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PRESENTATION

Operator

Good afternoon, and welcome to the Ethan Allen Fiscal 2022 First Quarter Analyst Conference Call. (Operator Instructions). Please note, this conference is being recorded.

It is now my pleasure to introduce your host, Matt McNulty, Vice President of Finance. Thank you. You may begin.

Matthew J. McNulty - *Ethan Allen Interiors Inc. - VP of Finance & Treasurer*

Thank you, Alex. Good afternoon, and welcome to Ethan Allen's Analyst Conference Call for our fiscal '22 first quarter ended September 30, 2021. Joining me today is Farooq Kathwari, our Chairman and CEO; and Corey Whitely, our Chief Financial Officer. Mr. Kathwari will open and close the call, while Corey will speak to the financials midway through. After our prepared remarks, we will then open the call for your questions.

Before we begin, I'd like to remind the audience that this call is being recorded and webcast live on ethanallen.com, where you'll find a copy of our press release, which contains reconciliations of non-GAAP financial measures referred to in this release and on this call. A replay of today's call will also be made available via phone and on our website.

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 in this call.

With that, I'm pleased to now turn the call over to Farooq Kathwari.

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

Thank you, Matt, and thank you all for participating in our earnings call today. We are pleased with the continued strengthening of many aspects of our enterprise, including our financial results, our talent, our manufacturing, our service, marketing, technology and social responsibility. We have continued to strengthen our talent in our vertically integrated enterprise by adding to our workforce in manufacturing, logistics and retail. Our head count of 4,212 has increased 18.5% from the previous year first quarter.

Continuing personal service of our interior design teams with technology has been a game changer and will continue to provide a major competitive opportunity to grow. Servicing our large backlog of orders is of critical importance. At September 30, 2021, our retail backlog was up 73% from a year ago, which provides us the continued opportunity to increase delivered sales. 75% of our products are made, and most of them custom, in our North American manufacturing workshops, providing us a good opportunity to serve our clients.

We have taken steps to strengthen the business including additional work shifts within our North American workshops, building a new addition to our Maiden, North Carolina plant, continuing our investments in Vermont plants in Honduras, Mexico, and also in our various logistics centers and also growing our manufacturing headcount by double digits over the last several months. Through these actions, we have increased capacity and are focused on servicing our large backlog of written orders.

We continue to strengthen our product offerings, the projection of our design centers and the various elements of marketing. For quarter ended September 30, 2021, we substantially increased our digital marketing, reaching over 15 million households with our 36 page digital magazine. We reduced our advertising in other traditional mediums, thereby reducing our overall advertising spend to 2% of sales compared to 4.1% in the previous year quarter. Going forward, we expect to increase our advertising to about 3% to 4% of sales.

We had strong financial results during our first quarter of fiscal 2022, which Corey Whitely will now briefly walk you through. Corey?

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

Thank you, Farooq. We had a strong performance for our fiscal 2022 first quarter ended September 30. Retail segment written order demand continued to accelerate during the quarter, achieving 6.1% growth compared to the strong prior year period and 17.6% growth compared to the first quarter ending September 2019. Wholesale segment written orders increased 8.1%. Strong retail demand and contract sales growth, which increased 51.1% due to a rebound in government orders, helped drive the strong wholesale performance.

Consolidated net sales for the first quarter were \$182.3 million, a 20.7% increase to the prior year quarter. Our retail sales increased 31.3% and wholesale sales increased 12.4%. At the end of the quarter, both our retail and wholesale segments had record high order backlogs that we expect to get caught up on during this fiscal year.

We were able to achieve a strong gross margin of 59.9% despite ongoing supply chain challenges. This growth was due to a shift in the ratio of retail sales to wholesale sales, improved operating leverage within our manufacturing from higher production levels and benefits from our optimization of manufacturing and logistics initiatives. The retail sales mix grew to 85% of consolidated sales compared with 78.2% a year ago, which positively impacted our consolidated gross margin.

We expect this higher percentage of retail sales to consolidated sales to moderate towards normalized levels as we ramp up delivery of the high wholesale order backlogs. Our merchandising and supply chain teams continue to work through the current environment of ramping escalating commodity and freight costs, product shortages, price increases and shipping delays. While we were pleased with the strong gross margin of 59.9%, we expect our gross margin to return to a more normal range of approximately 58% to 58.5% in the near term as the sales mix returns to more historical norms.

