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Arhaus, Inc.

Second Quarter 2022 Earnings Conference Call

August 11, 2022

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Dawn Phillipson, *Chief Financial Officer*

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Peter Keith, *Piper Sandler*

Curtis Nagle, *Bank of America*

Jonathan Matuszewski, *Jefferies Group LLC*

Adrienne Yih, *Barclays*

Steven Forbes, *Guggenheim Partners*

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PRESENTATION

Operator

Good morning and welcome to the Arhaus Second 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 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.

Ladies and gentlemen, I will now turn the conference over to Ms. Wendy Watson, Senior Vice President of Investor Relations. Please go ahead.

Wendy Watson

Good morning and thank you for joining Arhaus' Second 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, please return to the queue.

We issued our earnings press release and our 10-Q for the quarter ended June 30, 2022, before market open 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'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.

I will now turn the call over to John.

John Reed

Good morning, everyone, and thank you for participating in our second quarter call. We had another great quarter, our third as a public company, and we are excited to share our results.

This morning we reported record quarterly net revenue of $306 million, a 66% increase from Q2 last year, with our retail channel up 69% and our eComm channel up 54%. Comp growth was 65.2%, and demand comp growth was a strong 22.5%. Net and comprehensive income increased 436%, and Adjusted EBITDA increased 76%.

Our second quarter performance is particularly notable on top of last year's very strong second quarter performance that included comp growth of 71% and demand comp growth of 73%. Our two-year demand comp stack for the second quarter is over 95%. Despite ongoing macroeconomics, geopolitical concerns, including high inflation, rising interest rates and ongoing global supply chain challenges, demand for our product remains strong, driven by our passionate approach to design and development.

We seek inspiration from all around the world and are thrilled with our clients' response to our unique and artisan-crafted assortment. When the pandemic began in the spring of 2020, we continued designing and developing our products, which allowed us to continue to introduce new collections across our portfolio throughout the past year. We know and stay true to what we do well.

We are also keenly focused on our client experience. Our showrooms are designed to inspire, highlighting the beauty of every piece of furniture and décor within them. Our design consultants are available to help in any way and undergo rigorous training on our product designs and quality so they can thoughtfully guide our clients through the process of furnishing and decorating their homes. As you can see from our results, this is clearly resonating, and we take the showroom and website experience a step further by offering complementary in-home designer services to our clients, which results in an average order value that is over three times the Company average.

We are also very proud of our trade designer program, which continues to grow as we have responded to the needs of the design community on both the front end with our aesthetics, quality and education, and on the back end with the room design software.

We opened two new showrooms during the quarter, in Colorado Springs and in White Plains, New York. We continue to be pleased with the strong opening performance, and the quick ramp up of our new showrooms.

Additionally, our design studios continue to exceed our expectations and we are excited to expand this format in two to three additional markets over the next several months.

During the second quarter we also launched a partnership with the Surf Lodge in Montauk, New York, redesigning and outfitting the property's beachfront and private dining deck with artisan-crafted furnishings from our Outdoor Collection. Community and timeless designs are what inspire us at Arhaus, and we are thrilled to celebrate these values through our partnership with the Surf Lodge.

Regarding our supply chain, both inbound and outbound logistics continue to improve, and our lead times are coming down steadily. We expect lead times to continue to improve over the rest of the year. As we discussed last quarter, we believe our new distribution facilities will help alleviate our backlog, reduce our lead times and support our growth over the next seven to 10 years. Our North Carolina distribution center opening went better than expected and has played a large part in our first half net revenue outperformance. Our Texas distribution center is open, and we are intentionally ramping up at a slower-than-expected pace as we work to ensure a seamless integration. We also expect the expansion of our Ohio distribution facility to be complete near the end of this year.

Looking forward into Q3, we cannot wait to launch our Fall 2022 Collection. We've called our fall campaign *The Art of Home*, and I cannot think of a better title to celebrate this incredible collection of furniture and décor. Including hundreds of new arrivals and featuring some key home trends such as rich textured boucle fabrics, curved and sculptural forms, reeding, and a focus and celebration of natural materials and color, this collection is one of the strongest we've ever launched. From the beauty of our materials to the handcrafted artisan design of our furniture and décor, we believe our product is truly special within the market, and clients seem to be agreeing. Our *Style Issue* catalog will arrive in our clients' homes and our new products will be in showrooms by the end of August.

