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ETD.N - Q1 2024 Ethan Allen Interiors Inc Earnings Call

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PRESENTATION

Operator

Good afternoon, and welcome to the Ethan Allen Fiscal 2024 First 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, Chief Financial Officer and Treasurer. Thank you. You may begin.

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

Thank you, Doug. Good afternoon, and thank you for joining us today to discuss Ethan Allen's fiscal 2024 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 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 & Events tab on the Investor Relations page of our website. There, you will 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*

Thank you, Matt, and good to have you join our call to review our first fiscal 2024 results and our initiatives. As we reported, we maintained strong operating margins, gross margin of 61.1% and operating margin of 12.1% despite a decline of delivered sales of 23.6%. Our sales are impacted due to softening of the economy and the impact of a major flood in our Vermont manufacturing operations.

We are positioned well. We have continued to strengthen our vertically integrated enterprise. We have also continued to maintain a strong cash balance.

During the quarter, we distributed $0.36 of regular and $0.50 of special dividend; and we also, yesterday, announced a regular dividend of $0.36 in addition to these 2. After Matt provides a brief overview of our financial results, I will discuss our various initiatives in growing our business by

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positioning us as an Interior Design Destination, strengthening our talent, marketing, manufacturing, logistics and our unique retail network providing interior design service increasingly combined with technology. 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, unusual or infrequently occurring events, such as the Vermont flood 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 first quarter are highlighted by strong margins, sales being impacted by July flooding at our Vermont case goods plant, positive operating cash flow, the payment of a special cash dividend 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 $163.9 million, a decrease of 23.6% due to lower delivered unit volume from softening order demand, reduced manufacturing production from lower backlog, a strong comparable prior year and the impact from the Vermont flooding, which resulted in a temporary work stoppage and lowered net sales by approximately $15 million in the quarter. Our Orleans plant has since resumed operations, and we expect to recover from the delayed shipments during the upcoming second and third quarters.

Sales in the first quarter a year ago set a near record pace as we worked through historically high backlog leading to a difficult comparison. From a demand perspective, we are back to more normal conditions, down from the high demand we experienced during the height of the pandemic. Wholesale segment written orders decreased 15.6% compared to last year, while retail segment written orders were down 13.2%. We ended the quarter with wholesale backlog of $75.4 million, down 28.6% from a year ago but up $1.4 million since June 30, 2023, due to the timing of contract business orders, combined with production levels being impacted by the Vermont flood.

The number of weeks of backlog as of September 30, 2023, was down compared to last year, with notable improvements seen within upholstery and home accents. Our wholesale backlog is approaching pre-pandemic levels as our teams are managing the business to service our customers.

Consolidated gross margin was 61.1%, our tenth consecutive quarter that consolidated gross margin exceeded 58%. When compared to last year, our consolidated gross margin was up 70 basis points due to favorable product mix, lower input costs, investments in technology and reduced headcount, partially offset by lower delivered unit volume and a change in sales mix.

Retail sales were 81.5% of consolidated sales, down from 85.6% last year as we delivered out more wholesale backlog, including a greater percentage of contract business. Adjusted operating margin was 12.1%, down from 17.6% last year, primarily from lower sales. These costs were partially offset by gross margin expansion, lower headcount, and the company's ability to maintain a disciplined approach to cost savings and expense control. Our SG&A expenses decreased 12.7% and equaled 49% of sales, up from 42.9% last year from fixed cost deleveraging.

As previously stated, in July 2023, our wood furniture manufacturing operations located in Orleans, Vermont sustained damage from flooding. In addition to losses related to inventory and state-of-the-art manufacturing equipment, the flooding also resulted in a temporary work stoppage for many associates and a disruption and delay of shipments. The gross financial loss incurred from the disposal of inventory, inoperable machinery equipment from water damage, facility cleanup and restoration amounted to $3.6 million. And after insurance proceeds of $1 million and a grant from the state of Vermont of $500,000, the net amount of the pretax loss was $2.1 million and was reported within restructuring and other charges and is excluded from our adjusted earnings.

