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ETH.N - Q4 2021 Ethan Allen Interiors Inc Earnings Call

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PRESENTATION

Operator

Good afternoon. Welcome to the Ethan Allen Fiscal 2021 Fourth Quarter Analyst Conference Call and Webcast. (Operator Instructions) As a reminder, this conference is being recorded.

It's now my pleasure to introduce your host, Matt McNulty, Vice President of Finance. Thank you. You may begin.

Matthew J. McNulty - *Vice President, Finance*

Thank you, Kevin. Good afternoon, and welcome to Ethan Allen's Analyst Conference Call for our Fourth Quarter and Fiscal Year ended June 30, 2021. Joining me today is Farooq Kathwari, our Chairman and CEO; and Corey Whitely, our Chief Financial Officer. Mr. Kathwari will open and close the call, while Corey will speak to the financials midway through. After our prepared remarks, we will then open the call to 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 information referred to in the release and on this call. A replay of today's call will also be made available via phone in 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 the call.

With that, I'm pleased to now turn the call over to Farooq Kathwari.

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

Thank you, Matt, and thank you all for participating in our earnings call. While fiscal 2021 began with heightened levels of uncertainty, we were able to have strong performance for the fourth quarter and fiscal year ended June 30, 2021. After Corey provides a brief overview of the financial results, I will discuss our plans to grow sales, profits and cash. We believe we have a great opportunity to continue our growth and increase sales, profitability and cash flow and continue the strong returns to our stockholders. Corey?

Corey Whitely - *Ethan Allen Interiors Inc. - Executive VP of Administration and CFO*

Thank you, Farooq. Our fiscal year ended June 30 was challenging, yet we performed well. Our retail segment written order demand continued to accelerate during the fourth quarter, achieving 105% growth compared to the prior year fourth quarter and 40.2% growth compared to the fiscal

2019 fourth quarter. We are pleased that our July retail written orders are holding positive to the prior year's high order demand when our retail was reopening and are also positive to our strong July 2019 order demand.

Wholesale segment written orders increased 82.3%. Excluding GSA and other government orders, wholesale segment orders grew 87%. Consolidated net sales for the fourth quarter were $178.3 million, a 94.7% increase to the prior year quarter. Our retail sales increased 113% for the quarter and wholesale sales increased 106.2%. Our international sales increased 4.1%, while contract sales had a 7.1% decrease.

Contract or demand has recently started to rebound, especially for our government GSA contract. Total contract order demand increased 49.1% during the fourth quarter, and we expect this trend to positively impact wholesale net sales in the upcoming quarters as we produce and ship these orders.

At the end of the fiscal fourth quarter, both our retail and wholesale segments had high order backlogs that we expect to get caught up during fiscal 2022. Our GAAP gross margin for the quarter was 58.7%, while our adjusted gross margin increased to 58.8%. The growth in consolidated gross margin was due to a shift in the retail to wholesale sales mix, improved operating leverage within our manufacturing due to higher production levels and benefits from our optimization of manufacturing and logistic initiatives over the past years.

Retail sales grew to 84.5% of consolidated sales compared with 77.2% a year ago, which positively impacted our consolidated gross margin. We expect this higher percentage of retail sales to consolidated sales mix to continue in the near term as a result of the strong retail written order performance and related high retail order backlogs.

Operating margin was 13.5%. Adjusted operating margin, which excludes the impact of pretax charges from restructuring initiatives, asset impairments and other corporate actions, increased to 14.1%, primarily due to net sales growth, the improvement in gross margin and controlling costs by leveraging cost reductions from measures taken as part of our previously announced COVID-19 action plan.

Adjusted operating expenses were $7.2 million or 8.2% less than they were in fiscal 2019 fourth quarter. Adjusted operating expenses for the quarter were lower despite the strong sales growth due to reductions in certain selling expenses, including advertising costs and reduced G&A compensation expense as we are operating more efficiently with less headcount in our retail segment and at the corporate level than in the prior year period.

Advertising costs were approximately 2% of net sales in the fourth quarter compared to our historical run rate of 4%. We expect advertising costs to return to the 3% to 4% range in fiscal 2022.

Our GAAP earnings per share for the quarter was $0.71 compared to $0.48 loss per share in the prior year quarter. Fourth quarter adjusted diluted EPS increased to $0.74 compared with a loss per share of $0.15. For the full fiscal year, adjusted EPS of $2.37 compared to $0.52 in fiscal 2020 and compared to $1.56 for fiscal 2019.

As of June 30, our balance sheet remains strong with cash on hand of $105 million and no outstanding borrowings. Inventory sequentially increased 6.1% from our third quarter, reflecting our focus on increasing production and stock levels to service our backlogs. Customer deposits from written orders for our retail segment more than doubled during fiscal '21 and totaled $130.6 million at June 30. Strong retail order growth of 47.7% outpaced net delivered sales growth of 19.9% and led to high customer deposits.

