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EDITED TRANSCRIPT

ETH - Q3 2020 Ethan Allen Interiors Inc Earnings Call

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OVERVIEW:

Co. reported 3Q20 consolidated net sales of \$149.8m, adjusted operating income of \$0.4m and adjusted diluted EPS of \$0.02.



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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*

John Allen Baugh *Stifel, Nicolaus & Company, Incorporated, Research Division - MD*

Robert Kenneth Griffin *Raymond James & Associates, Inc., Research Division - Senior Research Associate*

PRESENTATION

Operator

Good afternoon, and welcome to the Ethan Allen Fiscal 2020 Third Quarter Analyst Conference Call. 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, Lee. Good afternoon, and welcome to Ethan Allen's conference call for our third quarter ended March 31, 2020. 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, all 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 Matt McNulty, our Vice President, Finance. After Farooq 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 we mentioned in our press release, our third quarter results were negatively impacted as a result of lower order backlog entering the quarter from our transition to the membership model, combined with the disruptions due to COVID-19.

In the March quarter, we saw strong growth for the first 2 months of our fiscal third quarter until the significant disruption in March due to COVID-19. We are pleased with almost all our design centers closed, we were able to generate about 35% of written orders in April compared to April 2019.

Our unique vertically integrated structure, where we produce about 75% of our products in North American manufacturing, enabled us to maintain our sourcing. In addition, all our logistics are delivering products to our clients and continue to operate. We are also pleased, as of today, over 60% of our about [180] (corrected by company after the call) design centers in North America are opened or about to open. We are also pleased that during the quarter, we have maintained strong liquidity, while also [repurchasing] (corrected by company after the call) 3.8% of our outstanding shares for \$14 million and paying \$5.5 million of our quarterly regular dividend.



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After Corey provides a brief overview of our financial results for the quarter, I will discuss in greater detail our initiatives as we move forward.

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

Thank you, Farooq. During the third quarter of fiscal 2020, our consolidated net sales were \$149.8 million compared with \$177.8 million the prior year quarter. Net sales were negatively impacted as a result of lower order backlogs going into the quarter from our transition to the Ethan Allen Member Program along with the emerging impact of the COVID-19 health crisis that rapidly intensified during the latter half of the quarter.

Wholesale segment net sales were \$93.1 million compared with \$108.4 million in the prior year quarter. There are 180 North American design centers this year compared to 184 in the prior year period as we continue opening new design centers, while closing older locations. We saw continued growth in our contract sales, primarily with the GSA contract. However, the growth rate slowed this quarter as the COVID-19 health crisis began delaying some GSA orders and shipments.

Our total wholesale orders decreased 21.9% in the third quarter compared with the same quarter last fiscal year. Orders from our North American retail network declined 32%, while wholesale orders from China declined 25.7%, mainly due to local quarantines in place for most of the fiscal third quarter. The closing of our retail design centers and manufacturing operations during March negatively impacted our results, as evidenced by a 37.3% decrease in March wholesale orders compared to a year ago.

Retail segment net sales were \$115.7 million compared with \$138.9 million in the prior year quarter. Our retail segment orders grew during the first 2 months of the quarter, in fact, our February retail orders increased by 13.6% with a very strong Presidents Day period. Business conditions then began to deteriorate as concerns over COVID-19 increased leading up to the March 11 announcement by the World Health Organization of the COVID-19 being declared a pandemic and the subsequent closures of our design centers.

By March 19, all our design centers were closed along with most of our North American manufacturing. Despite the disruptions and resulting lower net sales, our consolidated adjusted gross margin for the quarter of 56% remained strong. Adjusted operating expenses for the quarter decreased by 4.4% to \$83.6 million, which included \$8.3 million of advertising costs. Impacted primarily by the lower sales, adjusted operating income was \$0.4 million. Adjustments netted tax totaled \$0.8 million and represented restructuring and asset impairment charges during the quarter.

