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ETD.N - Q3 2022 Ethan Allen Interiors Inc Earnings Call

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PRESENTATION

Operator

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

It is now my pleasure to introduce your host, Matt McNulty, Senior Vice President, CFO and Treasurer. Thank you. You may begin.

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

Thank you, Paul. Good afternoon, and welcome to Ethan Allen's analyst conference call for our fiscal 2022 third quarter ended March 31. 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 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 transcribed and recorded live on ethanallen.com, where you will find a copy of our press release which contains reconciliations of non-GAAP financial measures referred to in the 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'm 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, and thank you for joining our third quarter earnings review call. We continue to make good progress in many areas, resulting in strong financial results for the quarter ended March 31, 2022. Sales of $197.7 million increased 11.7% from previous year quarter. Strong gross margins of 60.4% compared to 57.3% in the previous year quarter.

Control over our operating expenses resulted in adjusted operating income of $31.3 million, a 59.9% increase. Our adjusted EPS of $0.93 increased 60.3% from the previous year quarter.

After Matt McNulty provides a brief overview of our financials, I will talk about areas of focus. And with that, Matt, please take over.

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

Great. Thank you again. Consolidated net sales increased 11.7% as a result of strong demand and increased levels of manufacturing production that led to higher deliveries, combined with the prior year being negatively impacted by COVID-19. The increased production was partially offset by ongoing supply chain disruptions, which negatively impacted imports and raw material availability. As the third quarter progressed, we saw an increase in receipt of product from a higher volume of shipping container receipts.

Our retail orders were down 3% compared to a very strong prior year comparable. However, retail orders were up 18.2% compared to our pre-pandemic fiscal 2019 third quarter. Wholesale segment orders were down 0.2% to last year, but were up 8.4% compared to the third quarter of 2019.

The higher level of product demand that we continue to experience has also led to an increase in our backlog despite the fact that our manufacturing production levels have returned to pre-pandemic levels. Delivery lead times remain higher than historical average as the first half of our third quarter was marked with higher COVID-19 absenteeism among our employee base, raw material constraints and supply chain disruptions. However, March had strong production and related deliveries that enabled us to decrease backlog during that month. With that said, our order backlogs remain high, and at March 31, were approximately 25% higher than a year ago.

Consolidated gross margin increased 310 basis points to 60.4% primarily due to a change in sales mix, higher manufacturing productivity, previous product pricing actions that are beginning to work their way through our P&L and a favorable product mix, partially offset by higher import and raw material costs. The retail sales mix grew to 84% of consolidated sales compared with 79.9% a year ago. While we are pleased with our consolidated gross margin of 60.4%, we expect our margin to return to approximately 58% in the near term due to the impact of input costs and a return of sales mix to more historical norms.

Our operating margin increased from 10.7% last year to 16.5% in the current year third quarter. Adjusted operating margin was 15.8% of sales, up from 11.1% of sales last year due to fixed cost leverage on the higher sales volume, strong retail gross margins and cost containment measures, including lower marketing costs due to a change in marketing initiatives as will be discussed by Mr. Kathwari shortly.

Now turning to our liquidity and capital resources. We ended the third quarter with a strong balance sheet, including cash and investments of $104.6 million and no debt. We generated $17.3 million of cash from operating activities in the quarter due to strong net income and increased customer deposits, partially offset by additional purchases of inventory to support increased production as well as to help protect against future supply chain disruptions and price increases.

Capital expenditures were $5.3 million and primarily related to the expansion of our upholstery manufacturing in North Carolina, construction of 2 new retail design centers, spending on design center projection improvements, manufacturing plant upgrades to further increase capacity and efficiency and investments in technology.

Reflecting the strength of our balance sheet and strong history of returning capital to shareholders, our Board declared a regular quarterly cash dividend of $0.29 per share in January which was subsequently paid in February, bringing the total year-to-date dividends paid to $40.1 million. Also, as just announced this past Tuesday, our Board increased the regular quarterly cash dividend by 10% to $0.32 per share, which will be paid in May.