During the fourth quarter, we generated $27.8 million of cash from operating activities. And for the full fiscal year, we generated $129.9 million. For fiscal 2022, we expect capital expenditures to range between $16 million and $18 million as we reaccelerate our spend to further invest in technology, increase manufacturing capacity and open new or relocated design centers while also continuing improving all our design centers projection.

We paid a total of $31.7 million in regular and special dividends during the quarter. And for the full fiscal 2021, we returned $43.3 million to shareholders in regular and special cash dividends. We are also pleased to announce on August 3 that our Board of Directors declared a $0.75 special cash dividend, along with the $0.25 regular cash dividend, both payable on August 31 to shareholders of record on August 17. We intend to continue with the shortened time period between the regular dividend declaration date and the payment date as we've done for the past 2 dividends.

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

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

Thank you, Corey. We are uniquely positioned as a vertically integrated enterprise from developing relevant offerings, making about 75% of the products in our North American workshops, focusing on interior design services, increasingly combined with technology and a strong logistics network, providing in-home what we call white cloud service to our clients.

We continue to generate strong cash flow and provide very strong cash dividends to our shareholders. As many of you know, I was involved in taking our company public in 1993 at a share price, adjusted for stock splits and dividends, of $3.51. Since then, we have continued to generate strong cash flow, paying $526 million in dividends, paying off $585 million of debt and repurchasing $625 million of our stock. We also invested in our enterprise with capital expenditures and acquisitions of $839 million, strengthening our manufacturing, retail, logistics and technology.

For the past 10 years, since June 30, 2011, our adjusted share price increased from $14.76 to $27.60 on June 30, 2021. We used about $100 million of cash to repurchase our shares, paid cash dividends of $233 million and invested $183 million in capital expenditures and acquisitions.

Our focus -- the reason I'm saying all of this is that our focus is to continue to manage our business and to provide strong returns to our shareholders. The main areas of focus for us in fiscal 2022 and beyond are continued growth in sales, profitability and cash generation. For your information, we increased our July written orders at retail by 6% over a very strong July last year. Our wholesale written orders were up 13% in July year-over-year and up 16% over 2 years ago due to strong orders from U.S. government contract business, as Corey just mentioned.

Our second objective is a focus on supply chain. Our backlogs are exceedingly high and need to be delivered. While we are better positioned, making 75% of our products in our workshops in North America, we have been impacted by raw material shortages. The 25% of products coming from overseas have been impacted by COVID-19 in some countries and increases in transportation costs. Due to major investments in our North American manufacturing and logistics, we are well, I would say, better positioned for growth.

Third area is that we are actively managing the delta variant in North America and keeping close watch internationally. To date, it has not been a major negative.

Number four, as reported, we had strong fourth quarter adjusted gross margin of 58.8%. And again, it also reflected the greater percentage of retail business to total business, and our objective is to maintain around 58% gross margin.

And finally, we believe that we are well positioned in our product offerings and our plans to introduce very strong new products by early 2022. At this stage, we are pleased to answer any questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question is coming from Bradley Thomas from KeyBanc Capital Markets.

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

This is Andrew on for Brad. I wanted to start by talking about these raw material delays. You gave some helpful detail on the state of your supply chain. But could you talk more specifically on the raw material delays you're facing including which particular raw materials you're seeing the most delays from? And how has that situation evolved into July and August?

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

Yes. So the raw materials are as we are in both upholstery business, in manufacturing and wood products or case goods. As it relates to upholstery, the raw material issues like we heard, of course, from the industry, have related, for instance, to foam, in springs, things of that nature. We have, of course, operations also in Mexico, which have been less impacted than the one in the United States. As we know, a lot of this happened because of the problems in the Texas area, where a lot of these foam factories are. It's improving. It's still not where it needs to be, but we see gradual improvement every week. That is really on the upholstery side.

In our wood products, there has not been a major issue. We had initially some issues on the lumber procurement but that has sort of caught -- we have caught up, and I think it is more a question about catching up to high orders.

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

Great. And it's great to see the strong gross margin this quarter despite the higher product and freight costs you're seeing. But could you talk about how these rising costs may impact the next few quarters? And then how are you thinking about ways to mitigate those costs? I know you talked about price increases and changes to your discount or promotional strategy in the past. But could you talk about how you're thinking about it as we go into the next few quarters here?