Adjusted EPS was \$0.02 compared to \$0.31 in the prior year. In the fiscal third quarter, the decrease in wholesale net sales along with the decline in our stock price and the significant adverse changes in business climate from the COVID-19 health crisis, that is to determine that an impairment triggering event that occurred. This required an interim quantitative impairment assessment of goodwill and intangible assets. While our preliminary results released on April 22, included the effect of an impairment to our goodwill, based on the company's interim assessment performed, the fair value of our wholesale reporting unit exceeded its related carrying value by approximately 25%, thus, no impairment of goodwill as of March 31. We also performed the interim trade name impairment test and concluded that its fair value substantially exceeded the carrying value as of March 31. So there was no impairment of the trade name either.

Turning to the balance sheet. We ended the quarter in a strengthened position. Inventory of \$138.8 million compared to \$164.6 million in the prior year. Cash increased to \$116.9 million, with \$100 million in borrowings on our credit facility. As Farooq mentioned, we returned value to shareholders during the quarter by paying regular quarterly cash dividends of \$5.5 million and repurchased 3.8% of the company's outstanding shares.

As part of the company's COVID-19 action plan, the company has temporarily suspended the regular quarterly cash dividend and share repurchase program. As we announced on April 1, we are taking many steps under our COVID-19 action plan to ensure liquidity, including the furlough of approximately 70% of our global workforce. The decision by Farooq Kathwari to forgo his salary through June 30, 2020, and the salary reduction of up to 40% for all senior management and up to 20% for other salaried employees through June 30. Our Board of Directors reduced their cash compensation by 50% through June 30, elimination of our nonessential operating expenses, negotiating with our landlords to receive temporary rent deferrals or abatements for our lease design centers, delaying nonessential capital expenditures and taking other steps to reduce disbursements.

We are fortunate to own all of our wholesale properties and about 35% of our retail properties. We continue to monitor cash on hand through a detailed cash burn analysis and believe the fundamentals of the company remains strong. As of March 31, 2020, we had total cash on hand of \$117



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million and remaining borrowing availability of \$24 million under our credit facility. In addition, there are no debt maturities until December 21, 2023. Based on our current cash burn analysis, we believe our liquidity will be sufficient to fund our operations for at least the next 12 months.

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, thank you, Corey. As I mentioned, in April 2020, we were able to generate 35% of written orders compared to April 2019 with practically all our design centers closed. This was due to our interior design associates working remotely, utilizing technology we deployed over the past few years, including the Ethan Allen inHome augmented reality, 3D room planner tool, Live Chat on ethanallen.com and communications tools including Skype and FaceTime.

As we move forward, we have a strong combination of personal service of our interior designers and technology. We have started to open design centers. And as of now, as I mentioned, about 60% of our [180] (corrected by company after the call) design centers in North America are open or about to open. We continue to bring back furloughed associates.

Our vertically integrated structure is an advantage, including making about 75% of our products in our North American manufacturing. Most of our North American manufacturing is now operating, and we continue to bring back our associates. Our national and regional logistics are also fully operational. We are also pleased that our licensee in China has opened up most of their 100 locations, and we continue to do business with the U.S. government.

In April and May, we have maintained strong marketing initiatives, including distributing about 2.5 million copies of our spring magazine. The magazine projects fashion, service, accessibility and a strong offer of savings of up to 25%, free premium, home delivery, 48-month interest-free offer and very importantly, complimentary design service.

Our objective is to continue our strong advertising to bring clients to our design centers and let them know of our strengths at a time when many retailers are in trouble, creating consumer concerns. Crisis creates an opportunity, and I feel strongly that we are positioned well to grow.

With this brief overview, we would like to open for any questions or comments.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Your first question is from John Baugh from Stifel.

John Allen Baugh - *Stifel, Nicolaus & Company, Incorporated, Research Division - MD*

I don't know what that was, but good afternoon Corey. I was curious, first of all, could you perhaps tell us where your lease negotiations are going and what you think ultimately may happen there? And then secondly, I'm curious, when did you open the first, I don't know, handful or tranche of stores? And is there any sense -- is there enough time there to get a sense of how that's ramping versus full closure?

