REVOLVE

REVOLVE GROUP INC. (NYSE: RVLV) Q3 2019 CONFERENCE CALL

PREPARED REMARKS ON NOVEMBER 7, 2019

ERIK RANDERSON, VP INVESTOR RELATIONS

Good afternoon, everyone, and thanks for joining us to discuss REVOLVE's third quarter 2019 results.

Before we begin, I would like to mention that we have a posted a presentation containing Q3 financial highlights to our Investor Relations website located at investors.revolve.com.

I would also like to remind you that this conference call will include forward-looking statements. These statements include our expectations regarding financial results and guidance, market opportunities, our growth and increased efficiencies, our owned brand mix, our inventory position, our dilutive share count, our investments in customer experiences and fulfillment centers, the impact of tariffs and our tariff mitigation efforts, and our lower price point offerings. These statements, which are subject to various risks, uncertainties and assumptions, could cause our actual results to differ materially from these statements. These risks, uncertainties and assumptions are detailed in this afternoon's press release as well as our filings with the SEC, including our registration statement on Form S-1 that was filed with the SEC, our Form 10-Q for the second quarter of 2019 that was filed with the SEC on August 12, 2019 and the Form 10-Q for the third quarter of 2019 that will be filed, all of which can be found on our website at investors.revolve.com. We undertake no obligation to revise or update any forward-looking statements or information except as required by law.

During our call today, we will also reference certain non-GAAP financial information, including Adjusted EBITDA, Free Cash Flow and Adjusted Diluted EPS. We use non-GAAP measures in some of our financial discussions, as we believe they more accurately represent the true operational performance and underlying results of our business. The presentation of non-GAAP financial information is not intended to be considered in isolation or as a substitute for, or superior to, the financial information prepared and presented in accordance with GAAP, and our non-GAAP measures may be different from non-GAAP measures used by other companies. Reconciliations of GAAP to non-GAAP measures as well as the description, limitations and rationale for using each measure can be found in this afternoon's press release and in our SEC filings.

Joining me on the call today are our co-founders and co-CEO's Mike Karanikolas and Michael Mente, as well as Jesse Timmermans, our CFO. Following our prepared remarks, we'll open the call for your questions.

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

MIKE KARANIKOLAS, CO-FOUNDER AND CO-CEO

Thanks, Erik. Good afternoon, everyone.

Thanks for joining us on our third quarter earnings call. We had another very solid quarter in Q3, delivering growth in net sales, profitability and free cash flow to achieve record results in any third quarter.

Q3 SUMMARY RESULTS

Net sales increased 22% with the REVOLVE business continuing to be the primary driver of growth, delivering a year-over-year increase in net sales of 24%.

We also made progress in the other areas of our business and I'm excited to highlight that our international business accelerated to double digit sales growth this quarter, validating our many efforts to further improve the customer value proposition overseas. As a reminder, we localized the customer experience in the U.K. last year by providing all-inclusive pricing, free shipping and free returns. We expanded this localization to Australia earlier this year and we continue to improve the experience around the world. For instance, we now ship to most major international regions within two to three days.

We're also encouraged by the progress we continue to make on the FORWARD business, which delivered year-on-year growth of 14% for the second quarter in a row, continued evidence of the success of our discipline to reposition this business. We see several tailwinds in the works at FORWARD that Michael will talk about, including the recent launch of two coveted luxury brands and our first FORWARD owned brand set to launch later this month.

Across both segments, we are driving growth through the continued expansion of our customer base, further illustrating that we are in the early stages of penetrating a large global market opportunity. Total active customers for the trailing 12-month period surpassed 1.4 million during Q3, an increase of 33% year over year.

These customers placed 1.2 million orders in the third quarter, an increase of 26% year over year.

We delivered gross margin of 53.6% in the quarter, an increase of 90 basis points year-over-year, that was driven primarily by a significantly improved gross margin on the FORWARD segment as well as a change in accounting estimate that Jesse will talk about.

SEGMENT COMMENTARY

Supported by growing penetration of net sales from our Owned Brands, the REVOLVE segment gross margin remains healthy at 55.4% -- yet declined by approximately 50 basis points year over year. The decline in REVOLVE segment gross margin was primarily due to a slightly lower percentage of REVOLVE net sales at full price compared to last year, which we view as a function of our inventory position rather than external factors. As we invested in the rapid expansion of the owned brand platform in recent years, our overall inventory position has become higher than we would like. Even so, we still achieved our second highest third quarter full price mix ever, second only to the prior-year comparison in the third quarter of 2018.

This quarter we reached our highest owned brand mix of REVOLVE segment net sales to date, and increased our portfolio to a total of 24 owned brands, following an exciting influencer collaboration launched earlier this month on superdown. I should mention that the expansion of owned brands as a percentage of REVOLVE segment net sales has slowed in the past couple of quarters compared to the very fast expansion through the first quarter of 2019. While we expect the moderation in owned brands net sales to continue in the near term, the owned brand platform is a key part of our value proposition, and we remain confident in the long-term opportunity to significantly increase our owned brand penetration over time.

