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ETD.N - Q2 2022 Ethan Allen Interiors Inc Earnings Call

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PRESENTATION

Operator

Good afternoon, and welcome to the Ethan Allen Fiscal 2022 Second Quarter Analyst Conference Call. (Operator Instructions) Please note that this conference is being recorded. It is now my pleasure to introduce your host, Matt McNulty, Senior Vice President, Chief Financial Officer and Treasurer. Thank you. You may begin.

Matthew J. McNulty - *Ethan Allen Interiors Inc. - CFO, Senior VP & Treasurer*

Thank you, Diego. Good afternoon, and welcome to Ethan Allen's Analyst Conference Call for our fiscal 2022 second quarter ended December 31, 2021. Joining me today is Farooq Kathwari, our Chairman, President and CEO. Mr. Kathwari will open and close our prepared remarks, while I will speak to 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 during this call.

With that, I am pleased to now turn the call over to Mr. Kathwari.

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

Thank you, Matt, and good afternoon. I'm pleased that you have joined and happy to provide a brief overview of our results and focus as we move forward.

As reported, we had strong results. Sales increased 16.4% to \$208.1 million. Gross margins increased to 58.8% from 56.7% and adjusted operating margin rose to 15.7%, resulting in adjusted earnings per share of \$0.95, a 37.7% increase. We also maintained strong cash position of \$105.2 million and no debt.

Also as conveyed in our various communications, we are very pleased to celebrate 90 years of innovation and profitability. After Matt provides a brief overview of our financial results, I will review our initiatives to continue our growth in sales and earnings and also continue with strong dividends as we have done. As you know, Matt was recently promoted to CFO after serving as VP of Finance and Treasurer. Matt has a strong public and private accounting and finance background, and I'm very, very pleased to have him here to be part of the team. With that, Matt?

Matthew J. McNulty - *Ethan Allen Interiors Inc. - CFO, Senior VP & Treasurer*

Thank you, Mr. Kathwari. As we celebrate 90 years of innovation throughout fiscal 2022, we saw acceleration in our net sales with both wholesale and retail net sales reporting double-digit growth as well as in operating margin and diluted EPS during the quarter.

While our retail written orders were flat to the second quarter last year, orders were up 45% from 2 years ago. Similarly, wholesale segment written orders were up 1.7% to last year but up 30% compared to the second quarter of fiscal 2020. Our order backlogs at December 31 are approximately 50% higher than a year ago, but becoming more current, and we expect to get caught up during calendar 2022.

Retail net sales were up 24% and wholesale net sales increased 14.2%. Consolidated net sales were up 16% from increased manufacturing production that led to higher delivery combined with the prior year being negatively impacted by COVID-19 production delays. The increased production was partially offset by continued supply chain disruptions, which negatively impacted raw material receipts and imported finished products.

Consolidated gross margin increased 210 basis points to 58.8%, primarily due to a change in the sales mix, benefits realized from the ongoing manufacturing and logistics optimization project and a favorable product mix, partially offset by higher import and raw material costs. The retail sales mix grew to 86.3% of consolidated sales compared to 81% a year ago, which positively impacted our consolidated gross margin. While we are pleased with our consolidated gross margin of 58.8%, we expect our margins to return to approximately 57.5% in the near term due to the impact of rising raw material, labor and freight costs, combined with the return of our sales mix to more historical norms.

Adjusted operating expenses were 43% of sales for the quarter, down from 43.8% last year due to our operational leverage, along with reductions in certain selling expenses, including advertising costs. We reduced our advertising in various mediums, including national TV and regional radio markets, thereby reducing our overall spend to 2% of net sales compared to 2.8% last year. For the rest of fiscal 2022, we expect advertising to be approximately 3% to 4%. Adjusted operating margin, which excludes restructuring initiatives, and other corporate actions increased from 13.1% last year to 15.7% in the current year, primarily due to the strong gross margins and cost containment measures. Adjusted diluted EPS was \$0.95, an increase of 37.7% due to net sales growth, expanded retail and consolidated gross margins, our ability to minimize operating expense growth and improve production and delivery of products, partially offset by higher raw material and freight costs.

Now turning to our liquidity and capital resources. We ended the quarter with \$105 million of cash on hand, an increase of \$11.5 million in the last 3 months primarily from \$5.5 million of cash from operating activities and the sale of 2 properties for total cash proceeds of \$8 million. Our Board also increased our regular quarterly cash dividend by 16% in November 2021 reflecting the strength of our balance sheet and strong history of returning capital to shareholders. In addition, just yesterday, we amended our existing credit agreement, which provides a revolving credit line of \$125 million and extends the maturity of the facility to January 2027. The amended facility also provides the company with the transition to SOFR, improved pricing on borrowings and enhance future flexibility over the next 5 years.