Adjusted EPS was $0.63 compared with $1.11 last year. For historical context, our adjusted diluted EPS for the 3 months ended September 30, 2019, was $0.35. Our effective tax rate was 25.6%, which is comparable to 25.3% a year ago.

Now turning to our liquidity and capital resources. We ended the quarter with a strong balance sheet including cash and investments of $163.2 million and no outstanding debt. We generated $16.7 million of cash from operating activities during the quarter, which was driven by strong

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profits. Our inventory levels decreased $18 million from a year ago as we restore our operating inventory levels to more historical norms as backlog decreases.

We continued our practice of returning capital to shareholders in the form of cash dividends. In August, our Board declared a special cash dividend of $0.50 per share in addition to our regular quarterly cash dividend of $0.36 per share, both of which were paid on August 31. We have now paid a special dividend in each of the past 3 years. Also, as just announced yesterday, our Board declared a regular quarterly cash dividend of $0.36 per share, which will be paid in November.

In summary, our vertically integrated business was able to produce a double-digit operating margin during a period marked by industry-wide softer demand and a temporary work stoppage at our Vermont plant that led to lower sales. We generated $16.7 million in positive cash flow and protected our margins through disciplined investments and strong expense management. We will continue to carefully manage our expense structure.

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, thanks, Matt. As you know, we have had our interior design focus for decades. However, the recent focus, our initiative under the umbrella of Interior Design Destination, takes our business to an entirely different level. This includes the following impacts: repositioning of the interior of our design centers with strong and consistent programs across the entire network. We launched this concept in our Danbury design center in April of this year and have recently started launching in our design centers across North America and internationally.

Recently, we had ribbon cuttings in 16 locations. Just to give you a perspective, including having this enhanced projection in Manhattan, New York; in Albany, New York; in Cordova, Tennessee; Plaistow, New Hampshire; Marlton, New Jersey; Lancaster, Pennsylvania; Garden City, Long Island; Westchester, New York; Mount Pleasant, South Carolina; Green Bay, Wisconsin; Peach City (sic) [Peachtree City], Georgia; Knoxville, Tennessee; Princeton, New Jersey; and Setauket, Long Island. This week, actually just now, we are in the process of having grand openings in Kennesaw, Georgia. That's near Atlanta; San Francisco, California; Oklahoma City, Oklahoma; Birmingham, Alabama. Our objective is to continue implementing this in our 174 design center locations in North America. Next 30 days, 67 are scheduled and in December 27 and by end of December, 114 of the design centers have -- will have been repositioned with the products and the attitude.

The initiative has many benefits, including consistent projections across North America, continued strengthening of our interior design associates, consistent marketing across North America, strengthened and motivated interior designers and clients. Consistency in offering across North America helps improve service and gross and operating margins.

After the amazing focus of consumers in their homes during the COVID pandemic, we see consumers have spent more time and focus in other areas such as travel. We expect to see that moderate and more focus on home, although not at the level we saw during the COVID period. We continue to see reduction of costs such as in raw materials, energy and transportation.

While we have developed very strong new products during the last 2 to 3 years, we decided to hold off introducing during the COVID period. We have now started introducing new products, and we'll continue to do so in the next 12 months.

During the last 3 years, despite high demand, we continue to strengthen and streamline our operations, including strengthening our interior design teams in our design centers. Today, we have about 30% less interior design professionals who are about to do the same business. In fact, from 2019, our total headcount in the -- in our company is less by 21%. By using technology, in -- whether it is in our manufacturing, whether it's our retail, especially in retail, and in our logistics has helped us make our interior designers more proficient and as they say, is the game changer.

We have strengthened our talent and unfortunate recent bankruptcies of furniture retailers has brought us also new and experienced talent. Our manufacturing also has continued to benefit from strong teams and use of technology. Keep in mind that 75% of all our products are made in our North American operations. And 75% of the products are made custom when we receive the order. So we are in a good position, and I know that

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we are -- we have some challenges because of the economy and -- but we are positioned well. We are stronger, both in terms of our people, in terms of our offerings and in our facilities.

And with that, I'd like to open it up for any questions and comments.