As a reminder, we operate in a highly fragmented $60 billion home furnishings market in the United States. Our clients, who are predominantly from high income households, continue to invest in their homes, and we are executing our growth strategy by opening showrooms, making the investments to build the brand awareness and grow our omnichannel footprint, enabling us to gain market share. Our current momentum gives us confidence in our performance for the remainder of the year and we are raising our full year outlook, as Dawn will discuss.

In closing, I want to congratulate and thank our teams for their incredible execution and hard work. In the last year, we have grown our product selection, introduced newness across all categories, posted record sales, doubled our production capacity, moved from one distribution center to three, opened new showrooms, and produced excellent overall results. I have always believed that our people and our passion set Arhaus apart. I am proud to work alongside each of you. Thank you for everything you've done and continue to do to make Arhaus and the team the best in the business.

Now, I'll now turn it over to Dawn.

Dawn Phillipson

Thank you, John.

We are pleased to deliver second quarter 2022 net revenue and earnings that exceeded our expectations. Key items from the income statement include: net revenue of $306 million, comp growth of 65.2%, and demand comp growth of 22.5% on a one-year basis and 95.4% on a two-year stacked basis. This growth was driven by increased demand for our products in both showroom and eCommerce channels, as well as delivery of orders in the backlog as our supply chain continues to improve and deliveries from our new distribution center in North Carolina exceeded expectations.

Our second quarter net revenue significantly beat our internal expectations with upside across demand comp and delivered orders in both showroom and eCommerce channels.

Our second quarter gross margin increased 71% to $133 million in the quarter, driven by our higher net revenue, partially offset by higher variable costs related to the increase in net revenue and higher credit card fees related to demand.

Gross margin as a percent of net revenue increased 110 basis points to 43%, reflecting our ability to leverage our fixed showroom occupancy costs over higher net revenue, partially offset by higher transportation costs and variable rent expense. The year-over-year gross margin expansion in the second quarter also beat our internal expectations, primarily driven by lower-than-expected product and container costs, as well as leverage on fixed costs. I am very proud of the hard work across the Company managing our gross margin during a time of high inflation and supply chain complexity.

Second quarter SG&A expenses increased 20% to $83 million and decreased 1,060 basis points as a percentage of net revenue to 27%. The increase in expenses was primarily driven by investments to support the growth of our business, including increased warehouse and corporate expenses as new showrooms open and we expand distribution capacity, as well as public company related costs. These were partially offset by the nonrecurrence of a prior year derivative expense.

The expense decrease as a percentage of net revenue was driven by leverage on fixed costs on the 66% net revenue increase and the nonrecurrence of the prior year derivative expense.

Second quarter 2022 net income increased 436% to $37 million. Adjusted net income in the second quarter of 2022 increased 42% to $39 million, compared to adjusted net income of $28 million in the second quarter of 2021.

Adjusted EBITDA in the quarter increased 76% to $60 million, from $34 million in the second quarter of 2021. Net income and Adjusted EBITDA also significantly exceeded our internal expectations, driven by higher revenues and better gross margin.

Turning to the balance sheet and cash flow, as of June 30, 2022, cash and cash equivalents were $145 million, and the Company had no long-term debt.

Net merchandise inventory was $272 million, up 31% from December 31, 2021, and up 100% year over year, as we continue to build inventory in response to strong ongoing client demand and as inventory value increased due to higher freight and product costs. While our inventory dollars are growing due to inflationary conditions, our inventory units are growing at a significantly lower rate. We remain comfortable with our inventory levels.

For the six months ended June 30, 2022, net cash provided by operating activities was $41 million, and net cash used in investing activities was $20 million, with landlord contributions of $7 million. As a result, total capital expenditures, net of landlord contributions, were approximately $13 million in the first six months of 2022.

As we announced this morning, we are raising our Full Year 2022 outlook to reflect our second quarter outperformance. We have also recalibrated some of our revenue, cost and margin assumptions for the second half of the year. We now expect full year net revenue of $1.173 billion to $1.193 billion, full year comparable growth in the range of 43% to 48%, net income of $92 million to $98 million, and Adjusted EBITDA of $173 million to $180 million.