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

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

Thank you, Matt. Our unique vertically integrated structure where we focus on 1 brand from concept of idea to design, to manufacture, retail and logistics has provided us with strong returns in a very challenging environment. Our focus continues on 5 areas of talent, service, marketing, technology and social responsibility.

In the area of talent, I am pleased we continue to make great progress. Importantly, we have strengthened our Board of Directors, our newest member, Gina Casar elected earlier this week, joined us with our directors on this call. Welcome, Gina. Gina has a strong background in management, finance and ESG. During the last quarter, we strengthened our Board. In addition to Directors John Dooner, who is our Lead Director; and Tara Stacom, we were joined by a number of new directors. Cynthia Tsai, background in entrepreneurship and finance; John Clark, background in management and finance, and a President of University here; David Sable, a background of a CEO and a strong marketing background. John Dooner

has a distinguished career including as a CEO of a leading marketing advertising company and Tara Stacom, manages a leading real estate enterprise. So very pleased to have a very strong Board of Directors.

During the quarter, we also promoted a number of our executives. I'd like to mention about Amy Franks, a veteran of 30 years -- [23] (corrected by company after the call) years in our enterprise as Executive Vice President of Retail and Business Development. I mentioned about Matt McNulty being promoted to CFO. Corey Whitely, after 33 years of dedicated service, decided to work for us as an adviser consultant. We thank him for his work throughout this period.

The second area is service. Maintaining about 75% of manufacturing in North America is an important part of our strategy to service and almost all of the 75% is custom-made when orders received from clients. We continue to invest in our manufacturing, including a strong workforce addition to our plants and investing in technology. Our national and retail logistics delivers our products with white glove service at 1 cost nationally. This is a great, great advantage, which we started close to 30 years back.

While we have been impacted with major freight increases internationally and domestically, we have been able to provide good service to our clients. Third area is strong and relevant marketing continues to convey our differences. We have utilized strong digital, print and other mediums to help us reach a larger consumer base at lower costs. The fourth area is technology. Technology enhancements during the last 12 years or so have been critical to help our sales and improve efficiency through our enterprise. And finally, we continue with strong focus on social responsibility, which includes taking care of associates, especially in these challenging times and maintaining strong focus on environmental programs.

Now with this, I'm very pleased to open for any questions or comments.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Brad Thomas with KeyBanc.

Bradley Bingham Thomas - *KeyBanc Capital Markets Inc., Research Division - Director & Equity Research Analyst*

I'm doing well. And let me add my congratulations, Matt for the record here on your promotions. Congratulations.

Matthew J. McNulty - *Ethan Allen Interiors Inc. - CFO, Senior VP & Treasurer*

Thank you very much.

Bradley Bingham Thomas - *KeyBanc Capital Markets Inc., Research Division - Director & Equity Research Analyst*

Well, I had a couple of questions. I wanted to first ask a bit more about the cadence of the business. Still running from an order standpoint at really, really exciting levels from a company perspective and a historic perspective. But I was just curious, Farooq, what you've been seeing lately in orders and how you plan the business for the quarters ahead and think about the outlook for the furniture industry?

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

Yes. The last year was exceptional, Brad. And that, of course, created its own opportunities and challenges with tremendous amount of backlogs. It increased -- it has also resulted substantial increase in our written sales as we have declared. And of course, it also resulted in great impact on our profitability. Now the impact on the -- while we had very, very strong retail orders, the impact really was on the delivery side, on the cost

structure side which we have -- which really impacted everybody in our industry and in fact everybody else. So we were able to manage it because of the high sales that we were able to deliver that took care of some of the major increases that we saw on the wholesale side. Our wholesale side margins were impacted. If it wasn't the fact that we had a strong business in our retail, I mean, we really would have been -- if all our business was wholesale, I think we would have been severely impacted. I think that we have -- last year, and in fact, this last quarter, as you can see, our orders were pretty much somewhat flat compared to the previous year. But if you take a look at it, 2 years back, it was up. How much there, Matt?

Matthew J. McNulty - *Ethan Allen Interiors Inc. - CFO, Senior VP & Treasurer*

45%.

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

45% from the quarter of the previous year. So flat is good because we had very, very strong orders. And I see as we move forward from an orders point of view, I think if we maintain flat or even a little bit lower, we still have a very substantial orders coming in, Brad.

