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ETH - Q1 2020 Ethan Allen Interiors Inc Earnings Call

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OVERVIEW:

Co. reported 1Q20 consolidated net sales of \$173.9m and adjusted EPS of \$0.35.



CORPORATE PARTICIPANTS

Corey Whitely *Ethan Allen Interiors Inc. - Executive VP of Administration, CFO & Treasurer*

M. Farooq Kathwari *Ethan Allen Interiors Inc. - Chairman of the Board, President & CEO*

CONFERENCE CALL PARTICIPANTS

Andrew Kenneth Efimoff *KeyBanc Capital Markets Inc., Research Division - Associate*

Cristina Fernández *Telsey Advisory Group LLC - Director & Senior Research Analyst*

PRESENTATION

Operator

Good afternoon, and welcome to the Ethan Allen Fiscal 2020 First Quarter Analyst Conference Call. (Operator Instructions) It is now my pleasure to introduce your host, Corey Whitely, Executive Vice President, Administration and Chief Financial Officer. Thank you. You may begin.

Corey Whitely - *Ethan Allen Interiors Inc. - Executive VP of Administration, CFO & Treasurer*

Thank you, Mary. Good afternoon, and welcome to Ethan Allen's conference call for our fiscal first quarter ended September 30, 2019. This conference call is being recorded and webcast live on ethanallen.com, where you will also find a copy of our press release, which contains supporting details, including reconciliations of non-GAAP information referred to in the release and on this call.

As a reminder, our comments today will include forward-looking statements that are subject to risks and uncertainties that could cause actual results to differ materially. Please refer to our SEC filings for a complete review of those risks. The company assumes no obligation to update or revise any forward-looking matters discussed during this call.

Joining me on the call is our Chairman and CEO, Farooq Kathwari; and our Vice President, Corporate Controller, Matt McNulty.

After our Chairman and CEO, Farooq Kathwari, provides his opening remarks, I will follow with some details on the financial results. Farooq will then provide some closing comments before opening up the telephone lines for questions.

With that, here is Farooq Kathwari.

M. Farooq Kathwari - *Ethan Allen Interiors Inc. - Chairman of the Board, President & CEO*

Thank you, Corey. As reported in our press release, we had strong margins, earnings and cash flow for our first quarter ending September 30, 2019. The challenge and opportunity are to grow our sales, which provides the opportunity to further grow our earnings in a meaningful manner. We have continued to strengthen our talent, marketing, retail network, offerings, manufacturing, technology and logistics while also maintaining our focus on good governance and social responsibility.

As you recall, during the 1990s, we had migrated to an everyday best price model, which helped us to leverage our unique, vertically integrated structure and leading interior design enterprise. The Great Recession started a vicious cycle of sales which has impacted our growth as well as many in our industry.

During the past 6 months, we have had discussions with our retail network and made the major decision to revert back to offering our clients the best value of quality, service and everyday best price. During October, we launched this major initiative, the Ethan Allen Member Program. Those enrolled receive special members-only pricing, free shipping and white-glove home delivery, complementary design service and in our U.S. Design

centers, access to special finance options. The Member Program will benefit our clients, enable our team of approximately 1,500 North American interior designers and our vertically integrated operations to operate more efficiently, with an opportunity to improve our sales and operating margins. The Member Program is being launched during the second quarter with a strong advertising campaign utilizing direct mail, television and digital mediums. We plan to continue with enhanced marketing as we move through our fiscal 2020 year under our new We Make the American Home campaign, designed to further amplify our design heritage and our American brand identity.

This evening, we start our annual convention with over 500 interior designers and management from the U.S. and internationally. They will get a first look at our upcoming introductions for our spring 2020, including an upholstery brand aimed at a younger customer and a modern take farmhouse style. As I stated earlier, we have an opportunity to differentiate, provide great service and increase our sales and profitability.

And with this, I'll turn it back to Corey.

Corey Whitely - Ethan Allen Interiors Inc. - Executive VP of Administration, CFO & Treasurer

Thank you, Farooq. During the first quarter of fiscal 2020, the company continued with its previously announced optimization project to convert the old fort, North Carolina facility, into a distribution center and lumber processing facility, consolidate the operations at our Passaic, New Jersey facility and expanding our Maiden, North Carolina manufacturing campus. In connection with these initiatives, the company recorded first quarter pretax restructuring and other exit charges totaling \$1.7 million.