Breaking this down a bit, as I mentioned, we significantly beat our internal expectations for net revenue and earnings in the second quarter. We are raising our net revenue outlook for 2022, reflecting our first half outperformance, while slightly adjusting our second half net revenue assumptions due to an intentionally slower ramp up of our recently opened Dallas distribution center. Recall that this will add over 800,000 square feet to our distribution capacity in key regions for our long-term expansion. As we are growing from one to three distribution centers in less than a year, we want to ensure the integration is as seamless as possible and will meet our high standards for client experience.

We are very pleased with what we are seeing in the early part of the third quarter. Demand continues to be strong, though a moderation from the levels in Q2.

We are also raising our full year earnings expectations, while recalibrating cost assumptions for increased marketing spend and increased warehouse costs. We are continuing to see very attractive returns on our marketing dollars, even with the higher industry wide costs. The warehouse cost increases are the result of higher product storage costs due to the more gradual ramp of the Dallas DC than we originally projected, as well as certain Dallas DC costs that are higher than originally anticipated.

Our outlook assumes continued year-over-year inflation in product and transportation costs. We have lowered our full year expectations for capital expenditures, net of landlord contribution, to a range from $55 million to $65 million as some new showrooms have experienced construction and permitting delays. Please keep in mind, these delays are temporary and will have no impact on 2022 revenue given our backlog. Regarding backlog, just a reminder that it is driven by both demand and deliveries. We currently anticipate our backlog to be normalized by mid-2023.

Against this backdrop, we are mindful of current macroeconomic conditions, and we believe we have the experience, flexibility and balance sheet strength to address and weather cyclical environments. In the past, we have exited cycles with strong demand and having gained market share. For all other details related to our updated 2022 outlook, please refer to our press release.

In closing, we are very encouraged by our strong performance in the first half of 2022 and excited about the remainder of the year, as well as our long-term growth opportunities. Thank you for your attention, and we would now like to open the call up for questions.

Operator

Thank you. Ladies and gentlemen, at this time we will be conducting a question-and-answer session.

Our first question comes from the line of Peter Keith from Piper Sandler. Please go ahead.

Peter Keith

Hi, thanks. Good morning, everyone. Great results here.

I think you're kind of bucking the trend on overall demand, while there are concerns around the economy and recession. Could you maybe just kind of frame up, because your business has been around for a while, how you guys have done in past economic downturns and any comparisons you might see to the current environment?

John Reed

Sure, Peter. Good question. Nice to hear from you.

Yes, we've been through, you know, quite a few recessions over the last 30 years. I'm happy to report we've managed them very well. What our strategy had been through recessions is we were always focused on actually growing our business. We were focused on coming up with new products that would really entice and thrill our clients. That was a different approach. I guess it was more of an offensive approach we took than what our competitors would do, which we saw would pull back on things, not introduce new products, not pull back on marketing.

We certainly had some small hiccups during recessions, especially the Great Recession, but we pulled out of it nicely. We didn't take a huge hit in sales. But then once we started coming out, we had big, big increases and we really know that we increased our market share at that point.

Of course we managed our expenses. Where we had to adjust them, we did. We had to adjust inventory if we did. We were cautious, but we took an offensive approach, and it seemed to have worked every time, especially coming out of a recession.

Dawn Phillipson

Good morning, Peter. This is Dawn.

To add a little more context to John's comments, in 2008 we had a positive comp of 2%. In 2009 we had a negative comp of 13%, and then came out strong in 2010 with a 20% comp growth. To further elaborate on John's point, we're a different company today than we were in 2008 and 2009. In the long term, we view all expenses as variable, but we feel we're really well positioned with our balance sheet strength to kind of weather what uncertainties lay ahead for the next six to 12 months.

Peter Keith

Okay, that's helpful.

On the demand comp, again, it's kind of bucking the trend from everything we're hearing out there, even with premium home furnishings. You called out the two-year around a 94%. I think if we were even looking at a geometric basis, it's even over 100%. But we like to look at a lot of things on a three-year basis. Where is demand comp on a three-year basis, if you happen to have that in front of you?

Dawn Phillipson

I do. On a demand comp basis, the two-year is 95.4%. The three-year comp is 90.7%. On a comp basis, on a revenue comp basis, the three-year is 116.9%.

Peter Keith

Okay. Thanks so much, and good luck.

Dawn Phillipson

Thanks, Peter.

John Reed

Thanks, Peter.

