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ETD.N - Q2 2023 Ethan Allen Interiors Inc Earnings Call

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

PRESENTATION

Operator

Good afternoon, and welcome to the Ethan Allen Fiscal 2023 Second Quarter Analyst Conference Call. (Operator Instructions)

Please note that this conference is being recorded. It is now my pleasure to introduce 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, Camilla. Good afternoon, and thank you for joining us today to discuss Ethan Allen's Fiscal 2023 Second Quarter Results. With me today is Farooq Kathwari, our Chairman, President and CEO. Mr. Kathwari will open and close our prepared remarks, while I will speak to our financial performance 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 under the News and Events tab on the Investor Relations page of our ethanallen.com website. There, you will also 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.

Our comments today may 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, Matt, and welcome to our second quarter fiscal 2023 earnings call. We are pleased with our results. Our sales of $203.2 million were the result of many factors, including strong offerings and interior design destination, 75% products made in our North American workshops, a unique logistics network where we provide personal in-home delivery at one delivered price to our clients in North America. Combining the personal service of our interior designers with technology has been a game changer. We were also helped by a stronger backlog of orders.

Our gross margin increased to 61% and operating income margin increased to 18.2%. Our adjusted earnings per share of $1.10 grew by 15.8%. We ended with strong cash of $140.4 million and no debt. Our unique vertically integrated structure continues to be strengthened.

And after Matt provides a brief overview of the financials, I will review our focus and opportunity going forward. Matt?

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

Thank you, Mr. Kathwari. As a reminder, we present our financial results on both a GAAP and non-GAAP basis. Non-GAAP results include restructuring initiatives, impairments and other corporate actions and are further detailed in our press release. We believe that these non-GAAP presentation better reflects underlying operating trends and performance of the business.

Our consolidated net sales of $203.2 million were helped by strong backlog, pricing actions taken and the positive effects of product mix, partially offset by lower unit volume. The prior year second quarter was one of the largest historical second quarter for net sales, which led to a difficult comparison. Compared to the second quarter of fiscal 2019, which is prepandemic and more reflective of historical norms, our consolidated net sales were up 3%.

We ended the quarter with wholesale backlog of $78.5 million, down 36% from a year ago as we were able to reduce the number of weeks of backlog, bringing it more current. We remain 57% higher than pre-pandemic wholesale backlog levels. Wholesale segment written orders were down 20.2% to last year and down 18.6% to the pre-pandemic second quarter fiscal 2019, primarily due to lower international orders and the timing of incoming GSA orders.

Our retail orders were down 16.3% due to a strong prior year comparable. However, when compared to Q2 of 2019, retail orders were only down 1.5%. Consolidated gross margin grew 220 basis points to 61% in the quarter from product pricing actions, a favorable product mix, disciplined promotional activity and lower inbound freight costs, partially offset by a change in our retail wholesale sales mix and a decrease in unit volume. We had expected this percentage of retail sales to consolidated sales to moderate towards normalized levels and this began to take shape in Q2. Retail sales were 84.5% of consolidated sales, down from 86.3% last year, as we delivered out more of our wholesale order backlog.

Adjusted operating margin increased from 15.7% last year to 18.1% in the current year second quarter due to wholesale gross margin improvement and maintaining a disciplined approach to cost savings and expense control, partially offset by lower net sales and high retail delivery costs. Our SG&A expenses decreased from 43.1% of net sales last year to 42.9% this year, reflecting our ongoing operating leverage despite a declining net sales environment. Adjusted diluted earnings per share was up 15.8% to $1.10 due to improved gross margins and a reduced expense base. Our effective tax rate for the quarter was 25.7%, the same as last year.

Now turning to our liquidity and capital resources. As of December 31, 2022, we had cash and investments of $140.4 million with no outstanding debt. Our sources of liquidity include cash and cash equivalents, short-term investments and amounts available under our credit facility. We generated $2.5 million in cash from operating activities during the quarter, bringing our total up to $40.9 million during the first half of 2023, an increase from $22.7 million in the prior year period due to higher net income and an improvement in working capital.

