. We are seeing some of those flow through kind of in the latter part of Q1. So, from a timing perspective, we're still working through much of the backlog, but starting to see some of those summer price increases coming through, and then the December Q4 ones will come through Q2, Q3.

John?

John Reed

What was the second question?

Dawn Phillipson

Value proposition.

John Reed

Oh, value, right, right, Peter. We, obviously, study our competitors very closely and we've noticed price increases coming all over the board. But, no, we think our value is dead on, great value. We've got the best quality in the business and our prices are extremely competitive. We're not seeing us outpricing anybody, as far as overpricing, and we think we're in a good spot, a very good spot with that.

Peter Keith

Okay, good to hear. Maybe we'll move over to the backlog, and I've just been getting some investor questions on this in recent weeks, and just to think about the flowthrough of the backlog, it did increase quite a bit sequentially. You have talked about deliveries still above normal, but getting better and better. So, I guess, why is the backlog continuing to increase so much, and, at this point, how long do you think it's going to take to wind down the entire backlog?

Dawn Phillipson

Good morning, Peter. We will never wind down the backlog as it—I think when you're talking about backlog, you meant that client deposit number. We will always have kind of a client deposit number out there, as it's a rolling backlog, right? We do have backlog heading into this year kind of of what is normal, so orders from prior year in excess of what we would have historically seen. The outbound constraints are really what's holding us up from getting all of those delivered. We've seen inbound constraints alleviate nicely.

The outbound side, really getting our Texas distribution center up and running in the back half of this year is going to be critical to pushing through the backlog. As we think about that, we do expect a ramp-up period for that facility. We don't expect that facility to just come out of the gate operating at full capacity. NCDC, our North Carolina facility, is certainly outperforming expectations, doing a lot better than we expected, so we're very pleased with what we're seeing there. But, it will take some time. Most likely, we will have some backlog heading into next year, but we are working to get that down as quickly as possible.

But, I do just want to kind of reiterate that the client deposit number that you see, as our comps continue to grow—as our demand comps continue to grow, you will see that increase, that client deposit number will increase. So, the two main factors in that are the demand comp as we're taking new orders and then as we're getting those delivered. I wouldn't expect that number, on a nominal basis, to revert back to historical levels, because our demand is just much, much higher than it has been historically. So, just a dynamic that I think is important to keep in mind.

Peter Keith

Okay, thank you very much, Dawn, appreciate the help.

Dawn Phillipson

Sure.

Operator

Thank you. The next question comes from the line of Daniel Hofkin with William Blair. Please go ahead.

Daniel Hofkin

Good morning. My first question is—and I apologize if I missed this earlier, but can you comment on any sort of relative performance within the product mix in terms of designs, price point, etc., and also any geographic variance to point to?

John Reed

Sure, I can take that. First of all, geographic performance, we did notice, since it was so wet and cold in Midwest to the Northeast this spring, that our outdoor product did not excel as much as it did in the southern states, where it just got—we killed it in the southern states. So, we're expecting, now that the weather has warmed up this week—I don't know where you are, but it's 80 degrees here in Cleveland, finally—we're expecting that to level off and catch up with the south.

But, in other things, we're seeing our upper end products selling as well or better than ever. Some of the more price-conscious product, as the prices have gotten raised on those, we may not have seen as quite as big increases, even though we're still seeing increases. As far as design-wise, product is still very clean. We use so many different materials, our product is so handmade, we think that's resonating really well. Some of our most handmade product, and most expensive product, are some of our best sellers in many categories. We're going after that upper end client more and more. We're doing initiatives to look at other categories where we can really take it to the next level, I guess, as well as we're covering the entry client who can't afford a $5,000 dining table. So, we're trying to cover both bases. Again, the lower end things, because of the freight costs, if it's coming from Asia, is tougher to hit sharp, sharp price points, but we're going to leave that business to Wayfair and people like that, I think, and go after the other.

Daniel Hofkin

So, if I understood correctly, maybe just on a relative basis within them, it's a little bit of relative softness in lower price points and relative strength in higher price points; is that fair to say?

Dawn Phillipson

No, I don't think that's the takeaway here, Dan. We saw strength across all categories. Outdoor certainly performing better, like John mentioned, just given that time of year and it's a seasoned category for us. But, we're really pleased with what we're seeing across the board and I wouldn't say there's anything of note to communicate around price points or categories, in particular, apart from outdoor.

Daniel Hofkin

Okey, and then just the other question I had was from a competitive standpoint, any additional commentary that you can provide in terms of competitive promotional intensity, just what you're seeing out there. Thank you.

Jennifer Porter

Hi, Dan. This is Jen. Yes, I mean, we're starting to see a little bit more promotional activity, particularly with the lower price point brands out in the market. We are still really happy with how we're positioned. We've touched on prior calls our strategy, which really began a few years ago, is to pull back on a lot of our promotions and really focus promotions around those three-day sale weekends. We did one of those over the Easter weekend in April and that performed incredibly well for us. But, yes, I mean, we're starting to see things—like I said, right now, it does seem to be in those lower price point brands, so nothing that we are too concerned about, but we constantly monitor what's going on in the market.

I think, just going back to some of the prior questions, our primary focus, rather than promotions, is that value proposition, and so even while we are taking price increases, we're always very conscious to make sure the value and the quality and the uniqueness of the product warrants those price increases, so we focus our attention very strongly there, as well.