Operator

Thank you. Our next question is from the line of Curtis Nagle from Bank of America. Please go ahead.

Curtis Nagle

Great. Thanks very much for taking the question.

Maybe one just in terms of what you guys are seeing from a supply chain and cost perspective. It didn't sound like that was something that was like a material tailwind. The context looked pretty strong. Gross margins better than expected. But yes, I would love to just hear kind of how that's trending and where things are relative to expectations, or prior expectations, for the rest of the year.

Dawn Phillipson

Good morning, Curt.

Supply chain certainly is the constraints are easing up. From a gross margin perspective, year-over-year the product and container costs were relatively flat, so pleased with what we're seeing there.

As we think about the expectation heading into the quarter, we continue to say over the last few quarters that we expected the cost to elevate a bit more. We have seen stabilization in the fourth quarter, and again in the first quarter, so really pleased to see that stabilization in cost continue into the second quarter. I will say that there is some offset there relative to the fuel surcharges we're seeing in transportation on the outbound side. Just important to keep that in mind as we think about the balance of the year.

Curtis Nagle

Well good, that's very helpful. Then I wanted to clarify some points in terms of the design studio. It sounds like we're getting a couple incremental new builds coming up relatively soon. I guess just confirming that that is true that these are ones that maybe weren't expected previously. I guess just if that's the case, what's driving that increased investment in this concept? How should we think about going into 2023? Again, I think kind of what we were thinking previously was this was more kind of a long test and learn. Yes, I would love to hear your thoughts on that.

John Reed

Yes, I guess, Curt, that was my fault. I guess I changed my mind and wanted to add a couple. We were going to hold off, but looking at the results of them we felt we could handle a couple more. Quite honestly, the real estate just kind of popped up, and they were good deals in great markets, so we decided to go for them. I think we have two of them that we'll open, two to three open by the end of the year.

For the following year, again, we haven't set a final plan for how many we can open per year, but we should have that in the next quarter or so. We're going to, obviously; with everything going on, we thought two was plenty aggressive and we'll see how the market goes in the next three, four months, and then we'll put kind of an official plan in place after that.

Curtis Nagle

Okay, fair enough. Congrats, and thanks very much. Appreciate it.

John Reed

Thanks, Curt.

Operator

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

Jonathan Matuszewski

Great. Thanks for taking my questions, and nice quarter.

The first question is just on the complexion of the comp in 2Q. Curious if you could give us any color in terms of how much price contributed, and maybe how transaction growth is looking, and any commentary on units per transaction just to help us understand the growth. That's my first question. Thanks.

Dawn Phillipson

Good morning, Jonathan.

AOV was up nicely in the quarter. We're really pleased with what we're seeing there. That's driven both by price increases filtering through that were deployed last year. We also saw a nice uptick in our in-home designer program. The penetration of that program continues to expand, and the AOV continues to be over three times that of our average AOV for the Company. Really pleased with how that program is performing.

The number of transactions are up healthily, as well, so really pleased with those numbers. Units per transaction, traffic, also both up nicely. Really just pleased with all the metrics that we're seeing and the consumer response to our product and our marketing and our showroom.

Jonathan Matuszewski

Great. That's helpful. Then just my follow-up is on pricing. It sounds like you guys have been less aggressive in passing along price than some of your competitors. Curious if you guys are seeing, in terms of new customer acquisition, maybe an outsized increase in customers with presumably maybe higher household income, maybe potentially trading down. Any commentary on what the new customer that you're acquiring looks like, if it's any different than in the past, would be helpful. Thanks.

John Reed

Yes, I can comment on the price increases, and then maybe Jen can comment on if the customer has changed at all.

But no, we took price increases as we needed to. As product was increased by our vendors and suppliers, partners, and as container costs just coming into the facility and going out increased, we adjusted prices. We feel we are right where we need to be with that. We feel if we have to, we still have room to take other increases if we need to, but we're pretty happy with where we're at.

We haven't seen a lot of change in pricing, you know, price increases, I should say, from vendors lately, the last few months. Things have been pretty quiet. They took their price increases. They're happy with what they're getting right now. We haven't had any big surprises in that regard.