As part of the optimization plans, the company completed the sale of its Passaic, New Jersey property during the quarter to an independent third party. The company's wholesale segment recognized a pretax gain of \$11.5 million on this sale. These onetime charges and gains have been excluded from our adjusted results.

Now the financial results for our first quarter ended September 30, 2019. Consolidated net sales for the quarter were \$173.9 million compared with \$187.8 million in the prior year quarter. Net sales were impacted by a decrease in consolidated international net sales, which was primarily related to lower sales to China and in Canada due to economic uncertainties surrounding international trade disputes and a challenging global economy. Net sales to China were 49.4% lower compared with the same quarter last fiscal year.

Wholesale segment net sales of \$101.3 million compared with \$118.1 million in the prior year quarter. The lower net sales were primarily due to a decline in sales to China and the company's North American retail network. There were 183 North American design centers this year compared to 190 in the prior year period as we continue to relocate design centers and consolidate them where it makes sense. The company experienced strong growth in contract sales, which grew 62.4% year-over-year, primarily due to higher sales from the GSA contract.

While our wholesale orders from China declined 37.6%, mainly due to the imposition of tariffs by China, total wholesale orders, excluding our China business, increased 0.7%. Including the impact of decreased China orders, our total wholesale orders decreased 1.5% in the first quarter compared with the same quarter last fiscal year. As expected, our contract business, driven by the GSA contract, had another strong quarter. We believe a new format of reporting on wholesale orders booked through all channels provides a more holistic view of our business than our previous reporting approach that focused on the change in only the company retail division written orders.

Retail segment net sales were \$137.3 million compared with \$145.2 million in the prior year quarter. There was a 5.3% decrease in net sales in the U.S., while softer order trends in Canada resulted in a 10.8% decrease in net sales at our Canadian design centers. There were 145 company-operated design centers at the end of the first quarter, 2 less than the 147 in the prior year period.

Adjusted gross margin, which excludes restructuring activities, was 56.3%. Retail sales as a percentage of total consolidated net sales was 78.9% compared with 77.3% in the prior year first quarter, which favorably impacted consolidated gross margin. On a GAAP basis, consolidated gross margin for the quarter was 53.9% compared with 54.0% for the prior year period.



Adjusted operating income, which excludes restructuring charges and gains, was \$12.2 million or 3.5% higher than last year, with an adjusted operating margin of 7.0% compared to 6.3% in the prior year. An improved adjusted gross margin, lower depreciation expense and a decrease in wholesale distribution costs contributed to the growth.

Adjusted EPS increased 6.1% to \$0.35. The effective income tax rate was 24.4% for the quarter compared to 24.9% in the prior year.

Turning to the balance sheet, we ended the quarter with inventory of \$151.4 million, cash of \$45.9 million and no bank debt outstanding.

Looking ahead, as we mentioned in the press release, we launched our new Member Program during October. For an annual membership cost of \$100, Ethan Allen members will receive everyday savings of 20% on purchases, complementary design service and free shipping and white-glove in-home delivery. In the U.S., Ethan Allen members will also have access to special financing options. We will treat the membership fees as deferred revenue and recognize these fees ratably over the 12-month membership period. Since the \$100 membership fee will replace our former in-home delivery fees, which were recognized upon delivery, we expect the deferral of the membership fees to create a 3% to 4% headwind on net sales during the first year until we anniversary the membership program.

With that, I will turn the call back over to Farooq.

M. Farooq Kathwari - *Ethan Allen Interiors Inc. - Chairman of the Board, President & CEO*

Thank you, Corey. As I said earlier, we are positioned well, and the focus is to grow the top line while we continue to maintain strong earnings and cash flow. So I'm pleased with the progress that we have made so far, and we have a great opportunity and a great team.

So with that, I would like to open it up for any questions or comments.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Your first question is from the line of Bradley Thomas from KeyBanc.

Andrew Kenneth Efimoff - *KeyBanc Capital Markets Inc., Research Division - Associate*

This is Andrew on for Brad. We're trying to get a sense of how the new membership model might affect revenue and orders as it's rolled out. When you look at October, which was the first month under this new membership program, would you characterize this period as business as usual? Or did you see any lack of urgency from customers as a result of the program?