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

We are talking about our discussions on our current lease stores.

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John Allen Baugh - *Stifel, Nicolaus & Company, Incorporated, Research Division - MD*

Yes. The lease abatements on the 65% of leased stores.

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

Right. Yes, we are having good discussions with the various landlords and like in most other businesses, there is some abatements taking place, some reductions taking place. And I think we're making good progress. It's important. But as also, as Corey mentioned, the good thing is that we own most of our properties. If that was not the case, as you know, I've always said, it's good to own these properties because the next recession is going to make a difference. And fortunately, we are in a better position.

John Allen Baugh - *Stifel, Nicolaus & Company, Incorporated, Research Division - MD*

And then stores. Did you open -- when did you open your first, I don't know, 10, 15, 20 stores? And is there any color on the ramp since you did that?

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

Well, you're talking about -- I mean, we have not opened too many stores in the last couple of years, very, very few, actually. If you take a look at it about 1.5 years back, we opened Downtown, Chicago. I'm talking -- you're talking about new stores. Our focus...

John Allen Baugh - *Stifel, Nicolaus & Company, Incorporated, Research Division - MD*

No, no, I'm sorry. I was talking to close, but stores -- all the stores you had to close.

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

I'm so sorry. But we closed most of them towards the end of March and early April.

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

We opened most of them in the last 2 weeks. And some opened even the couple weeks before that in states that had more relaxed rules in place.

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

Yes. I'm sorry. I was wondering, but no, no, I understand that. Yes, we closed almost all of them by the first -- towards -- even in March, almost, all of them were closed. And now we are starting to open them up, in fact, even today. But every day, we are hearing of states which are allowing stores to open up as long as they're done safely and distance is maintained. And what we have done also is we have spent a great deal of time in making sure that we put the right kind of safety procedures on. And in fact, we have also been able to obtain and they're just kind of being received a fair amount of masks and gloves from our partner in China, they were able to arrange it for us so that we are able to distribute at our manufacturing and our retail.

So as I said, about as of now, 60%, but just in the last 1 hour, Wisconsin, for instance, decided that we could open up the design centers. Now what we are doing is this, we are bringing people in selectively. As Corey said, 70% of our folks were furloughed in our retail and in manufacturing. The good news is, we're starting to bring them back. Because this is going to ramp up, it's not going to do it going fast. We are also opening them up. And most of the stores are now being opened up, Monday to Saturday or Tuesday to Saturday, so that we don't -- we are not open 7 days in many -- in most of the locations.

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John Allen Baugh - *Stifel, Nicolaus & Company, Incorporated, Research Division - MD*

Okay. And my last question is you mentioned, Corey, that you've enough cash to run for 12 months. Any parameters around the scenarios you ran that make you comfortable? I mean, is there a percentage of sales decline, for example, worst-case that you could share that you still have the cash to operate for 12 months?

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

Yes. John, we used very conservative numbers. And we've actually ran a few different scenarios with very, very low based upon the kind of a worst-case scenario based upon the immediate drop-off in business that we saw after March 19 when we closed all our locations. So it was in a very slow ramp-up to business going forward. So it was very conservative. We felt very comfortable that would be a worst-case scenario. And of course, our outside auditors were also comfortable with it as well. So we feel comfortable making that statement concerning our liquidity.

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

You see I'd like to also add a couple of factors. One of the -- our business because it's mostly custom, as of March 31, we had \$86 million of order backlog in the retail division. Now that's important. We don't have a cash and carry business. So it's \$86 million of backlog on which we did have about 55% deposits by our customers also helped us maintain cash flow during this period, during April. Also, when we take a look at our business in April, 35% of our orders by a retail division were written without any of the stores open. So it was -- these are very positive factors here.

John Allen Baugh - *Stifel, Nicolaus & Company, Incorporated, Research Division - MD*

And Farooq, I'm sorry, you did, on the April, where you were 35% of last year's business. Was there -- did you get better towards the end of the month, adjusting to the virtual world and working online with the stores closed? Was there any improvement in that down trend through the month?