Capital expenditures were $5.3 million for the quarter and included investments in various areas within manufacturing, technology and retail. In November, our Board declared a regular quarterly dividend of $0.32 per share, which was paid on January 4. And just yesterday, as announced, we declared another regular quarterly dividend of $0.32 per share payable on February 21.

In summary, we increased gross margin, operating margin, operating income, net income and diluted EPS during our just completed second quarter despite operating in the current environment.

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

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

All right, Matt, thanks. We have substantially strengthened our offerings and new products will be introduced in the following 6 months. During the last 3 years, while we introduced only limited new products, the good news is we were busy developing strong new products. We have also greatly enhanced our marketing, combining traditional mediums increasingly with digital mediums.

Our supply side is stronger. About 75% of our products are made in our North American workshops, and about 75% made custom on receipt of orders. Our production capacity in North America has been increased with 2 very important factors: first, addition of qualified workforce and continued investments in technology. We are in a good position to service our clients. Our design centers are being refreshed and reintroduced as an interior design destination with very talented interior designers. We are reinventing the projection of our design centers with more fashionable and relevant projection.

Our plan is to convert most of the 173 design centers in North America in the next 12 months to this very exciting projection. We also plan to review the projection with our international partners. Combining technology with personal service of our craftspersons in our manufacturing and interior designers in our retail network has been a game changer. We are in a good position to continue our progress and maintain strong financial results.

With this, pleased to open for questions and comments.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our first question will come from Brad Thomas with KeyBanc Capital Markets.

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

Well, congratulations on the strong earnings here for this quarter. I thought the gross margins were particularly impressive. I was hoping you could talk a little bit more about how you're thinking about gross margins going forward? And if you feel like the industry is getting more competitive and if that's a risk for you?

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

Yes, Brad, we have had, as you said, very strong gross margins, which is, of course, a combination of higher volume and also reflects the improvements that we have made through technology. In terms of, for instance, in our manufacturing, just to give you a perspective, just from 2019 to now, we have increased our sales, actually over 7%, while our headcount overall has gone down by about 24%, very important, which is a result of having better quality people and technology at manufacturing, at our retail. So those are the factors that have helped us become more productive. Then, of course, also higher volumes do benefit gross margins, especially from the manufacturing side. But I think going forward, I think where we are in gross margins, our objective is to continue with that.

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

That's great. And Farooq, with the orders starting to slow a bit, of course, the whole industry benefit from volume during the pandemic and the orders have slowed a bit, how do you think about the cost structure of the business and the levers that you might pull if we see sales declining going forward here?

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

Yes. Our backlogs are, of course, very, very high. Well, good news is that while we have able to increase our production, deliver the products, reduce our backlogs, our backlogs are still decent, to start with. However, yes, we're watching very carefully the business, watching very carefully the environment. And we always have operated, as you know, you might say lean. We'll continue to do that. But at this stage, with our structure in place, both in terms of much fine-tuned manufacturing, fine-tuned retail network, our logistics. Just keep in mind, it was not that many years back, we used to have 30 manufacturing plants. Now we have Vermont, North Carolina, Mexico and Honduras. That's -- and that is producing twice as much the 30 did in North America. Similarly, logistics. We have 10 major national distribution centers. Now we have 2. So we have done a lot of work in terms of becoming more efficient, which is going to help us, Brad, as we go forward. But however, we are watching very carefully, the markets, the sales, the consumer attitudes. And so we will have to make some adjustments if sales don't hold up.

Operator

(Operator Instructions) our next question will come from Cristina Fernández with Telsey Advisory Group.

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

I had a couple of questions. Can you provide more color on what you saw around demand, the order intake for the quarter, how did it progress? Were there any categories or product lines that were more affected than others or any regions? Any callouts would be helpful.

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

Yes. Of course, when we compare this last in terms of the written business compared to the previous year, the business, of course, was down from very, very high levels we had in the previous year. But overall, we have had a very strong business in our upholstery business. Our upholstery has held up quite well. But also, we saw an increase in our accent programs to support the work that our interior designers are doing. Where, of course, the major factor has been the interior designers ability to utilize technology to help. That has really been a very important factor. And when they do that, they then are able to provide a much, you might say, a more total solution rather than selling items and products.

