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ETD.N - Q2 2024 Ethan Allen Interiors Inc Earnings Call

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Budd Bugatch *Water Tower Research LLC - Head of Consumer Hardlines*

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PRESENTATION

Operator

Good afternoon, and welcome to the Ethan Allen Fiscal 2024 Second Quarter Analyst Conference Call. (Operator Instructions) Please note, this conference is being recorded.

It is now my pleasure to introduce you to 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, Alicia. Good afternoon, and thank you for joining us today to discuss Ethan Allen's fiscal 2024 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 transcribed and webcast live under the News and Events tab on the Investor Relations page of our website. There, you will also find a copy of our press release, which contains reconciliations of non-GAAP financial measures referred to on this call and in the press release. A replay of today's call will also be made available on our Investor Relations website.

Our comments today may include forward-looking statements that are subject to risks and uncertainties that could cause actual results to differ materially. The most significant risk factors that could affect our future results are described in our annual report on Form 10-K. 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*

Thanks, Matt, and good to have you all joined. We are pleased to review our second quarter results and our initiatives to continue to strengthen our enterprise and our strong financial results. We are very well positioned. And after Matt provides a brief overview of our financial results for the second quarter ended December 31, 2023, I will review our initiatives and focus to continue to strengthen our enterprise and maintain strong financial performance. 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 exclude restructuring initiatives, impairments and other corporate actions, we believe the non-GAAP presentation better reflects underlying operating trends and performance of the business.

Our financial results in the just completed second quarter are highlighted by strong margins, lower sales and a robust balance sheet. Despite operating in a softening economy, our operations produced positive financial results, which I will now discuss.

Our consolidated net sales totaled \$167.3 million, reflecting lower delivered unit volume, reduced manufacturing from lower backlogs and a strong prior year comparable. Written order trends in the quarter were impacted by continued softening of the home furnishings market, reduced design center traffic and strong prior year demand. Wholesale segment written orders decreased 10.9% compared to last year, while retail segment written orders were down 9.4%. We ended the quarter with wholesale backlog of \$54.9 million, which is near pre-pandemic levels.

We improved customer lead times and reduced the number of weeks of backlog, bringing it more current. Helping to reduce lead times within casegoods was increased production in Vermont as we recover from significant flooding that occurred in July 2023. Our Vermont wood furniture plant has resumed operations and operated at approximately 75% capacity during the just completed quarter.

Consolidated gross margin was 60.2%, our 11th consecutive quarter that consolidated gross margin exceeded 58%. Our current quarter consolidated gross margin was impacted by deleveraging from lower unit volumes, combined with the change in the sales and product mix, partially offset by lower input costs and headcount.

Adjusted operating margin of 12.8% reflects lower sales, gross margin erosion and incremental costs from our design center refresh and grand reopenings. These costs were partially offset by lower headcount and our ability to maintain a disciplined approach to cost savings and expense control.

Our SG&A expenses decreased 9.1% and equaled 47.3% of net sales, up from 42.9% last year due to fixed cost deleveraging. On a sequential basis, our adjusted operating margin improved 70 basis points as we increased sales by 2.1% while reducing SG&A expenses by 1.4%. And when compared to our pre-pandemic 2018 second quarter, our operating margin has improved even more, up 460 basis points. Adjusted diluted EPS was \$0.67. Our effective tax rate for the quarter was 25.5%, comparable to 25.7% a year ago.

Now turning to our liquidity. We ended the quarter with a robust balance sheet, including cash and investments of \$167.8 million and no outstanding debt. We generated \$13.6 million of cash from operating activities during the quarter driven by strong profits, improved cash collections and lower inventory levels. In November 2023, we paid a regular quarterly cash dividend of \$9.2 million or \$0.36 per share. Also, as just announced yesterday, our Board of Directors declared a regular quarterly cash dividend of \$0.36 per share, which will be paid in February. We are pleased to pay cash dividends while maintaining a strong cash position.

In summary, our vertically integrated enterprise was able to produce a double-digit operating margin during this post-pandemic period marked by industry-wide softening demand. Our business model generated strong positive cash flow and protected our operating margin as we remain committed to disciplined investments and strong expense management.

