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ETD.N - Q1 2023 Ethan Allen Interiors Inc Earnings Call

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CORPORATE PARTICIPANTS

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

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

CONFERENCE CALL PARTICIPANTS

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

Zachary Donnelly *KeyBanc Capital Markets - Analyst*

PRESENTATION

Operator

Good afternoon, and welcome to the Ethan Allen Fiscal 2023 First 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 thank you for joining us for today to discuss Ethan Allen's Fiscal 2023 First 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 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 under the News and Events tab on the Investor Relations page of our ethanallen.com website. There, 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 obligations 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 we are pleased and gratified with very strong results. Our teams in our vertically integrated enterprise have done a good job in helping develop strong programs in our various areas from strengthening our interior design network, strengthening our product programs and marketing and effective use of technology in all areas, including our marketing, manufacturing and logistics. After Matt provides an overview of our financial results, I will review our focus to continue to grow our enterprise. Matt?

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

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

For the quarter, consolidated net sales increased 17.7% as a result of strong order backlog along with improved manufacturing production and efficiency and higher receipt of offshore products. Previous constraints, including COVID-related shutdowns, labor disruptions, supply chain challenges, shipping delays and raw material availability have eased in recent quarters, which helped us reduce the time to convert written orders to delivered shipments.

Beginning about 2 quarters ago, we increased our manufacturing productivity as well as saw an uptick in receipt of imports and raw materials from a higher volume of shipping container receipts, which led to strong sales growth during the first quarter. Our wholesale backlog as of September 30, 2022, was $106 million, down 24.4% from a year ago, but up 62.1% from September 2019. In the near term, our teams are effectively managing the business to work through this high order backlog and to service our clients.

Our written -- our retail written orders were down 8.6% due to a strong prior year comparable. However, when compared to the pre-pandemic first quarter of fiscal 2020, retail written orders were up 7.4%. Wholesale segment written orders were down 7.2% to last year, but nearly flat to Q1 of 2020. Consolidated gross margin was 60.4% for the first quarter primarily due to a change in sales mix with our retail segment becoming a larger portion, a favorable product mix, previous product pricing actions that are now working their way through our delivered sales and higher manufacturing productivity and efficiency, partially offset by higher input costs.

Retail sales growth of 18.5% increased our retail sales mix from 85% of consolidated sales last year to 85.6% in this year's first quarter, improving our consolidated gross margin. We expect this higher percentage of retail sales to consolidated sales to moderate towards normalized levels as we increase delivery of the wholesale order backlog. Our adjusted consolidated operating margin increased from 15.2% last year to 17.6% in the current year first quarter. Adjusted operating margin expansion was primarily from higher consolidated net sales, retail and wholesale gross margin expansion and strong cost containment measures, partially offset by higher selling expenses, including increased delivery in freight costs, combined with higher marketing spend.

Our ability to maintain disciplined cost and expense controls, including strong cost containment measures and tight expense management within our G&A expenses continues to help drive operating income growth. Our SG&A expenses when expressed as a percent of net sales decreased from 44.7% last year of 42.9% in this year's first quarter, reflecting our strong operating leverage. This operating margin expansion, combined with double-digit delivered sales growth helped generate another quarter of strong profits with diluted EPS of $1.17, up 48.1% to last year. Our effective tax rate for the quarter was 25.3% compared to 26.3% a year ago.

Now turning to liquidity and capital resources. We are committed to maintaining a strong balance sheet and continue to monitor our liquidity closely. Our sources of liquidity include cash and cash equivalents, short-term investments and amounts available under our credit facility. As of September 30th, we had cash and investments of $142.4 million and no debt outstanding. Our investments at quarter end were within short-term U.S. treasury bills designed to enhance returns on cash while ensuring capital preservation and liquidity. We generated $38.4 million in cash from operating activities during the quarter, an increase from $17 million in the prior year period, primarily due to higher net income and an improvement in working capital.