Because of that, we have seen -- we have maintained a good business in our various categories from our -- you might say, our living room, to dining room, bedroom and accent. So we continue -- I think we're going to continue to see that because our business has more and more gone towards interior design. That's why, Cristina, I said, and in fact, I'm sure you've seen in all our marketing and communication, our message is we are an interior design destination. Because we have today about -- when we look at our REIT designers, we have about 30% less designers than we had 4 or 5 years back, but more qualified, more talented. And in the last 2, 3 years, we have invested a great deal, and we're going to continue to invest a great deal in providing technology to them as we have been doing in our manufacturing. That's what we see, Cristina, going forward.

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

That's helpful. I had a second question, which is a follow-up on Brad's question about the cost structure. If quarters were to remain at this level and sales eventually go back to the pre-pandemic level, that was around $750 million annually, what level of operating margin do you think you can achieve in this scenario with the changes you've made to the cost structure?

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

Well, that's a good question. And I think that when you take a look at our gross margins, for instance, even when you go back to the pre-pandemic levels, they were at about 55%, 56%. When you look at our operating margins, our operating margins were also, at that time, 11%, 12%. So we are, of course, comparing 11%, 12% to 18%, I think we have an opportunity -- those were really on the lower side, which, of course, when you look at the industry, even at 11% is a pretty high margin. So I think we have an opportunity of maintaining higher margins, whether we can maintain it at 18% or so will depend upon our sales and how much we are able to deliver. But we have a good opportunity of maintaining stronger margins. Because of the fact of strengthening our retail network, strengthening our operations, our manufacturing, we have spent a lot of time on our logistics. So our cost structure today is lower with higher volume than it was 4 or 5 years back. But of course, it will also depend upon sales going forward.

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

Okay. That's helpful. And then the last one was on the refreshes for the interior design centers that you talked about. Can you provide more specifics exactly what will be new or refreshed at the -- in the stores?

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

Yes. I think that's a very important development. In fact, in March, we are going to have our Danbury design center, and also one in Manhattan, which is a new one that will open up, will really project what we are talking about the next Ethan Allen projection of design centers. We've been working on it. And that projection is going to be stylish, it's going to be more designer oriented. And that will then, as we do in January, we are also right now planning that in the next 1 year, almost all our 174 design centers in the country. That's our plan to renovate them to the new projection. The projection is higher end. The projection is style, color. And I'm sure that we are already doing a lot of it.

And if you take a look at our advertising, I don't know if you're getting our printed magazine. And in fact, today, I didn't talk much of marketing, but we are sending out 9 million digital magazines every 2 weeks. It was impossible to think 5 years back. It used to take us 2 months to make up a 32-page magazine. But today, with digital advertising, we have a very strong photo studio here, and then we're also fortunately able to use one in Ukraine, which does an amazing job in terms of providing us with digital photography. So digital is tremendously important. Our designers today are able to work with clients, whether they're in their homes, whether they're in the design center. So combining personal service and technology is tremendously important. And that's what we see, Cristina, in the next year or so. That is our design centers are going to be more design center rather than a furniture store.

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

And 1 last one. Is there a CapEx increase, or like how much you see investment you need to make to refresh all the design centers?

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

It is not going to be major because most of the work -- I mean, our design center is in good position. Most of it, refreshing is going to be paint, color and new products.

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

Okay. Helpful. Best of luck this quarter.

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

Thank you very much.

Operator

(Operator Instructions) There are no further questions at this time. I would like to turn the floor back over to Mr. Kathwari for closing comments.

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

All right. Well, thank you very much. Look forward to continuing our journey. I was just mentioning to Matt, that -- and Matt was mentioning to me that this is our -- and mine, 108th consecutive quarterly meeting. So it's great to see you all to talk to you, and we have -- and I always say we're just getting started. So thanks very much and look forward to talking to you soon. And Camilla, thanks.

Operator

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