Container costs, of course, have come down a little bit. Certainly, nowhere where they were three years ago, but lower than last year, so we're I guess as happy as you can be with paying that much for a container. But again, half of our product also is made in the United States, so again that hasn't hit us as much as a lot of our competitors, who have had to raise prices more because most of their things are imported. They may have taken more as a percent than we have but we haven't needed to because half of our product is here in the States.

Jen, do you want to talk about the—

Jennifer Porter

Yes, hi Jonathan. This is Jen.

Yes, speaking directly to the new customers and the demos, we really haven't seen any changes in the customers who are coming in. They're spending more, which is great to see. We continue to see that; but in terms of who they are, we're really not seeing any impactful changes there. That goes the same for the channel there. They're coming in as well to showrooms versus eComm. We continue to see really nice, strong results.

Jonathan Matuszewski

Thanks so much. Best of luck.

Jennifer Porter

Thank you.

Operator

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

Adrienne Yih

Good morning, John, Dawn, and Jen. Congrats. Really nicely done.

John, I was wondering if you can talk about the cadence across the quarter. I believe last quarter you said it was pretty steady across the three months in Q1.

Then this is sort of a question that it's more philosophical, I guess. How much, if at all, do the macro housing data points factor into your business forecast? That's probably for Dawn, or John, if you want to comment on that, the pending home sales, housing starts. There seems to be a long duration between seeing those data points and kind of where you are in your kind of growth curve. Thanks so much.

John Reed

Yes, I mean, I can start with that.

I don't look at those every day and worry about them too much. All I focus on is executing our plan, executing having the best product anywhere in the country. It's a $60 billion market.

Adrienne Yih

Yes.

John Reed

We're a very small part of that, so if we could get a couple more percent from our competitors, we're doing great. That's what I focus on.

Dawn, I don't know if you have any more facts than I do.

Dawn Phillipson

Yes, so you know, our customer is more tied to stock market volatility. The demand outperformance in the quarter really is indicating to us that in this time period there's a little bit less of a correlation than what we've seen historically. Really interesting data point for us as well. But less tied to housing starts, and more tied to stock volatility.

As we think about the cadence of the demand comp through the quarter, April was certainly the strongest month, and June was a little bit moderated from that point, but nothing kind of meaningful that I would call out there that shows a change in actual consumer behavior.

Adrienne Yih

Okay, and then, John, just a quick follow-up. I'm just trying to reconcile, demand is obviously super strong. Demand comp is strong. A little bit of moderation it sounds like as we go through the q-to-d (phon). But then the comment that backlogs didn't normalize until mid-Calendar 2023 suggests that there's going to be ongoing sort of long lead time, long lead times of delivery I should say. What's actually—is that getting any better the pass-through kind of like when they book to when they actually get delivered and recognized revenue? I'm trying to figure out like how those two things play into each other.

Dawn Phillipson

Yes, so product lead times are shortening really nicely. We're pleased with the majority of our lead times. Special order upholstery is still a little bit longer than what we would like it to be, and longer than pre pandemic.

John Reed

About a half of what it was.

Dawn Phillipson

Yes. Yes, so as we think about the constraints, it's really around getting Dallas ramped up, and being able to put the capacity towards pushing that product out of the distribution centers and delivering it into the clients' homes. It is a rolling backlog, so keep in mind that clients aren't waiting six-plus months for product. It is rolling, and we are able to deliver more today than we were even six or eight months ago. Really pleased with the performance that we're seeing out of North Carolina. The productivity there and the distribution center is phenomenal and has certainly outpaced our original expectations for that facility.

Dallas is coming up a little bit slower, so that's the constraint. But if you recall when we talked a few months ago, our long-term goals were really for backlog not to normalize until '24 and beyond. We're pulling that up shorter than, or earlier than, what we anticipated at the time of the transaction. Then lastly, I just encourage you to keep in mind that backlog is a function of both the delivery and the demand. If demand continues to be strong, it refills the pipeline, so therefore kind of pushing out the backlog a little bit longer.

Adrienne Yih

Super helpful. Thanks so much, and great job.

Dawn Phillipson

Thanks, Adrienne.

Operator

Thank you. Our next question comes from the line of Steve Forbes from Guggenheim Partners. Please go ahead.

Steven Forbes

Good morning, John, Dawn.

I wanted to focus on the customer experience. Maybe high level, John, if you can. Given the strength in demand, you think about just the scaling of the business over the past three years, I would love if you could just give an update on your current thinking around investment needs of the business, right, inclusive of people, technology, infrastructure. Where is your sort of mind in terms of making sure the investments are ahead of the growth here?