Our operating margin was 15% for the quarter. Adjusted operating margin increased to 15.2%, primarily due to net sales growth, the improvement in gross margin and controlling costs.

Adjusted operating expenses of 44.7% of sales for the quarter reflected operational leverage under our vertical structure, along with reductions in certain selling expenses, including advertising costs.

Our GAAP earnings per share for the quarter increased to \$0.79 compared to \$0.37 per share in the prior year quarter. First quarter adjusted diluted EPS increased to \$0.80 compared to \$0.36 in the prior year.

As of September 30, our balance sheet remains strong with cash on hand of \$93.7 million and no outstanding borrowings. During the first quarter, we generated \$17 million of cash from operating activities and paid a total of \$25.4 million in regular and special dividends.

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

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

Yes, Corey, thanks. And just to again focus on some of these important financial metrics. We had strong sales and profitability in this quarter. Sales of \$182.3 million increased 20.7%. Gross margin increased to 59.9%, and operating income increased 134.2%, and an operating margin was 15%, and the diluted EPS was 113.5%, also showing the impact of our vertical business and the leverage that we have on both our margins, gross margins and profitability.

Our retail segment operating margin increased to 9.3% from 2.3% last year. Again, a very, very important element just shows the impact of sales and its impact on our margins because we are able to then have -- a lot of our costs are fixed.

On the balance sheet, we ended with cash of \$93.7 million and no debt. We distributed \$25.4 million of regular and special dividends. Our inventory grew to \$158.7 million due mostly to sold orders that have to be delivered and improving our manufacturing position to better service our backlog.

We remain committed to our sustainability practices, including both corporate social responsibility and ESG practices as they are a fundamental part of our operations for the last 90 years. We understand that our approaching to managing the business must be aligned with the commitment to sustainability. Many of our decisions are based upon factors such as energy consumption, reduction of waste and emissions effect of our operations on climate change, equality, equity and inclusion in the workforce, employee safety and security in the workplace, all the more important in this last 1 year. Compliance with national and international legal standards for the Kanata business and enforcing the most rigorous social standards in every jurisdiction in which we conduct business.

We are pleased with what we have accomplished in the first 10 years of the major sustainability initiatives that we undertook and are setting our new 10-year goals through 2030. As part of those goals, we have established a commitment to achieving net zero emissions by 2050 and a developing methods, plans and resources to meet this commitment.

Now as we look ahead, our focus remains on long-term growth. And we acknowledge the support of our shareholder base with focus on longer-term returns, especially cash dividends. As I previously mentioned, we paid \$25.4 million in regular special dividends, and our objective is to continue strong shareholder returns.

And now I'm pleased to open for any questions or comments. Alex?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of Bradley Thomas with KeyBanc Capital Markets.

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

This is Andrew on for Brad. I wanted to start out by talking about capacity and delivered revenue. We know that in this quarter, you saw about a \$4 million increase in delivered revenue sequentially versus fiscal 4Q. But as your capacity continues to ramp, how should we think about the improvements in delivered revenue over the next few quarters? Do you expect to continue to grow delivered revenue by a similar amount of \$4 million sequentially in the quarters ahead? Or do you expect to achieve a different pace?

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

Andrew, I would think that it would be somewhat higher than what we have done because we -- as I mentioned, we have continued to invest in our North American manufacturing. Our some issues that we have had and some raw material supplies, they have -- our raw material supplies have improved. So I would say that it will be somewhat of an increase from what you have seen.

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

Understood. And speaking of raw materials, I know in the past few quarters, the foam supply was a significant bottleneck for you all. What are you seeing on the foam supply? And are you seeing continued improvement in that area of your supply chain?

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

Yes, we are almost back to normal.

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

Okay. Great. And so -- yes, as foam -- it looks like foam has recovered back to normal, what are some of the remaining bottlenecks you have to work through on the supply chain to meet this higher level of demand that you're seeing?

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

Well, as we have mentioned, that about 75% of our products are made in our North American facilities. You might have read about a couple of months back, I was when Vermont I was hiking on the Green Mountain and I said I better visit our plants. And they were having a tough time in terms of getting labor. We have a tremendous amount of capacities, investments.

So we discussed with our team and then we increased the base rate from, I think, \$13 to \$16 and then, of course, increase other wages. That getting labor was a big factor. But good news is, since we did that, we are starting to get good, strong labor, not only in North Carolina, but we, of course, implemented it in throughout North America, these new wages, especially in the United States.