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

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

Well, thank you, Matt. As we mentioned in our press release, we are now entering the post pandemic period. The pandemic period, defined as fiscal year 2021 through 2023, reflected strong consumer focus on home, high demand and major increase in sales. We had record high backlogs, which are now returning to pre-pandemic levels. For the second quarter ended December 31, 2023, gross margins increased to 60.2% compared to 55.2% for the quarter ending December 31, 2018. That is a pre-pandemic period.

Cash and investments of \$167.8 million increased from \$38.8 million five years ago. During this period, we have returned \$137.9 million to shareholders in the form of cash dividends, an increase of \$41.4 million or 42.9% during the 3-year period leading up to the pandemic. Our inventory was reduced 11.5%, and headcount reduced 31.1% from the pre-pandemic levels of December 2018.

Now going forward, we are well positioned. We continue to strengthen our offerings. And now that our supply chain has improved, we plan to start introducing new products. Our retail network continues to be strengthened. The repositioning of our design centers throughout North America has been a major undertaking and has us placed strongly. The interior design destination focus is very important to position us for growth.

We have also reduced the space of our interior design centers, which reflected selling of large amounts of floor samples. This resulted in lower customer orders, which is a core of our North American manufacturing reflected in lower production. We have completed most of the repositioning of our design centers. Our marketing has been greatly enhanced, while major reduction of costs. Advertising expenses equal to 2% of net sales as compared to 4% prior to the pandemic.

Despite lower delivered sales, maintained gross margin of 60.2% and an operating margin of 12.8%. We have strengthened our talent in many areas of our vertically integrated enterprise. While the post-pandemic period has seen consumer focus on other areas such as traveling, we believe that now consumers have again started to focus on their homes, which gives us an opportunity to continue our progress. We are positioned well and remain cautiously optimistic and very happy to open for any questions or comments.

QUESTIONS AND ANSWERS

Operator

Thank you. (Operator Instructions) Our first question comes from the line of Budd Bugatch with Water Tower Research.

Budd Bugatch - *Water Tower Research LLC - Head of Consumer Hardlines*

A couple of questions, if I might. First, on -- just -- can you talk a little bit about any variance across the country in terms of the volume and the results geographically that you can point to?

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

Yes, Budd, I don't think so. I think that, that has been pretty consistent across the country. If there were differences, it was more reflecting our strengths or the positioning of the -- in the market. But I cannot say that somehow that West or East or South is doing better. I think it is pretty consistent.

Budd Bugatch - *Water Tower Research LLC - Head of Consumer Hardlines*

Okay. And you mentioned that the consumer is starting to refocus on the home, which implies that -- or I infer from that, there might have been some difference in the quarter as you saw the cadence of orders or cadence of traffic to the website or the traffic in the stores. Any comment or any color you can give on that?

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

Yes. I would say that, well, in most of 2023, especially the last 6 or 7 months, consumers were focused on other areas. They had already purchased a lot of home furnishings. There -- and their interest in other areas was evident. And what we saw actually in December is the month where we saw

somewhat more of a -- you might say, greater trends and traffic and interest in the home. So we believe that after 6 or 7 months of not having that focus, consumers are getting back into the home.

Budd Bugatch - Water Tower Research LLC - Head of Consumer Hardlines

So if I ask you if -- the quantitative question, was December a positive month from a written order business at the retail network?

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

Yes, it was.

Budd Bugatch - Water Tower Research LLC - Head of Consumer Hardlines

And any -- do you want to put any more color to that, like a number?

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

No, no, Budd, it's still too early. I think as I said that we are in January, and we also see positives and also there are challenges in some areas. But overall, the perception is that consumers are now starting to get back in furnishing their homes. It's still early, but we are starting in a positive direction.

Budd Bugatch - Water Tower Research LLC - Head of Consumer Hardlines

Okay. And I noticed, of course, that the operating margin differential was significant quarter-over-quarter in both segments. You mentioned some deleverage in the -- which would imply from the manufacturing segment, I would think. Can you talk to about what might have been other than volume? Were there any other issues other than unit volume going through that might have impacted that?