Lastly, as mentioned on our January earnings call, we amended our existing credit agreement to provide us a revolving credit line of $125 million and extend the maturity of this facility to January 2027. The amended agreement also provides us 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*

All right, Matt, and I would just like to tell everybody that I was actually coming from New York to Washington. Plane got delayed, and I got into this office where I'm talking from just at 4:59, so 1 minute before this call. Things work out. So I'm actually speaking from my mobile phone, and covering a lot of good areas today.

Now our focus during the quarter continued on our key areas which will help us to continue the progress. The first area is talent. The development of strong talent continues to be an important area of focus in our vertically integrated enterprise. We promoted a number of key associates, including within our retail division and business development, product development, marketing, manufacturing, finance, technology, operational and logistics. We are -- I'm very pleased that we have a strong team in place.

The second area of focus is service. Improving our capabilities to increase production has been key to improving our service and shipments. About 75% of our products are made in our North American workshops, and almost all made custom when order is received. This requires effective management of inventories and parts to help manufacture in a timely manner.

We continue to greatly improve our delivery time. Our custom upholstery products, made in our North American workshops, ship in 7 to 9 weeks, as compared to 15 to 17 weeks 6 months back. We're also making good progress in improving shipping times in our wood products made in our North American workshops, now averaging about 10 to 12 weeks as compared to 14 to 16 weeks.

Continued investments in our workshops -- workforce and technology in our North American workshops have been key to increased production and efficiency. We acquired a new 50,000 square-foot upholstery manufacturing operation in Claremont, North Carolina and continue to consolidate technology operations in our recent 80,000 square foot addition to our Maiden, North Carolina upholstery operations. We also continue to invest in technology in our Vermont, Mexico and Honduras manufacturing workshops. We are pleased that we have, over the years, invested a great deal in our manufacturing and in our logistics.

Just to give you a perspective, in our case goods, we have close to 1.3 million square foot of space in our manufacturing. We own all of it. In upholstery, also close to 1.3 million square feet. In logistics, also 1.2 million square feet. This is our national logistics. All of this has really given us a great opportunity to improve our business model.

In our marketing, our focus has continued to reach a larger consumer base, utilizing many new models of communication, greatly increasing our reach while reducing costs. We have greatly reduced the cost of producing our advertising content, thereby further reducing expenses. Now while we have overall reduced our cost, we have been able to maintain effectiveness. Most of our money has been spent in advertising in the various mediums, not in producing it.

During each month -- our digital mediums have been key in our marketing efforts. During each month, we are now reaching about 20 million households through our 3 36-page digital mediums. During the quarter, we also ran national and regional television commercials. We also selectively utilized other mediums such as printed direct mail.

Another important effort has been the grassroots effort of our over 1,000 retail design associates and management who are reaching clients via social media. We have continued to add new products as we feel comfortable with our ability to service effectively. We have a strong product program ready for launch. And as we feel comfortable with our service position, we will launch them.

Now another area has been the major focus on technology. Investments and initiatives in technology, in marketing, manufacturing and logistics continues to be key in improving our ability to service our clients, increase our sales and profitability. Combining personal service of our interior designers and technology continues to be a game changer. We have maintained strong business during the last 2 years of COVID due to a number of factors such as offering quality, value, 75% made in our North American workshops, and importantly, due to combining personal service of our interior designers with technology. This continues, as I said, to be a game changer.

Continued repositioning of our retail design centers with smaller size excellent locations is tremendously important and the use of technology in our retail. We recently opened 2 new design centers projecting this concept, 1 in Westport, Connecticut. And second one, just 2 weeks back, in

Walnut Creek, California, which is in the San Francisco area. In March 2018, in our Retail division, we had about 1,900 retail associates and 900 designers. Today, we have 1,200 retail associates and close to 600 designers, so about 1/3 less. And the written is up considerably, and the quality of our teams is making this happen.

Finally, our social responsibility and safety is always a focus. Managing our enterprise in a socially responsible manner has been part of our 90 years of innovation. We have continued to receive many commendations and awards in conducting our business in a socially responsible manner. We believe that is an essential part of our DNA.