John Reed

Sure. As you know, we invested in the logistics side of the business with these new warehouses and so forth. Now we're focusing on putting some sophisticated systems in place to help us manage the different warehouses and so forth, and putting a management warehouse system in place and so forth.

We're investing in things like that. We're hoping to invest in a new planning system, again so we can plan our inventory more efficiently as we're growing and get into more warehouses.

Other than that, investing in new stores, new locations. Not only new locations, but going back and renovating older stores, or moving older stores, that have been proven to be very successful and are worthy of our new look and our new design. That has proven to be a huge success for us. We're going back and remodeling some existing stores, quite a few every year that I'm excited about, as well as the new stores.

Dawn Phillipson

Steve, I'll add on a little to that.

We are really pleased with the growth we're seeing and we're being prudent in how we're investing in the business for growth. You can see it in some of the SG&A spend that we're investing in to ensure that the business can support the level of growth that we've seen and the growth that we anticipate. At the same time, we recognize that over the next six to 12 months a lot could change. There's a lot of uncertainty out there. We're being fiscally responsible with our growth needs, and trying to balance the potential macro factors that could impact the business with supporting the growth that we anticipate.

Steven Forbes

Thank you and maybe just a follow up like in the comment, John, you made around remodels. Just curious if you could give us an update on the current store network, sort of how you view it, right from an investment need standpoint, and whether we should view the next 12-month period as a period of time where you may focus on remodeling the existing store network versus new stores, or how you sort of balance those two in the current macroenvironment.

John Reed

Yes, well as we mentioned, we're planning on five to seven new stores a year, plus in addition to that some—a few design studios. At least this year we're going to do two or three. I don't have a count on what stores we're renovating right now, but we're looking at them. We're looking at them for, as leases expire, and going back to landlords and if we want to stay in the space, then renegotiating leases, trying to get some landlord contribution if we are going to remodel. Or if we need to move it down the street or across the street or something, then we look at that. It's an ongoing, fluid situation that we're looking at one lease, one location at a time.

Steve Forbes

Thank you.

Operator

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

Peter Benedict

Hi. Good morning, guys. Thank you for taking the question. I have a couple.

First, just on the cost and pricing dynamics. I mean, it sounds like there's certainly some relief you're seeing on the cost front, stabilization, some things coming down. John, you also mentioned you've got some ability to kind of move price in case you need it. I'm just curious here what the outlook over the balance of this year assumes in terms of pricing. Is there anything else you plan to take?

Then in the event that costs continue to come down or moderate, is there a situation where you would maybe take some price back on any product, or do you think you're at levels that you can sustain? That's my first question.

John Reed

Yes, the other thing I just forgot is the dollar has gotten a lot stronger, so we've negotiated actually discounts from some of our vendors, or in some cases we pay in euro. Of course, you know, in that case the dollar is quite a bit stronger. But across the world, the dollar is stronger, so we have negotiated some discounts.

We're not planning on taking discounts, or discounting in the future, right now. Again, it's something we could do if we wanted to, but right now we're holding steady. With, you know, we think we're offering the customer a great value. We don't want to raise prices. Again, because we're happy with where they're at. We think you can go crazy with pricing, and that will effect, you know, take a certain part of the market out. That's something we're certainly aware of, but we're happy with everything the way it is right now.

Dawn Phillipson

Peter, we have adjusted the assumptions within the forecast and in the guide to reflect the lowered container cost that we're seeing stabilize over the last three quarters. As you think about the back half of the year, there's some expenses to keep in mind. We have recalibrated the model for the change in container cost. I think with the three-quarter stabilization now, it kind of makes sense to change those assumptions.

I'd also like you to keep in mind that Dallas is kind of at peak unproductivity for the third quarter. As we think about expenses and how those are layered in, second quarter had a little bit of that expense in there. But third quarter the expenses will ramp up as we have opened the facility, but are not shipping much out of there given the slow ramp. We've also thoughtfully invested additional funds into marketing, which Jen can speak to, and we're pleased with what we're planning to do there.

Jen, do you want to?

Jennifer Porter

Yes, hi, Peter.