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

No, I think it's substantially volume because if you take a look at it, we still had a strong margin. That's why I compared it to the pre-pandemic levels that our margins were higher than the pre-pandemic levels. When I said that our gross margin went from 55.2% to 60.2% and that our operating margins went from 8.3% to 12.8%, obviously, the year before, our operating margins were 18.1%, reflecting extremely high sales. But when you take a look at historically, this 12.8% is a pretty good operating margin.

Budd Bugatch - Water Tower Research LLC - Head of Consumer Hardlines

Okay. And my last question, just talking -- you talked about floor sample sales, that has an impact on both revenue and margin. Can you maybe help us get a feel of the color at the margin side and how much impact that might have had on the gross margin and the operating margin in the retail segment.

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

Yes. I think there are a number of impacts it had. As I mentioned in my comments that substantial, actually, all of our North American manufacturing, but almost all of it is custom. And when we decided to reposition ourselves as an interior design destination, one of the things we did is developed

and implemented was reducing the floor space. Today, with our strong interior designers, with our technology, we don't need 20,000 square foot design centers.

So we started -- we decided early last year, in 2023 calendar year, that we will start repositioning, and we would then reduce the size from, let us say, many of them from 20,000 to 12,000. And the rest of that product, we called it designer floor samples. And it helped us sell the products. Obviously, the margins were lower, but it also had another impact, it was on a manufacturing. Because when we were selling existing inventory, we were not making custom product. So good news is that most of that is over.

Budd Bugatch - *Water Tower Research LLC - Head of Consumer Hardlines*

Well, thank you very much, good luck on the next upcoming quarters and the year.

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

Thanks very much.

Operator

Our next question comes from the line of Brad Thomas with KeyBanc Capital Markets.

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

Always a pleasure. Thanks for having us. I was first going to ask, Farooq, maybe if you could talk a little bit more about new products and the degree of the broader assortment that you expect to change in the year ahead. And the degree of products on the floor in your galleries that you're expecting to change?

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

Yes. This is a good question, Brad, because we are now in a very different environment than we were a year back, which is that the interior design destination created a situation where we had the same product, almost the same product in all our design centers. So when we now introduce new products, we have to determine how much of that will go on the floor of our design centers and how much will be available for our interior designers to sell.

Now we have just finished repositioning our design centers all over the country with the products. And what we are now going to do is this. We are going to utilize the new products to a great degree by making them available to our interior designers. Because today, our interior designers are operating from smaller spaces, and they are able to utilize our technology in creating room environments designs with products that they don't have in their design centers. 10, 15 years back, we couldn't have done it. We had to put it in the stores or design centers.

Today, of this new product, I think at this stage, relatively small, will get into our floors. The rest will be available to our designers to use with customers. Because through our technology, they are digital technology, they are able to place that product in their designs with the customers.

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

That's helpful. A couple of other questions, if I could. Sometimes you all give us some details about trends quarter-to-date. Some of the data and feedback that we've been getting of late is that the trends have been a little bit softer in January, somewhat impacted by the weather. Curious if you have any color you could share about recent trends?

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

Yes. I think, Brad, that is important. We have -- the weather has been a major factor. And the good news is this, in those areas where weather was not a major factor, we did okay. But in areas where weather was really bad, bad, sales have been down. So I would say that, that the weather impacted it, but I would believe that as we come out of this and especially -- you can see the difference actually between the first 12, 15 days of this month and the interest that is taking place now. So I think there'll be much more interest, but the weather did impact our sales in those areas where the weather was very bad.

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

That's helpful to hear. And nice to hear that the non-weather affected regions have been stronger. And then, I guess, Matt, occasionally, you'll give us some commentary kind of like the first quarter in terms of how to think about perhaps where revenues or margins may shape up. Anything for us to keep in mind as we're modeling this March quarter?

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

Matt, what do you give them?