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

It did improve towards the end. Look at the fact, our e-commerce, for instance, increased by 215%. But the reason we don't do give a lot of -- put a lot of emphasis on that is all the business of this 35% was done through technology. At end of the day, these were our folks out of our meeting our designers. So yes, there was increase as people became more comfortable, but not like the normal towards end of the month, we usually get big, huge businesses, not that, but it was somewhat better as the month progressed.

Operator

Your next question comes from Bradley Thomas from KeyBanc Capital Markets.

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

This is Andrew on for Brad. I wanted to ask, given this changing environment we're in, has your strategy behind the membership model changed at all? And we were wondering if you could give us a sense for how you're thinking about non-membership model promotions during this time as well?



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

Well, it's a very important question. This crisis what's coming along, of course, when we saw it happening in China, we saw it happening overseas. So we decided that we would for the time being hold up the membership program. And in March, we took it out so that people would be able to purchase our products without being a member, and they would be able to get premium free delivery. So at this stage, with the way the conditions are, we really are giving everybody the benefit of a member.

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

Understood. And then it's also good to hear that contract sales continue to grow throughout the quarter. But going forward, how do you expect the pandemic and the changing environment to potentially impact your contract business?

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

Well, our government contract business at this stage is holding up. I think that there is always -- every -- all over the world, people have somewhat slowed down, but they're not slowed down in terms of their needs. People are placing orders a little slowly, but what we hear is that they will continue to do that. And generally speaking, this last quarter and the next quarter are generally very strong for the government business.

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

Got you. And then I guess the last question for me. I wanted to ask, given the changing consumer environment, have you noticed any changes in average selling price lately? And if so, how do you expect this to impact margins?

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

Well, as you know, even this quarter, we improved our gross margins considering the fact our volumes were low. Even if you look at our operating margins held up pretty good. It was because of the retail not being able to deliver that had most of the major impact. So I think that we have continuously made improvements in our operations. We have continuously made sure that we operate more efficiently. We didn't have to wait for this crisis to consolidate some of our manufacturing. We've already done it. So we are operating very efficiently. And I would think that we were able to maintain our gross margins despite very tough conditions. So we have an opportunity of improving our operating margins as we move forward.

Operator

Your next question is from Cristina Fernández from Telsey Advisory Group.

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

I hope you are all well. I wanted to ask about the expense reductions that you're making. Is there any way you can size for us in aggregate with all the efforts, including the furloughs, how much should we expect overall expenses to go down in the second quarter maybe on either expenses or cash? So we have a sense of where business could be from a profit standpoint.

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

Yes, it's a good question. I think let us study it because it's changing every day. We've already now opened up close to 60% of our stores. We've brought a lot of people in. Certainly, our expenses are going to be lower. There's no question about it. And how much lower, I think that might be better for us to discuss it at the end of this quarter because overall, we're going to all operate more efficiently. We are learning how to do business

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with Zoom and Skype and all of that. Our traveling is going to be much less. Our focus on making sure that our operating expenses across the board are not going to be reduced only now, but as we go forward. So I think Cristina, it'd be better for us to give that right at the end of this quarter would be a better time.

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

Okay. Understood. And in that light, I wanted to get your thoughts, obviously, a lot of change in the industry and perhaps some more permanent changes to how consumers shop more digital, more digitally. I guess, how you're thinking about the furniture and home furnishings business, how that can evolve over the next 1 to 2 years? And perhaps how the way you conduct your business will evolve as a result of this pandemic?

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

Well, I think that there's no question that there will be a great opportunity, and I'm talking for us and most probably our industry, too. But certainly for us, which is a combination of personal service and technology. When I mentioned that we did 35% business of our retail business in April under very tough conditions, all of which was done, almost all of it was done with our designers working with consumers with mostly remote in some cases, in some states, they were able to go by appointment to meet. So I believe the combination of personal service and technology is going to be very, very important. I think those businesses that basically sell a product as a commodity. Like for instance, we are seeing that in apparel. We are seeing this in other toys. If they can buy it online, they don't need much personal service. The chances are their not going to go to stores. So you've got to have -- stores got to be able to create the opportunity for people to buy off-line, but with personal service. And I think that is important for products like ours, services like ours because we're not selling items or toys. So I think that's where the difference is going to be Cristina.