Yes, so we are looking, as Dawn mentioned, increasing our marketing spend a little bit going into the back half of the year. A good way to think about it is as our revenue gets higher, we are spending more in marketing to support that, to support the long-term growth as well. We're really excited by the results.

As we touched on previously, those marketing spends are always based upon return driven targets. We can be very fluid as to how we're using and utilizing that—those dollars, shifting across campaigns and across channels. We've been really pleased with the results to date this year and are really excited moving forward with our new fall launch upcoming.

John mentioned it in the comments earlier. We are really excited about this launch with a lot of new products, a lot of new storytelling and marketing that aligns really, really nicely with some really exciting trends and things that are happening within the industry as a whole going into fall. That's all coming out in the next few weeks before the end of August. We're excited to see what the combination of increase in dollars and combined with that really strong product and really strong content can do in the market.

Peter Benedict

That's great. That's helpful. Jen, just to stick with you here for a minute, any color you could give us on kind of your eCommerce efforts, the impact that the upgrades that you've made over the last year have been having, what's been particularly effective, and then what's next on the horizon there? It's obviously an ongoing process to improve the digital side of your business. But what's been working specifically, and then what should we be expecting over the next 12 to 24 months on that front? Thank you.

Jennifer Porter

Yes, great question. Yes, we tend to be really, really pleased with the performance of the new site. I believe I mentioned for Q1 that we're seeing really positive results in terms of traffic and conversion and client time on site and how they're engaging with our content. We have seen that really continue nicely into Q2 as well. As you mentioned, it is a really exciting and continuous process of we had the initial, great reveal of the new site launch back in December and then it has been a constant learning, updating, elevation, testing our process ever since then. Really, we anticipate that to continue, definitely through the next 12 to 24 months, as you mentioned, and then beyond that as well.

I think some of the things that we are really seeing working are our clients are engaging with our content more, and I think that is a combination of both the logistics, if you will, of the site itself. Ease of use. Our ability to understand the analytics and really see how clients are engaging with the site and optimize our content and our journey and all of those possibilities based upon real time learnings, which is a big thing we are excited about with moving to the new platform. I think we are seeing our product, content, and storytelling really engage; a lot of the AI-assisted merchandising capabilities and the ability to share specific content with clients has been working really well.

I'm not going to get into too many more specifics there, because I don't want to give away all of our secrets, but we are very excited for what we're seeing. We just launched a week or two weeks ago we added a room planner onto the home page, so really being able to show off product in clients' homes. That's something that we know works incredibly well for us on our social channel, so we're really excited to bring that into the commerce experience as well.

There are a lot of things happening there. I think the key things that we are working on are really looking at those conversion optimization capabilities, the way that we are presenting and merchandising our product, all of the analytics capabilities on the backend, and really have an exciting runway over the next 12-plus months and continue to optimize that and learn what we can do more of in the future.

Peter Benedict

That's very helpful. Thanks so much, and best of luck.

Jennifer Porter

Thanks, Peter.

Operator

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

Simeon Gutman

Hi. Good morning, everyone.

I wanted to ask first about Dallas, and understand it's going to be a cost headwind in the second half. Is there any quantification around that? Then is it limiting your ability to write orders?

I couldn't tell if you were implying that it was hurting sales, as well.

John Reed

No, not one little bit.

Dawn Phillipson

Yes, Simeon, so Dallas, you know, we learned a lot in the opening of our North Carolina facility. Dallas is over twice the size of that facility. It's also operated by a third party; so as you can imagine, the processes and the systemic implications of that are a little more robust than opening a facility that we have full control over, and our system is seamlessly integrated already. As we were evaluating the facility, it just made sense to us to make sure that the client experience is consistently that luxury experience, that premium experience, and that a slower ramp up of that facility on the outbound side makes a lot of sense to make sure that that experience is what we want it to be.

There's no implications for demand. As I mentioned, we're really, really pleased with how North Carolina is shipping product out. So relative to expectations eight months ago, there are some puts and takes there between the two, but we think it's the right thing to do for the business and the client is to have a slower ramp of Dallas.

Simeon Gutman

Okay, fair enough. The second question, maybe two parts. Second half gross margins, I guess excluding Dallas from the equation, Dawn, because I'm more curious about the markup and then against shipping costs. Really, gross margin outside of what Dallas is doing. What's embedded for the second half? Then on to the fall product release, can you give us a sense, is fall always going to be a new product release for this business? What percentage of merchandise is it replacing? Are you adding to your SKU count? If you can give us a little bit of flavor.