Daniel Hofkin

Great, thanks very much. Best of luck.

John Reed

Thank you.

Operator

Thank you. The next question comes from the line of Adrienne Yih with Barclays. Please go ahead.

Adrienne Yih

Great, thank you very much. Congratulations, what a great report to hear in the midst of a tough Q1 for retail. I guess my first question, Dawn, can you help me sort of bridge the gap between, say, inventory growth. Inventory at the end of the quarter was about 100%, versus the sales growth, about half that. So, there's clearly average cost inflation in there, but also how much of that is sort of early receipts and had a safety stop built into that, as you kind of think about the supply chain and the disruption therein? Thank you very much.

Dawn Phillipson

Sure. Hi, Adrienne, good morning.

Adrienne Yih

Good morning.

Dawn Phillipson

It's a great question, it's a complicated question. All of those factors that you mentioned are certainly playing into it. Our inventory is up. As you think about freight costs being significantly higher than the past, we do have a landed cost method, so all those freight costs are incorporated into the inventory. Product costs have increased in many cases. We are working very diligently to get product in stock. However, I'd want to be clear that it's not stock that we're sitting on for a long time. It's product that's coming and able to meet demand; potentially new demand that's coming in, as well. So, all of those things, we are working to make sure that our inventory levels are appropriate. We've expanded to three DCs, so, as you can imagine, the allocation models have gotten more complicated, more complex. We think we have the right inventory levels, we don't believe that we're too heavy, and we are working to bring in the right amount to clear through the backlog, and make sure that our lead times will decline throughout the year and get to pre-COVID levels, and hopefully better than pre-COVID levels. So, we're working diligently. We've implemented some planning software that will help with us, and are constantly evaluating the right methodologies for inventory management.

Adrienne Yih

Fantastic. A quick one for John, you know, the comment, obviously, demand that was strong throughout the entirety of the quarter. We heard another home furnishing retailer say that they were actually down at High Point at an event or at a conference, and the upholstery manufacturers there were saying that there was demand weakness from their customers end of March into April. Just wondering, because you do so much there, if you can reconcile that comment for us. Then, Jen …

John Reed

(Inaudible)

Adrienne Yih

Go ahead.

John Reed

I was going to say we would love to take their production. Let me know who they are. Because, we're trying to get in as much as our manufacturers, including our own factory, can make. So, we have not seen a slowdown in North Carolina at all.

Adrienne Yih

Okay, that answers that. Then, Jen, just very quickly, as you're building sort of the advertising and demand creation across multiple different channels and strategies, what are you finding is the most effective, particularly as you enter new markets, like California—not new markets, but expand in markets, like California?

Jennifer Porter

Yes, hi, nice to talk to you. That's a great question, and it's one that we talk about and we debate and we change our minds on, honestly, every single day, I think. I don't mean to give you a non-answer here, but I think what really works very well for us is the mix and us pulling different levers depending on, like you said, which markets we're going in or what are our objectives are or what we're seeing happening within the business. We've talked in prior calls (audio interference) industry. Prices are going up with all the privacy elements, so that's affecting some of the efficacies within some digital channels, but we're identifying digital channels and opportunities that have proven really effective for us. So, it's been an interesting mix as we split there. Direct mail continues to be a shining star. I think, particularly, as we go into our new markets, the team has done a phenomenal job in evaluating what is working, really adapting our circulation strategies, our content strategies. We actually just switched up our content strategy a little bit this year and had the Outdoor catalog hit homes a little bit earlier, and we've seen really positive responses to that.

I hate to not be able to give you a specific answer, but, really, it does vary on the moment and the objective that we're trying to achieve, and I think the overall strength that we're seeing is a result of all those elements coming together.

Adrienne Yih

Fantastic, that's very helpful. Great product really does win the day, so congrats to the team.

John Reed

Thank you.

Operator

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

Peter Benedict

Hey, good morning, everyone. Thanks for taking the question, just two from us. One, have you seen anything on cancellation rates relative to how they had been trending prior; and then just on the gross margin, do you think that 39.7% mark in the first quarter will be kind of a low point for your gross margin as you look out over the next few quarters? Thank you.

Dawn Phillipson

Good morning, Peter. With regards to the cancellation rate, we are still lower than pre-COVID rate, so we're pleased with what we're seeing there. It is a metric that we track closely. Lead times are coming down nicely, which is, as we know, today, clients are perhaps a little less inclined to wait versus kind of in the middle of the pandemic, consumers, in general, I would say. So, nothing notable with regards to the cancellation rate.

With regards to the gross margin rate, we don't guide to the gross margin rate, but, as you're thinking about it high level, as we've talked about the price increases and when we will expect to see those flow through, it would be reasonable to assume that there will be benefit from those price increases starting, as I mentioned, in the second and third quarters this year.

So, in the event that's helpful to you.

Peter Benedict

Yes, no, sure is. Thanks very much.

Dawn Phillipson

Thanks, Peter.

Operator

Thank you. Ladies and gentlemen, we have reached the end of the question-and-answer session and I would like to turn the call back to Wendy Watson for closing remarks.

Wendy Watson

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

John Reed

Thanks, everybody.

Operator

Thank you. This concludes today's conference, you may disconnect your lines at this time. Thank you for your participation.