M. Farooq Kathwari - *Ethan Allen Interiors Inc. - Chairman of the Board, President & CEO*

No, Andrew, that's a good question. There's a crazy way of sales, as I mentioned earlier, resulted in creating for us a monthly sales. So end of the month is where the rush hour was. And in the last 2 days or 3 days, we got about 30% of our business in that period. It also was not very efficient. People were rushing, and some mistakes were being made. So what we did was, we did see that in the end of October, the business, that 30% or so did not come through, but we did get business. And good news is that it flowed well into November. Because normally, after the end of the month, the first 2, 3 days, there's not much happening. What we have seen over here is not many mistakes, not cancellations and good business in the next 3 days, although, of course, October was lower.

What we need to -- what we are going to take a look at is the 3 months, that is October, November and December. Our team members are very excited, slightly nervous, obviously. They were used to this end of the month, but they like it. They are behind it. As I said earlier, I spent 6 months

going all over the country, making sure this is something that our team members were ready for because they're also taking the risk. We have 1,500 interior designers. We have management in retail, which depend upon their earnings coming from revenues. So I'm pleased that they are positive. And it just so happened, coincidentally, that we are also having our annual convention starting today. So we have our 500 team members here. We have a lot of discussions. And I think that we have a lot to take a look at. We are even taking a look at the total compensation metrics for the whole quarter rather than a monthly as we did previously. So this is a change and a very positive change for us.

Andrew Kenneth Efimoff - *KeyBanc Capital Markets Inc., Research Division - Associate*

Great, great. Understood. And then as you review the efficiencies related to the membership program, could you share some of the benefits that you'd expect to see as sales trends become more stable as a result of the program?

M. Farooq Kathwari - *Ethan Allen Interiors Inc. - Chairman of the Board, President & CEO*

Yes, absolutely, 75% of the products, we sell our major North American manufacturing, where 30% of the products come in the last 2, 3 days of the month. It is very disruptive. A week before that, our folks are working hard to get business. And over the next 10 days after the end of the month, they are rushing to make the products. This is going to help us become efficient from retail, from manufacturing, and we'll have an opportunity of also improving our margins on both sides.

Andrew Kenneth Efimoff - *KeyBanc Capital Markets Inc., Research Division - Associate*

Understood. Great. And then last question from me. We don't generally think of you guys strictly as a holiday retailer, but over the years, you all have run a number of promotions around holiday events like Black Friday. And I was just wondering, for this year's holiday season, what sort of messaging do you plan on implementing now that you've switched over to the membership model?

M. Farooq Kathwari - *Ethan Allen Interiors Inc. - Chairman of the Board, President & CEO*

The messaging is very simple, that we offer great products, we offer great service, we offer everyday savings of 20% from our everyday best price. We offer white-glove home delivery anywhere in the United States at no charge. And then in the United States, we're also offering 24 months financing. I mean those are very, very important elements. Now consumers are used to the fact of thinking that a company will do something different a month later. So they wait. Now we've got to have the discipline and the strength to say that we're going to stick by it, we're going to advertise it, we're going to get the message strongly so that it's a message of confidence. If they believe, customers believe, whether it's a Black Friday or Green Friday, whatever, they believe that companies are going to do something, they wait. Our own associates waited. I've got to give the message. No, this is the best we're going to do, but we are going to increase our advertising to get this message. We just increased our advertising. We're going to -- this quarter, we will most probably go to 4.5% or 4.7% from 4.1% that we just spent this last quarter. I'm not talking in the second quarter. So we're going to spend more money on advertising. And I don't know if you have seen our new campaign. It has been very well received.

Andrew Kenneth Efimoff - *KeyBanc Capital Markets Inc., Research Division - Associate*

Great. Well, I'm looking forward to see how it all rolls out.

Operator

Your next question is from the line of Cristina Fernández from Telsey Advisory Group.



Cristina Fernández - Telsey Advisory Group LLC - Director & Senior Research Analyst

I wanted to also follow up on the Member Program. You commented what the impact would be on sales on the first year, but how should we think about the gross margin and expenses, sort of like the operating margin profile over the next couple of quarters as the program rolls out?