So labor was a big factor that is under. That in a much better position -- we are better positioned. And then, of course, on the 25% or so of the products that are coming from offshore have been a challenge. We are in a better position than most, but still a challenge in terms of getting containers. And then, of course, the cost of the containers has gone from, let us say, about \$2,250 to \$20,000 to \$25,000. So it's not only the question of costs, it's been availability. However, as I said, 75% coming from North America has given us an opportunity to increase our production and our deliveries.

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

Understood. That's good to hear. Shifting to written trends. It was good to see continued positive written sales growth through the quarter despite the long delivery times. However, it's difficult to assess how written trends compare to the strength you saw in recent quarters, given the lumpiness of the pandemic compares. So I was wondering if you could share how written trends are faring on a 2-year basis and how that strength compares to what you've seen earlier this year?

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

Corey?

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

Yes, for the quarter, just ended, while we were up 6.1% to that really strong prior year when we saw the recoveries just started after the lockdowns. If we go back all the way to September 2019 is 17.6% growth. So it's still a good trend from either direction, and that's been good to see. And we're

also seeing the growth on the contract sales as the GSA business has rebound as well. And we just in the end of the government fiscal year. So that helped on the order growth side and then now turn, of course, into wholesale shipments as we then start delivering that product out.

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

Yes. Brad, having said this, the way we have had strength has been in the State Department where the weaknesses we have been in our international business because there's still a lot of issues, whether it's in China or in other Southeast countries or in the Middle East, that has been somewhat slow. But fortunately, most of the business is North America, state department is a big part of our business. So they're doing well.

Operator

Our next question comes from the line of Cristina Fernandez with Telsey Advisory Group.

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

Congratulations on a good quarter. I had a couple of questions. I wanted to follow up on that order question. And maybe if you can talk more broadly about demand trends, how do you feel about continuing to generate positive orders over the next couple of quarters? And as you look at the health of the consumer, I guess what gives you confidence that the strong demand we've seen for whole furnishings can continue as we go into 2022?

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

Yes, Cristina, that's a very important question. It's -- when we take a look at it in the last year, we have done extremely well. Corey just mentioned that in September quarter, we were up 6.1% and written against a very strong order that we had in the previous year.

I believe that the consumer interest in the home has been very strong in the last 1.5 years. And we would -- I would think that the consumer interest will not be as strong going forward. So we've got to work harder. We've got to be in a much better position. I would say that the easier days for our industry are over.

Now having said this, we are in a better position because we have strengthened our offerings, we have strengthened our retail teams, we have really a very, very strong interior design network and combined with technology because even our retail -- our designers are -- about 75% of the products that the order that they take is custom designed. If we didn't have the technology, and the ability of our interior designers to work from their home or wherever else, or consumers working at home, we would not be doing this business.

I think we have an opportunity to continue our growth, and we have an opportunity to continue to expand our reach to more people as we are doing -- we are going to be in early next year, we are going to be introducing a very strong product offerings, which we held back. We held back because of the supply situation. So we're going to get that in the early part of this year. And I think that also is going to make an impact. So we are positive, but I think we are also cautious.

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

Okay. That makes sense. Then my second question, I wanted to delve a little more into the gross margin. I know it was very high this quarter, and it seems like some of it was due to the retail mix. But as you look forward, 58% to 58.5%, it's a little bit higher than what you talked before. So I wanted to see if you could talk more about I guess, how are you offsetting some of the supply chain pressures? And what are the drivers of that higher gross margin?

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

Well, Corey also mentioned is that gross margin of 59.9% that this quarter is very -- is higher. And it reflected a number of factors. One was that we had a higher total retail sales to total sales. But as we increase the more shipments, let's say, for the contract that gross margin may slightly go down. But it has a positive impact on the operating income.

So keep that in perspective in mind because our -- you have to look at gross margin and you also got to look at operating margins. So I think that the gross margins, if you are able to maintain at the rate more close to the rates we have that's a very, very strong gross margin. It also reflects the fact that we have been able to even offer great savings to our clients and also absorb some of these costs that we've talked about, some of the raw material costs. We had a job on 25% or 30% of our -- 25% of our products coming from offshore, very high freight factors.

Now we have passed on some increases, but we have not been able to pass all because I would hope that those crazy increases in contained costs are temporary. So we have taken some price increases, but we don't want to overdo it. So I think this gross margin of close to 58 or so is a very, very good gross margin for us.