Capital expenditures were $3.2 million for the quarter and included further investments in various areas, including manufacturing, retail design centers and technology. We continue to pay quarterly and special cash dividends. In August, our Board declared a special cash dividend of $0.50 per share in addition to our regular quarterly dividend of $0.32 per share, both paid on August 30. Since our IPO in March of '93, we have paid over $595 million in cash dividends to shareholders, repurchased $625 million of our stock and invested over $856 million back into the business in the form of CapEx and retail acquisitions.

To sum up our quarterly financial results, we delivered excellent results amidst challenging trends within the global economy. Net delivered sales, operating income and diluted EPS were all above expectations, and our teams executed with excellence.

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. Thanks, Matt, and a pretty good overview. So we are pleased with the progress. And as you have heard me in the past, we are just getting started. Crisis creates an opportunity. For over 90 years of our history, every major crisis gave us an opportunity to examine what we do and take steps to innovate and position us for growth in the next chapter of our long history. Our focus going forward is on the following areas: First, continued transitioning from a furniture store to an interior design destination. This involves a number of key areas, most importantly, having qualified and motivated interior design talent. Today, we have about 1,200 interior design associates in our North American network compared to about 2,400 10 years back doing more business. The quality of talent is extremely important and most critical has been adding technology to enable the interior designers to work effectively with clients in our design centers and remotely, adding effective technology to our talented interior designers will remain a major focus.

Secondly, a repositioning of our design centers. Today, over 70% of the 170 design centers in North America have been relocated in the last 25 years, of which, 48% have been relocated in the last 10 years and the process continues. Currently, many design centers are being relocated, including in Manhattan, Chicago, San Jose, Northern Florida and New Hampshire. We will also continue to refresh our current locations to make them even more effective as an interior design destination.

Third is continued strengthening of our product offerings. While during the pandemic, we had to slow down our new product introductions, we are now in a position to accelerate and introduce new products. Both investing in our marketing, we have substantially increased our digital marketing, which has expanded our reach and has been very cost effective. In addition, during COVID, we did lower our advertising expense as there was strong interest by consumers to redecorate. This past quarter, we increased our advertising spend, including on national television. We will continue to strategically invest in marketing and utilizing the new digital mediums available to us today. Investing in technology will continue to be a priority. This involves effective technology for our interior design network, manufacturing, logistics and marketing and continued focus on our manufacturing and logistics.

About 75% of our products are made in our North American workshops. We have continued to make major investments in our manufacturing and logistics, thereby providing a great competitive advantage. Our logistics is a major advantage in providing good service to our clients while managing overall costs. Delivering product at 1 cost throughout North America to our network was a challenge during the pandemic with major increases in freight costs, both internationally and in North America, however, a great competitive advantage.

Our continued focus on social responsibility is very important. This includes providing many benefits to our associates, including safe working environment and health care and other benefits. Environmental responsibility is a key part of our focus and ensuring we have proper compliance programs in place. And finally, continue to maintain strong cash and return to stockholders.

As Matt mentioned, we ended the quarter with $142.4 million in cash and investments. During the last quarter, we paid $20.9 million in regular and special dividends. Since our IPO in March 1993, we have paid over $595 million in cash dividends to our shareholders and invested over $856 million in capital expenditures to strengthen various areas of a vertically integrated enterprise.

With that brief overview, pleased to answer any questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Our first question comes from Cristina Fernandez with Telsey.

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

And congratulations on good result. I wanted to get your thoughts on the demand environment, how did demand progress through the quarter? And I guess what is your outlook going forward and might some of the housing metrics being softer?

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

Yes, Cristina, we are coming to the next stage, which is where after having gone through a very high demand for all -- for -- in our industry, especially in our products, we see that there is, obviously, it is leveling off. However, as Matt said, we are still doing higher than our business prior to the COVID. So I would say that we'll continue to do well because of the various programs we have. Obviously, our written business has moderated and not as high as it was 2 years back. But still, it is there. So we will continue to see some growth going forward.