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

Yes, Andrew, as I said, we will also keep in mind this -- having about a 58% gross margin, it was also -- it reflected, of course, improvements in our sales efficiencies, but it also reflected a higher percentage of retail to total sales. So as we move forward, I think the gross margins reflect what our percentage of business is of wholesale versus retail. So that will be having some impact. But that also doesn't necessarily mean that much of an impact on the operating margins. Because in operating margins, if, for instance, we have higher operating -- higher business overall from our, let's say, the contract business, it's possible that our gross margin could be slightly lower, but the operating margin will be higher. That's why I said you got to keep in mind, approximately close to 58% is a good goal.

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

Okay. That's helpful. Shifting to the revenue outlook, given continued strength in your written order trends, your rising capacity on top of a very large backlog. I wanted to try to help connect the dots and try to think about what's possible from a financial perspective in the quarters ahead? I know that over the last 3 quarters, you've done just shy of about $180 million in revenue on a per quarter basis. But from a capacity perspective, do you think -- now that these raw material delays are getting -- are moderating on a week-by-week basis, do you think you're in a position to break above that $180 million revenue level in the next quarter or in the next few quarters ahead?

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

Yes, Andrew, I think, obviously, that is an opportunity, is a possibility. I would say that if we go up to say -- again, we have to be mindful of about -- still the issues about raw material and other factors. But I think if you go up another $5 million or say -- $7 million, $8 million, that would be a good number to use.

Operator

Next question today is coming from Cristina Fernández from Telsey Advisory Group.

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

A couple of questions following up on the previous one. I wanted to see if you can update us on sort of what are the time frames now from customer orders to delivery? Have those compressed over the past couple of months as you've been able to increased capacity? Or are they still pretty meaningfully above like the pre-COVID time frame?

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

No, Cristina, there's still much, much above the pre-COVID time period. We -- as you know, in our case, 75% of our products that are made in the North America, most of them are custom. Now that's a big difference between us and many others who purchase inventory, and then the average -- their time frame is average between what they sell out of stock and perhaps what is custom. In our case, everything is custom. So that's why our time frames are impacted. And it will come down but it's coming down slowly. But on the other hand, it just gives us an opportunity to continue to operate more efficiently, increase sales. And the other good news is that we don't have a lot of excess inventory to sell.

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

Okay. That's helpful. Another question we had was, can you talk about why you're seeing in traffic at your interior design centers? It seems like trends are normalizing. Obviously, July orders were still above last year. But how did the quarter progress? What do you expect to see here over the next couple of months?

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

Yes. Cristina, one of the important factors, of course, we were fortunate that in the last 4, 5 years, we invested in technology like 3D, virtual reality. If we had not done it, I do not know how our custom business would have fared. If we had a lot of inventory and stock, then people see it and buy it, but that's not what we had. Our designers have to work with clients in physically and virtually. And it's amazing that I get every week on -- actually yesterday about at least 50 events where they involved a customer. And I'm myself surprised and pleased to see how much of the business is being done with the combination of personal service and technology. That's the difference between our business and those that are selling inventory out of stock or on the floor. We don't have much of that.

So as we continue to build our business, we have less interior designers, but more qualified interior designers. We are going to continue to invest in technology, in giving them the tools to be able to use their personal service and technology. And we will continue to see that. And that is going to be a tremendously important factor, and I see an advantage for us.

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

And then the last one I had. Can you talk about marketing? How are you thinking about marketing spend this upcoming year? And also, I guess, I mean, as you've seen new customers over the past few quarters, are you doing anything differently to try to retain those customers and bring them back in the next year or 2?

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

Yes, Cristina, that's an important factor. Of course, as Corey mentioned, we did reduce our overall advertising spend last quarter. A lot of it was due to the fact that we had tremendous amount of people coming in did have to spend. That was one thing. The other factor is we changed the means of where we advertise now. We are using a lot more digital advertising compared to print and even to some degree, television. So our cost is lower, but our reach is greater. Having said this, if 2% is somewhat on the lower side, we will -- just for budgeting purposes, we'll take it between 3% to 4%, but I'll try to continue to keep monitoring it so that we use less money but more effectively. So our advertising mediums are changing, which is very important. We are reaching more people actually by spending 2% of our -- on advertising when we did spent 4%. So for budgeting purposes, I think anywhere around 3%, 4% would be a good thing to use.

Operator

As there are no more questions in the queue, I'll turn the floor back over to Farooq for any further or closing comments.

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

Well, thank you very much. And we are -- as I said, we're very pleased with the progress we have made, but we have a lot of work ahead of us. We've got to make sure that we continue to serve our customers. We've got very high backlogs. So that's a lot of focus that we have. So thanks very much to everybody and look forward to talking to you soon.

Operator

Thank you. That does conclude today's teleconference and webcast. You may disconnect your line at this time, and have a wonderful day. We thank you for your participation today.

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

All right. Thanks very much. Take care.