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

I think the trends will stay relatively consistent with the past couple of quarters. The puts and takes that we're seeing would lead us to similar projection. Now we don't give guidance out there for Q3 or beyond, but I would anticipate it to be somewhat similar to the quarter we just ended up in.

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

Yes, Brad, you can see that even with some decline in sales, we did relatively -- we had decent gross margins and operating margins. Obviously, when you compare it to the previous year when we had the benefit of all the pandemic sales, they were high. So we have been able to maintain decent margins.

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

Very helpful. And good luck this quarter.

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

Thanks very much, Brad.

Operator

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

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

I just have a couple. I wanted to ask, of the \$15 million in delayed sales due to the flood in the summer that you had called out on the last call, how much of that were you able to deliver in the December quarter? And how should we think about the remaining amount? When is that going to flow through the income statement?

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

Matt, you have been working on it very closely. What do you say?

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

Yes. So to give a little background, we're pleased that the plant was able to get up to over 75% capacity in the quarter. As you recall, back in July, it was shut down for quite a while. So we ramped up, we're in good shape now. We were able to deliver a portion of that amount. I would say roughly 25% to 35% of that amount, we delivered. Now what that does is it keeps our plants running efficiently up in Vermont. Given the softening of the demand, it was able to keep us continue going. So we're about 1/3 of the way through, and we'll deliver the rest of it in this upcoming quarter.

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

Yes. Cristina, this -- the Vermont situation had a number of implications because when -- in the last few years, we brought in a lot of technology. And we didn't think of the fact of what this climate change is going to do. So a lot of the technology was put on the first floor. It's a multistory. Then a number of that equipment, we had to repair, replace, it took time. And now some of that equipment is going on the second floor because we don't know what's going to happen. So most of that equipment is in. And I think that as we continue, it's -- we had to purchase new equipment, and we ran also to repair. But I think in the next few weeks, more or less, they'll be back to normal.

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

And then the second question I had, was there any specific amount as far as the store refreshes that was onetime that was expensed this quarter that will not repeat going forward?

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

Yes. I mean, Matt, I mean, we are really talking in terms of -- almost what is \$1 million...?

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

About half that number, about \$400,000...

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

About \$0.5 million or so because it was really paint and some minor changes, some flooring and things of that nature. The rest, of course, was products. And the impact really was selling of the floor products, which had an impact, certainly to increase sales, but it had an impact on our gross margins. It also has an impact, as I said earlier, on our manufacturing. About \$0.5 million or so was used, mostly paint.

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

Okay. And then the last question I had, anything -- any updated parts where you're seeing from a cost perspective, whether it's input cost, materials or freight that we should be aware as we move through 2024?

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

Yes. Cristina, look at what's happening right now in the transportation in the Suez Canal, now fortunately for us. So that is going to have some impact. But because of the fact that 75% of our products are made in North America, we are going to be less impacted. But if we had most of our products coming through from offshore, it would be an issue.

We did see overall container rates have come down from, let's say, from East Asia to North America, they have gone up to \$30,000 from \$4,000, \$5,000. They came down to \$5,000, \$6,000, but now you can start seeing they're starting to increase. Our exposure is limited because of the fact that we are involved with making our products in North America.

And then we shift our products through our own network at one delivered price nationally. That also had an impact. During the COVID, we did not change any of our prices. I mean, we did not change any what I would say any special charges. We maintained, and it was absorbed, all those increased costs. Whether it was international cost or our domestic costs, our high volumes helped us. But now most of those costs are back to normal, but they've come down quite a bit. And we will see some impact of what is taking place internationally. For us, it is somewhat smaller than most likely others.

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

Thank you. Those are all the questions I have.

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

Thanks very much. And Alicia, anybody else?

Operator

No. There is nobody else in the queue at this time.

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

All right. Thanks for joining and look forward to continuing our progress and in terms of repositioning our brand is very excited. In fact, today, I have 12 senior members of our retail division here discussing our programs and how we need to position ourselves and they are very much involved in making sure that we take all these great advantages we have of repositioning and that we continue our growth. So thank you very much for participating.

Operator

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

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

All right, Alicia, thanks.

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