OPERATING HIGHLIGHTS

As our results illustrate, we continue to operate in a disciplined manner, managing costs while at the same time making significant investments to support future growth and expansion. Most notably, we successfully launched further automation in our new warehouse, which began to drive efficiencies as we exited the quarter.

As illustrated by our warehouse automation, REVOLVE is a company focused on leveraging technology to drive efficiencies and improve the customer experience. We recently launched a powerful set of visual navigation capabilities on our REVOLVE iPhone app that allows our customers to quickly discover their preferred styles – for example, customizing a search for dresses across various colors, lengths, necklines, sleeve options and more. As you may recall, we had previously launched this same functionality for our mobile website.

We also continue to create solutions to drive deep relationships with and an even better experience for our customers. Earlier this week, we launched what we call the REVOLVE Fitting Room, enabling our core REVOLVE customers to do home try ons of an extra size at no additional cost. I'm personally very excited about this initiative as it provides a great experience for customers and since our experience has proven that customers who order more than one size of a style have a materially higher "Keep Rate" than customers who order just one size of a style.

Another important innovation that is ideally suited for our digitally native, mobile first customer base is our progressive web application set for a test launch later in Q4. The progressive web app enables mobile websites to offer a highly engaging, app-like experience – which we expect will drive a higher conversion rate than standard mobile web sites.

Now, I'll turn the call over to Jesse to provide additional detail on our third quarter results.

JESSE TIMMERMANS, CFO

Thanks, Mike.

As Mike mentioned, we delivered another very good quarter highlighted by growth on all fronts: net sales, profitability and cash flow.

Before I get into the numbers, I want to point out that our Q3 2019 financial results reflect $1.5 million in net sales realized as a result of a change in estimate related to the recognition of store credit breakage.

Now, starting with the top line….. Total net sales for the third quarter were $154.2 million, an increase of 22.5% year over year. The REVOLVE segment remained the key growth driver, delivering segment net sales of $135.4 million, an increase of 23.7% year over year. Turning to FORWARD, we are very pleased that our FORWARD segment delivered another solid quarter of double-digit revenue growth following the inventory reset. FORWARD net sales were $18.8 million, an increase of 14.2% year over year.

Our top line growth continues to be driven by the combination of new customer additions and continued loyalty from our existing customers. Our active customers during the trailing 12-month period grew to 1,438,000, an increase of 33% year over year, and total orders placed in the quarter increased 26% year over year.

Average Order Value, or AOV, was $275 in the third quarter, illustrating the premium nature of our offering. On a comparative basis, AOV was unchanged sequentially from the second quarter, and down 1.8% year on year – slightly offsetting the significant increase in orders placed. The decrease in AOV year over year is the smallest decline for the past eight quarters, even as we recently launched our lower price point offerings.

International net sales for the quarter were $26.0 million, a year-over-year increase of 14.7%, and a meaningful acceleration from the 4.3% growth in the second quarter. Australia was a key success story in driving the stronger performance internationally, resulting from our efforts to improve service levels, drive faster shipping and provide expanded payment options. We also experienced growth in other regions where we have previously made investments, such as the U.K. and Western Europe. During Q3, we also began to see stabilization in greater China and some moderation in foreign currency headwinds. Finally, this was the first full quarter comping the incremental Goods and Services tax on Australian imports, that was implemented in July of 2018.

Moving to gross profit…. Consolidated gross margin was 53.6% for the third quarter, an increase of 90 basis points over the prior year.

FORWARD segment gross margin was 41.0%, an increase of 970 basis points year over year and our highest ever third quarter gross margin, as a result of the successful repositioning of this business as well as a favorable comp as a result of discrete items that negatively impacted the prior year.

By comparison, the REVOLVE segment gross margin contracted by about 50 basis points year over year, as continued growth in Owned Brand penetration was more than offset by a reduction in the percentage of REVOLVE Segment net sales at full price. We mainly attribute the increased markdowns to our inventory dynamics rather than external factors. As we have invested in the rapid expansion of owned brands and the launch of superdown, our inventory has increased at a greater rate than that of net sales.

Looking ahead, we expect the fourth quarter dynamics to be similar to the third quarter with continued strength in FORWARD Segment gross margin offset by a year over year decrease in the REVOLVE segment gross margin – as the expansion of owned brand mix as a percentage of REVOLVE Segment net sales begins to moderate and as we work to more closely align growth in inventory with growth in net sales.