QUESTIONS AND ANSWERS

Operator

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

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

Just a second. It's Budd Bugatch.

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

Congratulations on the margin performance and what has got to be, I'd say, a very challenging environment. And I do have a few questions, and I'm trying to just project forward.

As you look at the volume and going forward, you noted that your deposits are down about 29% year-over-year at customer deposits. That would be at retail. So I'm thinking -- and you did a pretty good job of less -- you were less down in orders for the retail than you were in actual net sales. So I suspect that, for the second quarter, retail sales will be down year-over-year but probably somewhat lower than what we saw in the first quarter, lower than the -- less than the 24% -- 27% for retail, pardon me.

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

Yes, it's a little bit early, Budd, but I think that your comments are good comments in the sense that while we have reduced our backlogs to a great degree but still, keep in mind, as I said, our backlog is now down and because -- it's down because we delivered. We're down by about 27% and 28% or so at our wholesale, 27% at retail. So we generated a lot of backlog.

We still have a reasonably good backlog. We are still -- backlog is -- when you go back to pre-COVID when, for instance, our backlog is still about 20% higher than it was in 2019, so we have a decent backlog, not as what we had last year. But that backlog still gives us an opportunity to continue to ship products. And we are also expecting, hopefully, hope is not a method, but we're expecting that consumers' attitudes, as I mentioned, are going to somewhat go back into home after, in the last 3 or 4 months, they have spent a tremendous amount of time in travel and other areas.

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

I understand that. And you did note that the retail orders were down 13% year-over-year, and I'll ask the obligatory. How did that proceed during the quarter? What did those comparisons look like as the quarter progressed?

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

You're talking of this last -- the first quarter?

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

Yes, sir. Yes. It was -- 13% was for the entire quarter for -- there was a little trend.

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

It was consistently more or less the same.

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

Okay. And for me, too, just one thing on the margin performance, which is notable with that 61%, can you kind of give us a -- I know you don't disclose that, but give us a flavor of how that compared retail versus wholesale? I know you had the issue in the Orleans plant. So I'm just curious as to how that proceeded.

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

Matt, do we give those margins or what?

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

We do not break out gross margins on a retail and wholesale perspective. We do on an operating margin.

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

Budd, generally, I would say this, that if you take out this question of what happened in Orleans -- but again, what happens in Orleans was considered as extraordinary. I think that on a basis of our operations, we've been consistent both in our wholesale margins and the retail margins.

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

Okay. And last for me on the inventory. It's down, I think, what was it, about 11% year-over-year. How does that compare retail -- again, retail versus wholesale?

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

It's approximately, let me just see. Matt, do you have that information?

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

Inventory is down 11% from last year.

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

No, he says inventory is down...

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

It would be more down on the wholesale side versus the retail side. As Mr. Kathwari pointed out, we do have a new product that's coming out on the floor of our design centers, so the retail inventory was a little bit higher compared to a year ago versus the bigger decrease with that wholesale.

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

Yes, about 11% or so down, Budd.

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 wanted to ask about the SG&A expenses in the quarter. I know that declined 13% but obviously significant deleverage on the sales decline. So what -- I guess what I wanted to know, was there anything onetime or related to the store refreshes in the initiative that was incremental this quarter? And is the 12% operating margin like a new level that we should think about the next couple of quarters given the macro and the refreshes in the stores? Or can it get back to a little bit higher level like what you've seen in the past couple of quarters?

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

It's a good question, Cristina. At this stage, it's really hard to say because the good news is that we are operating much more efficiently, both at the manufacturing level and at the retail level. When I talked about the decrease in our associates, it has taken place in all levels and especially with the use of technology.

It's amazing how the technology has helped us, especially at retail, where our interior designers today are about 30% less than what we had just a few years back, writing more business because of the combination of technology and their personal service. And of course, this was also tremendously important in the COVID when many, many people were working with them from their homes. So I think that from a perspective, it is more or less, I would say, consistent between the 2 major areas of our business, wholesale and retail.

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

Maybe asked another way, is there room to cut expenses more? Or is the kind of $80 million you saw this quarter sort of like as low as you can go on the expense side?