Dawn Phillipson

Sure. I'll start there, and then I'll pass it over to John for the second portion of your question.

As I mentioned, we have recalibrated the model to bring down container costs for the balance of the year, so we're pleased with what we're seeing there and think that now is the right time to make that change. We do anticipate continued fuel surcharges on the outbound side. Those have continued at the level that you expect.

We don't guide to gross margin, and we don't guide on a quarterly basis but those are some of the higher puts and takes that you can think about. I'd also call out variable rent expense is certainly a component, so as we continue to drive those—that revenue number higher the variable rent will also play a role.

John.

John Reed

Yes, I mean, product wise we're, I think you asked about we're launching our fall product now, as Dawn mentioned, that we're very excited about. I don't know how many SKUs that is. It's a fair amount. Very excited about the product. We think it's all very, very solid, very, very salable. We'll continue to do that.

Our next major rollout then will be at the end of the year going into the winter and spring season, first with indoor product, and then certainly after the holidays and so forth we start rolling out our outdoor product that we're excited about. We're continuing as our plan, as we've planned, and we're very, very happy with the product. We think it's extremely strong.

Jennifer Porter

Simeon, just to add some color to that as well, I think one of the exciting things for us as we talk about new product and adding to the assortment is when you look at the marketing campaign elements around those launches. For example, when I was speaking about the outdoor catalog and product launch back in early Q2, and now talking about the fall campaign launch in conjunction with the new product going into fall, we really see a very strong response from clients and potential clients about that infusion of newness into the assortment. Clients love to engage with it, be inspired with it, visit the showrooms to experience it.

But ultimately, as clients start to engage with us, as they talk with our design consultants and our interior designers, it's really about finding those perfect products that work for them, their style, their families, their lifestyle, and so it's really interesting. We see a really nice halo effect when we're talking about new product. We're seeing sales results across our entire assortment within the business, as well.

Simeon Gutman

Thanks, everyone.

Operator

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

Cristina Fernandez

Yes, good morning, and congratulations on the quarter results.

I wanted to ask about the competitive landscape. Any changes that you've seen over the past couple of months? In relation to that, what should we expect from Arhaus as far as promotions around key events for the back half of the year?

John Reed

Yes, I can start. Jen can help me with that.

But we have no changes in our marketing. We're continuing to roll out incredible product that's really well priced. We're not planning on any big promotions or anything that we haven't done in the past. Everything is kind of as is in that regard.

Jennifer Porter

Yes, Cristina, just to add to that. I mean, we're seeing promos out there with other competitors. But as John mentioned, we feel really good about our strategy. Obviously, we're paying very close attention to everything. We're going to continue to pay very close attention to see what happens in the future. But we're also seeing really strong results. Clients are responding incredibly well to our product. They're responding well to our marketing. They're responding well to everything we're doing. We're really just focused on optimizing what we do well, and like I said, we'll continue to monitor what's going on in the environment, but right now we feel really good about where we are.

Cristina Fernandez

Thank you, and then my follow-up is I wanted to ask about the store opening cadence. You alluded to some delays in opening stores. Should we still expect like five to seven of the larger showrooms for this year, or have some of those been pushed into 2023?

John Reed

Yes, we have three will be open this year. Or three have been pushed into next year, sorry. I don't know how many. How many have we opened this year?

Dawn Phillipson

We've opened two this year. We anticipate two to three design studios over the next several months. The expectation for those would, as John said, be by the end of the year, but perhaps due to timing they might shift slightly into the first quarter a little bit. We'll see. More remains to be seen there. But three that we had anticipated opening this year will shift into early next year.

John Reed

Right. We are planning on over a two-year basis to stay with our plan of five to seven, so that will be 10 to 14 over '22 and '23, plus design studios.

Operator

Ms. Fernandez, has that answered your question?

Cristina Fernandez

No, that's it for me. Thanks.

Dawn Phillipson

Thanks, Cristina.

Operator

Thank you. Ladies and gentlemen, we have reached the end of the question-and-answer session, and now I would like to turn the conference over to Ms. Wendy Watson for closing comments.

Wendy Watson

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

Operator

Thank you. The conference of Arhaus Inc. has now concluded. Thank you for your participation.