Bradley Bingham Thomas - *KeyBanc Capital Markets Inc., Research Division - Director & Equity Research Analyst*

That's great. And then just on the question of capacity, you were able to deliver more than we would have expected this quarter. Some encouraging execution on your part. Can you just share with us what the outlook is for capacity? And how much do you think you could generate in the quarters ahead?

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

Yes. Because of the fact that 75% of our products are made in our plants in North America, that has been a great help. Although, Brad, we have been impacted by COVID, employees being out. We have been impacted by -- in some -- by cost increases. So what we did was in North America in the middle of last year towards the fall, we decided -- I was actually visiting Vermont, our plants over there.

And we saw that we had to get people. So we decided to increase our base wages and we started getting people in. But still, in our manufacturing, while we have produced well, but it has been impacted by COVID. So going forward, I believe that we have the opportunity to continue to increase our capacities in our manufacturing because we have invested a great deal in technology, and we continue to. Technology, in our wood manufacturing, technology in our upholstery with the newest technology. If we have not done that on the manufacturing side, I'll talk a little bit about on the retail side, too. But that has really helped us.

So I think we do not know where this COVID is heading. But -- at this stage, we have the opportunity to continue to increase our capacities and production. 25% of our products do come from offshore. And of course, as you know, they were impacted with the issue of COVID and major, major transportation costs. Fortunately, we have very, very strong partners. And the interesting thing is that we have a fairly large number of containers coming in. So our overseas is not too bad as well because we have only 25% of our -- which is still a bit large. But if we had 80%, 90%, which most folks do, I don't know -- it really would be a major problem.

Bradley Bingham Thomas - *KeyBanc Capital Markets Inc., Research Division - Director & Equity Research Analyst*

Very helpful. Congrats on the great quarter.

Operator

And our next question comes from Andrew Efimoff with KeyBanc.

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

I wanted to start off by following up on Brad's capacity question. You mentioned that you continue to plan for significant capacity increases in the quarters ahead. But at the same time, this quarter saw -- for the first time, you saw delivered revenue outpace written revenue. And so I'm just wondering a little bit more clarity, do you expect to slow down the rate of capacity increases that you are doing? Or how should we think about that for the coming quarters?

And finally, how should we think about how that translates to delivered revenue. In this last quarter, for example, you saw about a pretty significant, about \$26 million of delivered revenue growth on a sequential basis. Do you expect to see that level of magnitude in the quarters ahead? Or do you expect that magnitude to slow down?

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

Well, there are 2 factors. First is, Andrew, that we do have still a strong backlog. So that backlog is going to enable us certainly in this quarter and maybe in the following quarter, to be able to maintain strong shipments provided, of course, that we don't have any major issues on the supply side. I don't think so, but we always have to keep that perspective in mind. So the capacities that we have increased and we plan to increase, we'll cover the backlogs we have. And then, of course, we also have very strong programs in products and in marketing to continue to grow our business so that any increased capacities should be there for us to grow our business.

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

Understood. And you mentioned that you're seeing a little bit more COVID disruption on the labor side, if I heard you correctly, and that makes sense given the heightened Omicron wave we're in currently. But wondered if you could give us a sense for how those -- that increased COVID disruption may impact delivered revenues for the next quarter or so?

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

Yes, it's a good question, Andrew. Right now, we do see some impact. However, I think that in some areas, it's impacting more than others. It looks like that we'll be able to maintain fairly close to the production levels that we had in the second quarter.

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

Okay. That's very helpful. And then on written sales, I know that you gave some commentary, but just wanted to follow up here. While written sales were flattish for the quarter, it was good to see the acceleration on a 2-year basis, at least for the retail written orders. Could you talk about what drove that acceleration? Or if that was more because of the timing of the membership model actions you had about 2 years ago? Just any color there would be great.

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

Yes. You're talking about the increase from not the last quarter, but the previous year. And yes, it had a number of factors. Of course, first is that consumer interest in the home has continued to be strong. And that to me is the main factor. The second is that our competitive advantage of having about close to 1,500 interior designers in our network who are -- who have been empowered with technology.

I would tell you, Andrew, that if we had not in the last 8, 10, 12 years invested in technology with our designers, training them to be able to work virtually from home, from the design center, working with clients, we would not have the business we have. So today, combining the professional

work of our designers with technology is critical to not only what we have done but critical to the future. And I think that will be very important as we move forward.