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

Well, it's a good question because when we went from $92 million that we had in the previous year quarter to $80 million, that's a pretty major decline in -- from year-to-year. So I think that we always keep on taking a look at what needs to be done, but there's always a possibility. We are always looking at the opportunities. And again, as I said, the combination of technology and personal service in our manufacturing, in our retail, in our logistics is tremendously important. So there is a possibility, but I think we have cut down it quite a bit.

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

Okay. And then I wanted to see if you can share more color on the demand side. What you're seeing from your -- from their design centers, the feedback you're getting. It seems like the consumer took another step down this quarter. Maybe any more color on the behavior you're seeing, how it's changing relative to 3, 4 months ago earlier this year?

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

I think that consumers, if you take a look at it right now, they're still somewhat very conservative. I think that we are expecting that will remain for the next few months. And again, it is a question of how -- what we are comparing it to. Comparing it to last year was -- is a very tough comparison. But if you compare it to -- for instance, going back to pre-COVID, you can see the differences that we are starting to -- we are actually higher than the pre-COVID in both at our retail business, our wholesale business.

And I would think this, that consumers are -- and we are looking to see the consumers somewhat get back into furnishing their homes. They've already done a lot of it. I think they spent a fair amount of time in travel and other areas. And so we would say that certainly coming into this quarter and the next quarter, we should have more consumers and more interest in the home.

Operator

Our next question comes from the line of Zach Donnelly with KeyBanc.

Zachary T. Donnelly - *KeyBanc Capital Markets Inc., Research Division - Research Analyst*

I know Matt had mentioned earlier that you don't break out gross margins based on retail or wholesale segment. But in the Q, just kind of noticed that you had mentioned that gross margins were unchanged year-over-year for the retail segment. And so I was wondering -- I'm assuming you're seeing some form of favorable product mix on that end, favorable input costs but noticed that clearance sales were higher. So I was wondering if you could kind of bridge that for us or maybe help us understand what impact elevated clearance has had on gross margins on the retail segment.

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

Yes, that's a good question because of the fact that we did a number of initiatives. One was, of course, that after we did the Danbury design center with a great projection, of course, I think you saw that we also had it in Manhattan, and now we are launching it all over the country. What it has done is this. It has done a great job of having very strong projection in all our design centers, but it also created some products that had to be sold clearance. So that is -- and that clearance has been sold at a lower margin. So that affected our gross margins.

The other thing we did, which I think we have -- may not have mentioned too much, is that the size of our design centers has -- is going to change. It's already changing. Keep in mind, Manhattan, for instance, we, for 30 years or so, were in a 30000-square-foot location and we went to 7,000 square feet. In many, many areas of the country, we are going to 7,000, 8,000, 10,000, and what we also did, starting in Danbury when we repositioned Danbury, which was a 20,000-square-foot design center, we said anything over 12,000 square foot will not be part of a regular design center.

So we created space, so products had to be sold, and that product was sold at lower margins. They are all good products. They did 2 things that obviously -- certainly give us business, brought in customers, but it also, in the short term, did sell products at a lower margin. But as we get out of those, we will have a greater benefit of having less products on the floors because, today, I also mentioned that almost 75% of the products that we sell is a combination of interior design and technology.

25 years back, we sold whatever we showed on the floors. That's why we had 20,000-, 30,000-square-foot design centers. All of that has had tremendous impact. But as we go forward, I think it will take us another 6 months or so to sell off this excess products that we had in all these design centers in the country. The good news is, as we move forward, we'll have smaller design centers and much more efficient.

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Zachary T. Donnelly - *KeyBanc Capital Markets Inc., Research Division - Research Analyst*

Got it. That's really helpful. And kind of piggybacking off of that, just really honing in on retail segment gross margins, something we've been kind of tracking really closely maybe over the past month or so is just credit delinquencies and kind of financing for big ticket for discretionary items. We've noticed, over the past 2 quarters, you've kind of called out increased financing costs as an impact to retail gross margins. I was just wondering, could you -- do you have any sense of what percent of your retail sales are financed versus non-financed? And then on that end, can you provide any color on what you're seeing in terms of interest rates associated with that?