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

Okay. Another question I had was on marketing. You mentioned today that the goal is to get to 3% to 4%, up from 2% this quarter. Back to pre-pandemic, it was more like 4%, 5% -- 4% or 5%, if I recall correctly. So has anything changed in how you're thinking about marketing and how much you want to spend in 1 way do you want to spend it?

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

Yes, Cristina, that's a very good question. Our marketing people, I said we're going to control our destiny rather than leave it to all these characters out there. I don't want to give you all the names of these companies that are utilizing, they're taking a lot of our money on all on the digital medium. So we said we're going to control it ourselves.

So we went and decided that we have the ability to reach consumers, clients, ourselves or to clients through digital mediums that we didn't have before. That's why I said -- we've been -- we are now mailing close to 15 million copies of our digital magazine every month. So we're buying the prospects. They are much less expensive than the traditional mediums. So we're going to continue with that. So that was 1 very important factor. The other 1 was we felt that with this high demand for consumers' interest in the home, there was no need for us to spend a lot more money. But as we go forward, we'll spend some more, but the medium that we will spend on will continue to be different than what we did in the past.

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

Okay. Very helpful. And 1 last one, which is just more of a modeling question. The increases that you've made on wages, particularly in the manufacturing, I guess, how material are those to SG&A? Or I'm not sure those are on cost of goods sold going forward over the next couple of quarters?

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

Yes, that's a good question. I think that both, I think, Corey and Matt are trying to figure that out. It has 2 elements because on 1 hand, it does increase cost of goods. But on the other hand, it reduces because we can produce more. So if you're not able to produce more, you may have a lower labor cost, but you don't have the profit, you don't have the products.

So overall, I think the benefit is going to be better -- be more beneficial for us to recall we increase our production. If we don't increase our production, then, of course, it goes the other way.

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

Okay. Got it. Yes. So higher labor costs, but you're going to manufacture more, should you get more leverage on those costs, okay, that makes sense.

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

Exactly that's the main thing. Yes. If on the other hand, we increased all of this and don't increase then that's going to be an issue, Cristina.

Operator

Our next question is a follow-up from the line of Bradley Thomas with KeyBanc Capital Markets.

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

Thanks again for letting me in here. This is Andrew on for Brad. Just wanted to follow up on some of the written trend commentary. I was wondering if you could talk about the cadence and what you saw on a monthly basis throughout the quarter? And if those trends have continued thus far into fiscal 2Q?

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

Are you talking or the first quarter that we just ended?

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

Yes.

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

Yes, I think that the -- what we saw, the trends were as usual that we had strong end of the month. That's what happens every month, and that continued every month. Now in October, October, we haven't closed the month, it's always in the last week, we are able to do 30% of the business. However, we are now comparing to very high numbers last year. So we've got to always keep that in perspective.

So our comparisons are going to be more tougher, most likely less pleasantly surprised that we have very high numbers. But I think we are going to have lower increases or as we move into the quarter than we had in the last previous year, that's what we are taking at this stage because compared to very high numbers.

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

Andrew, I would just add that the Labor Day was also a strong period for us.

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

Okay. Got it. And just wanted to follow up. I know that earlier in the call, Corey, you mentioned that retail segment written order growth was up 17.6% on a 2-year basis, if I heard that correctly?

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

Yes.

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

And so that compared -- I mean that's very strong. But that compares to last quarter where you saw around a 42% increase in retail segment written order growth, if my notes are correct. What do you think drove the deceleration there? And do you think it has anything to do with these extended lead times?

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

Corey, you look at the numbers. But Andrew, we are comparing with numbers when we had a lot of our business was closed. You're talking last year, right?

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

You got the 2-year stack. Yes. And I think part of it, though, is also just the timing of the quarter being the September quarter versus the June quarter. comparison, it's a little hard to compare from period to period, but still positive growth as we moved along and also the marketing programs that we had running at the time have an impact in that as well.

Alex, any other question?

Operator

No. Ladies and gentlemen, there are no further questions in the queue. I will now turn the call over to Farooq Kathwari for closing remarks.

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

All right. Thank you, Alex, and thank you for all for participating. And as usual, if you have any comments, questions, please make sure you let us know and Matt is available, and I'm sure that he will take your questions but we look forward to continuing this very the journey.

We have lots of opportunities and of course, challenges, too. But I think we are well positioned. So we are in a good position to continue the positive growth that we have had. So thanks very much.

Operator

This concludes today's conference, and you may disconnect your lines at this time. Thank you for your participation, and have a wonderful day.

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