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

Understood. And I guess, for my last question here, in your prepared remarks, you noted that you plan to take some additional selective price increases to further counter the rising costs you are seeing. I know that you have already implemented some price increases and some reduced discounts to offset the higher prices previously. But I was wondering if you could share -- if you have it, if you could share how much higher your average prices are currently tracking versus pre-pandemic levels? And going forward, how much more do you expect to increase that to fully offset the cost inflation impact?

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

Yes, Andrew, first of all, our values of our products are excellent because we really haven't taken the price increases to take care of all the increases, especially from a transportation to raw materials to everything else. I would say that we have done it selectively in the sense, many of our product programs coming from offshore had to be increased first, and that's what we did. And those increases were fairly large, anywhere from 15% to 25% based upon -- the cost of a container has gone from \$2,000 to \$24,000.

I also mentioned, which is a very unique setup that we have, which really helps our retailers, both our company-operated and especially our independents, which is that we deliver our product at 1 cost to them, whether you are in Seattle or Texas or wherever. So we have also had to absorb domestic cost increases in transportation, which while not being at the level of the international still have been high, maybe 8% or 10%. So we have absorbed that, and that is why our retail margins, in addition to the fact we had very high sales, but the fact is their cost did not increase like any -- I would think any other retail in the country.

So going forward, I think we'll be able to maintain this advantage that we have of our vertical integration. We will take some more selective price increases, but I would say that if you have to average it out, it's about a 10% price increase.

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

Understood. That's helpful and great to hear.

Operator

Our next question comes from Cristina Fernández with Telsey Advisory Group.

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

Congratulations on a good quarter as well. I had a couple of questions. I wanted to see if you could talk about, as you've been able to increase manufacturing and deliver more goods, I mean, are customers seeing shorter order to delivery times? Or is it too early?

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

No, for us. That's a good -- that's a really good comment because our advantage is the fact that our -- let us take upholstery, which represents about 50% of our total business. Our upholstery, average upholstery delivery time, and this is custom is about 8 to 10 weeks. And I would think now because, again, it might be a little bit larger if it goes to Seattle or it goes to some other places because upholstery is made in North Carolina and in Mexico -- Silao, Mexico. I would think that most folks have a much, much larger lead time.

Same thing in our wood products, it's a little bit larger because of the backlog that we have. And keep in mind, almost 100% of the products we make in North America is custom when we receive the order. So there, I would say that our delivery time in our wood products ranges from anywhere from 12 to 15 weeks, which is still much, much lower than what we have what the industry has.

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

That's helpful. And then with the supply chain going on delays in your manufacturing capacity, are there any other -- are there any -- are there product categories that you might consider like bringing back to North America?

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

Well, yes, it's a good question. We are looking at it. But keep in mind, we, against all odds, we maintain manufacturing in North America, both in the United States, but then we decided that we also had to go south of the border.

And that was a very important move for us. Mexico, we went about 20 years or so back. And Honduras, we went about close to 10, 11 years back. So we've invested a great deal, I would say, over \$100 million in those facilities to be where we are, otherwise we would not be. So we have the opportunity, certainly in furniture, but we're also looking at the opportunity on nonfurniture products being more made in North America.

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

And then last question I had in the -- the SG&A had a step-up this quarter, maybe this is more for Matt to about \$90 million. They have been trending lower. Is this, I guess, more structural driven by higher wages and cost? Or is it just due to the higher sales, maybe you can help us think about SG&A going forward?

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

I'll say but Matt can follow up because Matt is pretty smart on this. But I tell you this, most of it is good news. It is based upon the written sales in our retail. Our designers have done an excellent job and they've been rewarded with a fair amount of money, and that's where most of it is and some in transportation. Matt, go ahead.

Matthew J. McNulty - *Ethan Allen Interiors Inc. - CFO, Senior VP & Treasurer*

Yes, you're making my job a lot easier. But as a percentage of overall sales, our SG&A was actually down a little bit, right, from 43.8% to 43% flat. And most of the overall dollar increase though was exactly what Mr. Kathwari said, driven by increased sales, higher freight costs. So delivery fees are included in there as well as compensation to our interior designers. So we want to see -- that designer comp going up means there's more written and more sales going on. So that is why you saw that come up to about \$90 million.

Operator

There are no further questions at this time. I'll turn the floor back to Mr. Kathwari for closing remarks.

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

Well, thank you. Again, I'm very, very gratified at the work that our people have done. Our teams have done an amazing job. And we'll continue to maintain our focus, maintain to make sure that we focus on providing great quality, great service and maintain and continue to -- and improve our retail network plus also our manufacturing in North America. So again, thanks very much.

Operator

Thank you. This concludes today's conference. All parties may disconnect. Have a great evening.

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