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

And last one, any trends you're seeing differently by region across the U.S. for example, urban versus more suburban and in the type of items consumers are buying?

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

Well, obviously, when you look at urban areas like, for instance, New York, obviously, it's almost shut down. I'm talking about Manhattan. Suburbs are a little bit better. And I think that certainly, there has been some -- somewhat of an increase in home office because people are using their homes, and we have been also advertising it too. But overall, really, people are paying more attention to their homes. If you take a look at our advertising, we've gone to an advertising that we have done many, many years back. We said, home is a haven. Our whole advertising is on that concept. Home is a haven. People are spending more time. They're learning how to operate. So it has to be functional, utilitarian, and people have got to be able to combine great design, but also function. And that's what we see.

Operator

Our next question is from Bobby Griffin from Raymond James.

Robert Kenneth Griffin - *Raymond James & Associates, Inc., Research Division - Senior Research Associate*

I jumped on the call late I was having some problems getting in. So I apologize if this was already addressed. But the first question I wanted to ask is maybe about the health of the independent network, the non-company-owned stores?



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

Well, I tell you this. Good news is they are in very good shape for a number of reasons. The average association of our independent family is about 40 years, second generation, third generation. And over the years, the ones who retired, we took over those. So the ones we have are really fairly strong. I have an opportunity of talking to them every week because they want to know how things are. So they are -- they're maintaining their business so far. We have not heard of anybody going out of business, which is a great news.

Robert Kenneth Griffin - *Raymond James & Associates, Inc., Research Division - Senior Research Associate*

Okay. And then how have they adopted to the membership model? What's the feedback you're getting from them on the membership model?

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

Yes. Just a question that was asked. Basically, we decided, I saw in February that things were going to get bad because we saw what's happening in China, what's happening in other countries. So we in March, even before a lot of this emergency was taking place, we said we are going to give the opportunity to every customer to become a member. So every customer is getting the benefits of the membership without having to pay \$100 fee. And we believe in this for the time being, and that's what we're going to do.

Robert Kenneth Griffin - *Raymond James & Associates, Inc., Research Division - Senior Research Associate*

And now is that just temporary? I didn't hear your answer to the prior question on that. Is that just temporary or...

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

No, we'll see, at this stage, we'll continue. It's a great opportunity, great benefit because what it means really is, to a great degree, giving an opportunity of delivering of products free to their homes, which we used to do, which we have done from time to time. We'll continue. We'll see how -- where this crisis leads to. But for the time being, we'll give everybody an honorary membership, and that's what we are doing.

Robert Kenneth Griffin - *Raymond James & Associates, Inc., Research Division - Senior Research Associate*

Okay. And then I guess lastly for me, I saw in the release, the commentary about the China orders, wholesale orders during the quarter. But how have those trended in April and early May? Are you seeing a recovery in our China wholesale order business?

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

Yes. They had gone down quite a bit, not only because of this crisis, but because of all the other issues that were faced in China. The good news is, that actually, just starting in the last month, and it was a good surprise to us, they decided to utilize our television commercial, which really focuses on Ethan Allen, We Make the American Home. With all the conflicts and problems facing and we hear about with China, they decided to use that commercial. And based on that, they are doing some decent business. So we're starting to get back orders after few months of really business being down.

Operator

(Operator Instructions) And there are no further question at this time. Presenters, you may continue.

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

Well, thank you very much. If there are any questions, comments, please feel free to contact Matt McNulty or Corey or even myself, you want to, but both Matt and Corey are available for any questions or comments. Thank you very much for participating. And thank you very much, Lee.

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

Thanks, Lee.

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

Lee, take care.

Operator

You're most welcome. Thank you, everyone, for participating. This concludes today's conference call. You may now disconnect.

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