M. Farooq Kathwari - Ethan Allen Interiors Inc. - Chairman of the Board, President & CEO

Yes, it's a good question and a good – we, of course, are watching all of this very carefully. As Corey mentioned, there'll be a number of factors. One factor is that our delivery charges were part of our sales. Approximately 5% or so were added to our sales. And now that is taken out from the top line. And we are now making that as free delivery. But overall, our gross margins should be somewhat better than what we had in the past. That's important. So it's possible that our sales will be impacted by the Membership Program. Then also, it could be positively impacted by marketing. Our gross margins, we believe, will be positively impacted, of course, as long as our sales remain the same or increase with efficiencies in our manufacturing. Efficiency is due to what I just mentioned in operating in a more efficient manner. Plus also, keep in mind, with the changes that we made, consolidations we made that has helped us in terms of becoming more efficient, we had to, as you know, consolidate 2 manufacturing operations, which reduced our headcount by 14% to over 600 persons. That also will help us in the margins.

Cristina Fernández - Telsey Advisory Group LLC - Director & Senior Research Analyst

Okay. So it seems like near term, we should not expect a lot of change or pressure on the operating margin. If anything, it could a little bit better, assuming the sales are the same or better.

M. Farooq Kathwari - Ethan Allen Interiors Inc. - Chairman of the Board, President & CEO

Yes. Because it's possible that our sales are – will be impacted because, as I said, close to 5% will be impacted because of these delivery charges. It's possible that there is also the timing, that's timing from a quarter-to-quarter. But overall, I believe that the opportunity is for us to maintain our gross margins and operating margins.

Cristina Fernández - Telsey Advisory Group LLC - Director & Senior Research Analyst

Okay, that's helpful. And then I wanted to ask about the new disclosure on wholesale orders. Can you help us understand how do the retail orders factor into this new metric?

M. Farooq Kathwari - Ethan Allen Interiors Inc. - Chairman of the Board, President & CEO

I'm sorry, say that again.

Cristina Fernández - Telsey Advisory Group LLC - Director & Senior Research Analyst

You have a new sort of metric of total wholesale orders versus, previously, you disclosed in your retail orders. I guess how are the retail orders included in this metric? Or are they included at all?

M. Farooq Kathwari - Ethan Allen Interiors Inc. - Chairman of the Board, President & CEO

Yes, I understand. You see, what happened, as you know, we have a wholesale business, and we have the retail business. The wholesale business receives orders from our own retail division. It receives orders from our independent retailers in North America, our independent retailers internationally. And all our contract business, it also goes through our wholesale. So the wholesale received all these orders, and our main business will depend upon how much of a business the wholesale receives from all these various channels. And for instance, the garment business is

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becoming important. The China business has gone down. So if, for instance, we only measured our U.S. retail, that was not the right measurement to take a look at the opportunities we have. So all these different channels end up going to our wholesale business, and the wholesale business has the opportunity of benefiting or not benefiting based on all the business it gets.

Cristina Fernández - *Telsey Advisory Group LLC - Director & Senior Research Analyst*

Understood. And one last one. I guess what is your latest view on the trend in China? And when could we start seeing some improvement there?

M. Farooq Kathwari - *Ethan Allen Interiors Inc. - Chairman of the Board, President & CEO*

Yes. We have -- unfortunately, the worst is somewhat over because we have seen major reductions, and now coming into our second quarter, we had a fairly major reduction last year. So compared to last year, I think it's going to have stability. Now in terms of increasing business, it's something we do see some improvement in trends. Our partner in China is also in a major marketing campaign. However, the Chinese economy is soft. The tariffs are still there. There is a talk about the fact that they may do something about it, which could potentially positively impact us. So I would say that at this stage, we may have some gains, but I don't think we're going to have a major decline from what we did let us say, going into the second quarter of our fiscal year.

Operator

(Operator Instructions) There are no further questions over the phone. You may continue.

M. Farooq Kathwari - *Ethan Allen Interiors Inc. - Chairman of the Board, President & CEO*

All right. Well, thank you very much. Thanks, everybody. I look forward to continuing our discussions, dialogue. Any questions, please let us know. Thanks very much.

Operator

Ladies and gentlemen, this concludes today's conference call. Thank you for participating. You may now disconnect.

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