Now we'll move down the P&L and give you some color on the expense line items:

Fulfillment, which reflects the costs incurred to staff and operate our distribution centers, totaled $5.1 million**.** Expressed as a percentage of net sales, fulfillment costs grew to 3.3% from 2.6% a year ago. The 70-basis point increase in fulfillment expense reflects temporary duplicate costs and inefficiencies incurred in implementing our new warehouse automation technology.

As with any new warehouse technology system, gearing up for the new process and providing employee training for a new way of doing things – while continuing to meet the fulfillment needs of our customers -- required significant overtime and duplicate costs in the early going. We experienced the peak of temporary inefficiencies during the month of July. In August, we began to realize some efficiencies – particularly in the last two weeks of the month. And by the time September rolled around, the process had become much more efficient -- exiting the quarter with fulfillment costs as a percentage of net sales a full point lower than where we started in July.

The takeaway is that we exited Q3 on a much-improved run rate for fulfillment efficiency. Most important, our new fulfillment center infrastructure provides not only significant growth capacity, but further opportunities for operational efficiencies and enhancements to our customer experience going forward.

Selling and distribution costs, which consist primarily of shipping, merchant processing fees and customer service, were $22.6 million, or 14.6% of net sales, an increase of 10 basis points year over year. We are very pleased with our ability to manage efficiency on this line item despite macro cost headwinds and the pressure that has come from an outsized number of orders, units and customer touches in relation to net sales.

Marketing costs were $23.1 million and remained at a relatively consistent efficiency level as the prior year at 15.0% of net sales, a decrease of 10 basis points year on year. We increased our brand marketing investment in the quarter while realizing year over year efficiencies in our digital performance marketing efforts. The constant flow of events, social media and influencer-based marketing, combined with more traditional performance marketing enables us to cost effectively acquire and retain customers, build on the REVOLVE brand and build each of the unique brands within our portfolio of Owned Brands -- all with a long-term view towards driving customer lifetime value.

General and administrative costs, which primarily consist of salaries and wages, were $19.0 million. G&A costs as a percentage of net sales improved to 12.3% of net sales in the third quarter from 12.9% of net sales in the prior year. With our platform largely built, we are able to gain efficiencies with scale while, at the same time, making investments in our team and infrastructure to support future growth and to operate as a public company.

The combination of top-line line growth and a well-managed cost structure resulted in strong bottom-line results in Q3. Net Income was $9.6 million, an increase of 34% year over year, and Adjusted EBITDA grew to $14.4 million, an increase of 40%. Adjusted EBITDA margin expanded to 9.4% of net sales, up 120 basis points over the prior year.

Diluted earnings per share, or EPS, was 13 cents per share, up from 10 cents in the third quarter of 2018.

All of the profitability measures benefitted from the $1.5 million in net sales realized as a result of the change in estimate mentioned earlier.

For the quarter, we had 72.7 million diluted shares outstanding, which is a reasonable number to use for modeling earnings per share for the next few quarters as well.

I would like to remind everyone that we are reporting our Q3 earnings per share and EPS going forward on a GAAP basis, without adjustment. The only instance where we will report Non-GAAP earnings per share is to adjust for the corporate conversion discussed last quarter that occurred in connection with our initial public offering.

CASH FLOW AND BALANCE SHEET

Moving to the cash flow statement, we operate a highly capital efficient business that positions us to generate positive free cash flow. In the third quarter, we generated $9.2 million in cash flow from operations and $7.4 million in free cash flow, approximately 4 times greater than the prior-year quarter on both measures. The favorable comparisons resulted from an increase in net income and Adjusted EBITDA and also benefitted from the timing of tax payments that I spoke about on last quarter's conference call.

For the past few quarters, the build out of our new fulfillment infrastructure has been a headwind to free cash flow. These investments are now largely behind us, so we are well positioned for cash flow generation going forward.

This healthy cash flow generation has further strengthened our balance sheet. As of September 30th, we had no debt and cash and cash equivalents of $51.1 million, an increase of 14% from June 30th of this year.

We ended the September quarter with $103.7 million in inventory as compared to $89.8 million at the end of the third quarter of 2018. As a reminder, with the adoption of the new revenue recognition standard, we reclassified a portion of our inventory to prepaid and other current assets starting in 2019. The amount of this reclass on the September 30, 2019 inventory balance was $14.0 million.

TARIFFS

Before I move to a discussion of the outlook, and since we have received many questions about the impact of tariffs and our China supply chain, I'll provide an update regarding our tariff exposure. The incremental tariffs imposed starting on September 1 did not have a meaningful impact on the quarter, and similarly, we do not expect the tariffs to have a significant impact to the remainder of 2019 given the timing of the tariffs, our inventory position, and our inventory turns.

Importantly, we have made significant progress towards our stated tariff mitigation effort of negotiating pricing with our current vendors, and we continue to explore diversification of the supply chain. We have not increased prices to the end consumer in response to the tariff situation, and while this remains a lever we could choose to pull in the future, at this time, we don't anticipate a meaningful change in retail pricing in response.