With this brief overview, I'm happy to open to any questions or comments.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question is from Brad Thomas with KeyBanc Capital Markets.

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

A couple of questions, if I could. First of all, Farooq, I was hoping you could talk a little bit more about the cadence of business. We've heard from some other retailers and manufacturers of home items and furniture and mattresses that things have been a little bit softer over the last month or so here. I was hoping if you could just comment a little bit about the pace of business and what you've been seeing as we moved into April.

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

Yes, Brad. There are 2 factors in here. One is the question relative to the very, very strong businesses that we have seen in the last 6 months. We have continued that in March. I think in April this month, of course, it's not finished. But I think we can see that people are being cautious. And I think it was to be expected.

So I think that, I think that people are cautious. But on the other hand, they're also looking at much more clearly -- carefully on value, value in terms of quality, in terms of pricing and in terms of service. The good news is that we are pretty much well positioned in all those areas. So while we do expect people to not to have the kind of a crazy thing that happened in the last 1.5 years, that business will slow down, but I think we will be able to continue to maintain our momentum as we move forward.

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

Got you. That's helpful. And how would you all characterize the backlog today? I know you're having success reducing some of the delivery times, as you mentioned. But I think when we look at the customer deposit numbers, it's one of the highest numbers we've seen in company history. So how should we think of the size of the backlog and the opportunity for that from a revenue perspective?

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

Yes, I think that if you take a look at our backlog, for instance, compared to our retail and wholesale backlog is up between 22%, 23% compared to the previous year, even after very strong deliveries. So I think that certainly, for the next few months, we will work to continue to reduce its backlog. We have already reduced the time frame, as I mentioned, in terms of our deliveries, which is, of course, also positive because of the fact we make it.

So I think that right now, backlogs are decent. And we -- but our production has also increased. So I think we will continue to improve our shipments and deliveries, and the backlog will most likely continue to go down, although it is at a decent level right now.

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

Great. And Matt, I think I heard you make a comment about the gross margins being in the 58% range. Did I hear you right? And were you focused on a particular quarter or the annual level? What was the comment on gross margins?

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

Yes. So we ended this quarter, Q3, at 60.4%. But we expect it, with some higher raw material and freight costs continuing and uncertainty out there, we expect it to come down a little bit. We provided the number, 58%, and that's in the near term, not specific to 1 particular quarter, but in the near term.

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

And again, that is -- Brad, it just -- we're just making certain assumptions on gross margins. Right now, it's 60.4%. It's at a record high. And if you take a look at it, last year, coming into our fourth quarter, our gross margins were at about close to, I think, 58.7% -- 58.7%. Correct, Matt?

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

Correct. Yes. Yes. Correct.

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

So we already were still quite high. So I think that what Matt is saying is that most likely between 58% and 60%, that's most likely where we'll end up.

Operator

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

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

I had a couple of questions as well. I wanted to start with, if you can give more color on what you're seeing as far as cost inflation versus the last time we had the call. And also, the level of price increases. I think last time you said you had raised prices around 10%. Is that still the case? Or are you finding that you need to raise prices more to offset cost inflation?

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

Yes. These are very important areas, Cristina. Now -- we're -- Matt has -- I mean, I have the numbers, too, but Matt, you and I were discussing the numbers. In terms of -- we have a number of factors. One is, fortunately, that most -- 75% of our products are being made in North America. These products have been less impacted than our imported products. Our imported products, Matt, correct me, but we are talking often, we have seen an increase of anywhere from 20% to 25%.

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

That is correct.

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

And while our domestic, I mean, on North America, you're talking of that mix, I mean, maybe 10% or 12%. And so I think that -- and a lot of this -- international has been also with the impact of the freight costs going. We also, of course, as you know, deliver our products at one cost nationally. And that has also -- we've had some impact on the cost of transportation domestically. Maybe -- and I'm talking about domestic in North America. I mean, from Mexico to Honduras to North -- to our facilities and then shipping it to all our retail network, I think that also has gone up 8% to 10%.