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

And then another question I had was on the gross margin. So it was very high this quarter, 60.4%, which is at a peak versus historical levels. Can you -- I understand a lot of that it's like the higher mix of retail sales, but the other drivers, I guess, how structural are they should we see the gross margin still stay, let's say, like in the high 50s level? Is that a reasonable assumption?

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

Yes. But if you can -- if you take a look at our gross margins in the last -- even the last year or so, not even before, we have been able to keep them at the high 50s levels. And I believe that is what our intention is.

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

And then last question is on the supply chain. You talked about seeing a better flow of products. Can you comment on the order to delivery times, where are those now? And how long will they take -- will they take to get back to pre-pandemic levels, if they're not there yet?

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

Yes, we do, of course, Cristina, our advantage has been that 75% of our products are made in our North American workshops. And then about 75% of our total products are accustomed when we get the orders. So it had somewhat of a unique and a different structure than most businesses. What we have seen is that, for instance, almost 100% of our upholstered products. They're custom, but made in North America, and we have caught up and our lead times have gone to very good levels, up anywhere close to 8 weeks or less.

Our wood products, which are made mostly in North America also -- and again, it's custom. So keep in mind, it's a very different model than those folks who ship products from stock, that also is now close to 10 to 12 weeks, which for custom is still a pretty good delivery period.

Operator

(Operator Instructions)

Our next question comes from Zachary Donnelly with KeyBanc.

Zachary Donnelly - *KeyBanc Capital Markets - Analyst*

Congratulations on the strong quarter. Yes, of course. I was just wondering kind of looking at your wholesale backlog, which was $106 million as of September 30. I know last quarter, you had stated the backlog was about $102 million. So kind of just seeing a little bit of an uptick in the backlog. And kind of despite strong delivered sales within the wholesale segment and us seeing written orders kind of decline year-over-year and increased manufacturing efficiencies and deliveries. I was kind of just wondering if you could maybe shore up how we got to an elevated backlog despite higher delivered wholesale sales and kind of written order trends coming down year-over-year?

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

Yes, good question. As you know, that our wholesale backlog still is at about $106 million at 9/30, down from $192 million, which was very, very high levels but still at a good level. The reason is based upon also we still have a business to deliver at our retail network and also our contract business has been strong. So that has resulted in the higher wholesale backlogs.

Zachary Donnelly - *KeyBanc Capital Markets - Analyst*

Understood. If I could, just a follow-up question on some of the margin inputs. I know you had kind of mentioned with freight and raw material prices kind of remaining elevated this quarter. I was wondering, just some of the data we're looking at whether or not it's inbound freight, containers or domestic transportation rates or gas, we're seeing prices and trends kind of pump down year-to-date or throughout the year. So I was kind of just wondering are you seeing any benefit associated with that year-over-year? And do you kind of expect that to maybe be a tailwind moving forward as it relates to margins?

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

Well, there is when you take a look at, for instance, ocean freight coming from East Asia have gone 50% down. They have gone up from $5,000, $6,000, $7,000 to $30,000. Now they've gone from $30,000 to about $16,000. But still very high, but at least going in the right direction. Similarly, our transportation cost domestically, still on the higher side, but the trend is lower. And so I believe that as I mentioned, we deliver our products at 1 cost nationally. So we have -- despite the -- fortunately, despite the increase in freight costs we have been able to maintain high gross margins across the board, which reflected a tremendous amount of efficiencies, and of course, higher volume. But as we go forward, we do see that our domestic freight will also start moderating because of the overall lower business.

Operator

Thank you. And we see no further questions at this time. I'll hand the floor back over to Mr. Farooq Kathwari for closing remarks. Thank you.

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

Right. Well, thanks very much. And again, we're very -- I'm very, very pleased and gratified at the work of our associates. They've really done an amazing job in terms of positioning us, but we are just getting started as I started by conversation. Our focus on more and more getting the message across of being an interior design destination is going to have a tremendous major impact and benefits as we go forward. And you're going to hear a lot about it in the future quarters. So thank you all for attending and look forward to talking to you again next quarter.

Operator

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