With that, I'll turn to our full year 2019 guidance. And just as a quick reminder about our seasonality. Revolve does not follow a traditional retail seasonal cadence that results in a disproportionate amount of revenue in the holiday quarter. In fact, for the past three years, Q4 has averaged close to 25% of the annual net sales.

Given that we are down to just one quarter left in the year, we are narrowing our guidance ranges. We expect net sales to be between $598 and $606 million, which represents growth over fiscal 2018 of between 20% and 22%.

Adjusted EBITDA is expected to be between $51 and $55 million, which represents growth of 10% to 18% over fiscal 2018. This equates to an Adjusted EBITDA margin of 8.5% to 9.1%, as compared to 9.3% in 2018.

Now I'll turn it over to Michael.

MICHAEL MENTE, CO-FOUNDER AND CO-CEO

Thanks Jesse. Hi everyone.

A quarter is such a short period of time, especially when we manage the business with such a long-term view, consistent with how we have managed the business for the last 16 years.

Nonetheless, we had another solid quarter on a number of fronts. Starting with marketing – where we had another very active and impactful few months. Along with the efficient performance marketing that comprises most of our spend, REVOLVE is recognized as a pioneer in building our brand through our disruptive social marketing. Working with influencers since the earliest days has played a critical role in enabling us to develop authentic connections with the next-generation of consumers. The events we host each quarter create the experiences that excite, inspire and engage our community.

We kicked off the third quarter with a RevolveSummer event in Cuixmala, Mexico and August brought us to REVOLVE around the World in Canada before traveling to fashion shows in New York and Paris in September. Across all of these events in Q3, we dressed hundreds of influencers and generated billons of impressions showcasing our merchandise in a way that resonates with our target customer. These events define our aspirational global lifestyle brand that is REVOLVE, while the massive social reach continuously drives traffic to our sites in a very cost-effective way.

Our strong partnerships with influencers are increasingly extending into the development of new collections leveraging our owned brand platform. Coming on the heels of the successful collaborations with Aimee Song and Camila Coelho in the second quarter, in October we launched an exclusive owned brand collaboration with Draya Michele for superdown. An actress and style icon, Draya is an ideal ambassador of the superdown lifestyle to her 7.6 million Instagram followers. The debut collection will be followed by additional styles over the next several months.

Now, I would like shift to an update on superdown more broadly. Earlier this year, we launched superdown as a dedicated new website targeting younger consumers with on trend apparel at lower price points. We are excited to further expand our addressable market to include Gen Z consumers. We see a compelling "customer lifecycle" opportunity to convert a younger superdown customer of today into a more affluent REVOLVE customer over time.

We are encouraged by the early results. Despite making only limited marketing investments to date, we experienced a steady uptick in traffic, engagement, conversion and spend per website session on superdown in the third quarter. For instance, Intragram followers on superdown now exceeds 140,000, about twice as many as we had at this time last quarter.

We have a lot more testing, refinement and iteration ahead of us to optimize for this new initiative that remains in the early stages. Nonetheless, we are excited about the long-term opportunity to create an additional growth driver for the company.

On the opposite end of the price spectrum, we couldn't be happier with the continuing progress at Forward, our website focused on luxury offerings for the more affluent consumers.

Aside from the improved top-line growth trajectory and margin strength, we are making great progress in creating an even more coveted selection of iconic luxury brands on Forward. In September, we launched a full collection of apparel and handbags from the French luxury brand Balenciaga. Early customer response has been very encouraging. Adding to our merchandise momentum, in October we launched a full collection of handbags, shoes and accessories from Gucci.

Also very exciting is that third-party luxury designers have become more aware of our increased scale, the value of our customer base and the impact of our marketing strategy and, as a result, have partnered with us to develop styles exclusively for the Forward customer. In fact, last month we partnered with French luxury house Givenchy to launch a luxury handbag exclusively through Forward. We also collaborated with luxury designers during the recent Paris Fashion week when Alexandre Vauthier, David Koma and Peter Dundas each launched exclusive collections for FORWARD customers at premiere Fashion Week events. And last but not least, we are excited to introduce our first Forward owned brand at a launch event next week. The collection will initially feature elegant evening dresses starting at price points of around $900 -- just in time for the holidays and for our Annual REVOLVE Awards event next week.

As you can see, we continue to be relentless in our goal of being the trusted premium lifestyle brand and go-to source for discovery and inspiration for millennial and Gen Z consumers. We're proud of our continued success and more excited than ever about what's ahead.

I want thank our team for all of your valued contributions to our success. Your dedication makes all the difference in maintaining our focus on executing against the opportunities ahead.

Now, we'll gladly take your questions. Let’s go to Q&A.