So I think going forward, most likely, we are most -- I would think that we have seen the worst of the increases that certainly in transportation and overseas. We have taken price increase, I would say, averages between 10% and 15%. And as we move forward, we will continue to look at our pricing to see what increases we may have to take, but perhaps anywhere between 5% and 10% in the next 6 months possibly. And that's what we're looking at, Cristina.

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

Okay. No, that's very helpful color. And I guess as a follow-up, how are you reconciling the price increases that you need to take to offset cost inflation with the consumer being a little bit more cautious when it comes to pricing and values? I guess, did you expect -- because we get asked a lot about promotions, and promotions have been still low year-over-year, I guess. How are you thinking about your promotional tone as the year progresses?

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

Yes, that's a good question. We have maintained approximately a 20% savings on our, what we say, everyday best price. I think that one has to be careful and concerned about the fact of what kind of price increases the consumers will accept. We have been very careful because, again, the fact of 75% being made in North America where the prices really have been impacted to a great degree, have been all the offshore product, both in the cost of the product, but most importantly, in the transportation. As you know, cost of a container has gone from $2,000 to $30,000. We have not, fortunately, seen that domestically.

So I think you're right. We are being very cautious in our price while we are taking price increases. We also have been able to offer people special savings, and we'll continue to do that. We'll continue to make sure that we are competitive, and we keep that into perspective that consumer is not going to continue to keep on just paying more higher prices.

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

Yes. Absolutely. Then I guess another topic I wanted to discuss was on marketing. I mean you commented about how you've been able to be more efficient with marketing. Last call, there was a number talked about getting marketing back to 3% to 4%. Is that still the target? Or you think you can come below that just based on the changes you've made?

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

Well, this quarter, we -- Matt, what did we spend? 3% or less? What did we spend?

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

2.3%.

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

2.3%. Now there are a number of factors. Interestingly, as I mentioned in my comments, while we reduced our expenditures, we were more effective. Number of reasons. First is, we also reduced -- in our marketing, keep in mind, when we talk of 3% or 4%, it also includes -- it includes the -- all our costs of producing our marketing, that's our advertising costs, our photo studio costs, and then also actually placing the advertising. So our marketing costs include all of that.

We have been able to, through many factors, reduce substantially our cost of production. And then we have also reduced the mediums that we are using. For instance, we spent a fair amount of money on direct mail, printed direct mail. Now in the last year or so, 2 years, we have been increasingly using digital mediums. For instance, we are now sending out, as I mentioned, 3 direct -- 3 digital media magazines. 2 years back, we didn't even think of it.

So the mediums are changing, plus also the cost of producing is changing. So having said all of that, but I think keeping anywhere around between 3% and 4% for budgeting purposes, I think is a fair thing to keep in mind.

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

Okay. And then I just had one last one, and it's on sort of like the new product introductions. I noticed that you introduced flooring LVT, which is a new category for Ethan Allen and more on the home improvement side. So can you talk about why decided to expand to that category? Is that product you're manufacturing yourself? And just how is -- are the new product introductions this year compared to last year?

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

Yes. I mean, we have introduced products based upon also availability, but also, obviously, in our ability to sell the products. This flooring program is a very innovative concept. It's a product that is being -- that is sold by our designers. And it is -- it can be used, it can be applied without putting in all kinds of materials. It is -- it works in a manner that -- it's put together. It joins together as the product rather than having be cemented or things like that. So a much, much easier way of using it. Now we do have, and always had, a strong program in carpeting, in area rugs. So we look upon this as an addition to those programs and has been very well received.

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

Good luck this quarter.

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

All right. Cristina, thanks very much.

Operator

Thank you. It looks like there are no further questions in the queue at this time. I'd like to turn the floor back over to Farooq Kathwari for any closing comments.

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

All right. Well, thanks very much, and thanks, everybody, for joining. And I want to also thank our teams for doing a great job. And we look forward to continuing our progress and growth. So thanks very much.

Operator

Thank you. This concludes today's conference. You may disconnect your lines at this time. Thank you for your participation.