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

Yes, that's a good question because interest rates on financing has gone up quite a bit. And we were offering, until 2 months back, 24 months free interest. I mean loans with a free interest for, I don't know, 12 months or 24 months?

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

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

24 months. And we said no, that was too much. And even though we realize that most probably close to 15% to 20% of our business was done with that -- with those loans, we took it down to 12 months instead of 24 months. And because I think the interest rates went up from 3% to close to 5% -- 6%, so I think as we go forward, what we feel is that still there are people who will need financing, but we believe that 12 months is sufficient.

Now we have to be careful that we don't want to lose business. So we're going to watch very, very carefully. But at this stage, we have taken down from 24 months to 12 months, which has an impact of about -- as I said, the impact on the margins, the interest has gone from 5% to 3% or so.

Zachary T. Donnelly - *KeyBanc Capital Markets Inc., Research Division - Research Analyst*

Got it. Okay. That makes sense to us. And then I guess my last question is kind of just on wholesale written order trends and just breaking those out. We kind of noticed that in terms of contract orders, you were down about 18% year-over-year this quarter. I was just wondering if you can maybe touch on what sort of impact is that or if there's any sort of timing shift that's impacted that where maybe the GSA is pushing out orders later potentially into fiscal 2Q for you and just how to think about that maybe moving into the next quarter. That would be really helpful.

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

You've actually answered most of the question yourself. It is the GSA used to have a cutoff at the end of the government's fiscal year, that is September 30, that all orders had to be put in. But this year, I don't know if they'll do it the next year. They have allowed them to enter orders after the end of the fiscal year. So that way, what it's done is it's created sort of lower orders in September because now everybody didn't have to put it in.

So they are now going to put this in this quarter. So we believe or what we hear is that the orders that didn't come in, in September, they'll come in this quarter. And that's been one major factor.

The other is, if you talk of wholesale, obviously, when our retail business is lower, it does affect our wholesale orders and most majority of our wholesale is from our own retail division. But when you asked about the question of the government, yes, the government business has been

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lower. And that outside business that you referred to that's nonretail was impacted by this decision by the State Department and the GSA that -- to not enter all the orders in September.

Zachary T. Donnelly - *KeyBanc Capital Markets Inc., Research Division - Research Analyst*

Got it. Got it. That's really helpful. And then I guess just a follow-up on that as a final point maybe. So with that being the case, moving into fiscal 2Q, as we kind of see that timing shift, maybe benefit written orders in 2Q, I also believe that fiscal 2Q of the prior year, your contract orders were down maybe around 88%, so just easier comparisons moving into the next quarter, the benefit of the timing shift. Would it be fair to assume that we should see some sort of sequential improvement in written order trends on the contract side moving into the next quarter?

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

Yes, I think that we can make that assumption because unless the government has something different, but we are expecting that. And the retail, of course, will depend upon how the -- how our retail network works, how the economy is. We are -- I think we are -- our people are very motivated. This initiative of Interior Design Destination is creating a lot of impact because, at this time, we didn't do it because of the fact that we're going to end into the soft economy. We did -- it was the right thing to do.

But this has given us a great opportunity to get our message around at a time when the only message that is being given out is that of deep discounts and going out of business. So we are getting the message across that we are alive, well and very strong in our offerings. I think that is going to help us.

Zachary T. Donnelly - *KeyBanc Capital Markets Inc., Research Division - Research Analyst*

Got it. Yes, that's it for us. Good luck on the refresh and congrats on the strong margin this quarter.

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

Thanks very much. Any other questions?

Operator

There are no further questions in the queue. I'd like to hand it back to Mr. Kathwari for closing remarks.

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

Well, thank you very much, and thank you for participating and attending. And as Budd knows, this is most likely, I think over 120th, around 125th consecutive quarterly call. And we're just getting started. So stay with us, and we've got a lot of good things happening. So thanks very much for participating.

Operator

Ladies and gentlemen, this does conclude today's teleconference. Thank you for your participation. You may disconnect your lines at this time, and have a wonderful day.

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