

REVOLVE

REVOLVE GROUP INC. (NYSE: RVLV) Q3 2020 CONFERENCE CALL

PREPARED REMARKS ON NOVEMBER 11, 2020

ERIK RANDERSON, VP INVESTOR RELATIONS

Good afternoon, everyone, and thanks for joining us to discuss REVOLVE's third quarter 2020 results.

Before we begin, I would like to mention that we have posted a presentation containing Q3 2020 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 current expectations regarding the continued impact of the COVID-19 pandemic on our business, operations and financial results, and our outlook for net sales, product mix, gross margin, operating expenses, and capital expenditures for the fourth quarter. These statements are subject to various risks, uncertainties and assumptions that could cause our actual results to differ materially from these statements, including the risks mentioned in this afternoon's press release as well as other risks and uncertainties disclosed under the caption "Risk Factors" and elsewhere in our filings with the Securities and Exchange Commission, including, without limitation, our Annual Report on Form 10-K for the year ended December 31, 2019 and subsequent Quarterly Reports on Form 10-Q, 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 and Free Cash Flow. We use non-GAAP measures in some of our financial discussions, as we believe they more closely represent the true operational performance and underlying results of our business. The presentation of this 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-CEOs, 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, and thanks for joining us today.

Before we get into the details of the quarter, I'll provide some **higher-level thoughts on our longer-term vision**. We founded REVOLVE 17 years ago with the goal of becoming the fashion destination for the next-generation consumer. From the beginning, our focus was on the customer experience, the utilization of data to drive decisions, and the creation of an authentic connection with our customer through our merchandise offering and marketing message. These areas of focus are still at the core of what we do today, and what differentiates us, and what we believe will continue to drive growth into the future.

As a brand known for the discovery of on-trend merchandise centered around aspirational experiences and lifestyle content, including social gatherings, travel, and special occasions, the current environment, impacted by COVID, has resulted in revenue pressure and what we believe is a temporary deviation from our historical growth pattern. Despite these pressures, we have been able to leverage the investments in our platform over time to produce notable increases in margin and profitability that we are excited to share with you today.

We believe the revenue pressures are temporary as people will eventually socialize in person again and travel will return. Until then, we'll continue to invest in our brand and platform to set ourselves up to take advantage of what we believe, post-COVID, will be a strong rebound as a result of prolonged pent up demand.

With that longer-term framework as a backdrop, there are **three key financial highlights of our third quarter** that I want to call out:

- **First**, we delivered record EPS of \$0.27, record net income of \$19 million and record Adjusted EBITDA of \$24 million. Adjusted EBITDA grew 66% year over year and EPS grew at an even faster rate.

- **Second**, we achieved our highest-ever gross margin in a third quarter of 55.3%, a nearly five-point increase from the second quarter and up almost two points year over year. The higher gross margin year over year was a key driver of our significant growth in profitability, and reflects a high percentage of net sales at full price in the third quarter and improved inventory dynamics.
- **Third**, we generated \$14 million of operating cash flow and \$14 million in free cash flow, which was up 86 percent year over year – on the heels of generating \$54 million in operating cash flow in the second quarter. We now have \$159 million in cash on the balance sheet. Our strong balance sheet not only provides us with the capital necessary to navigate through this uncertain time, but more importantly, allows us to re-invest in the business to drive long-term growth.

I'm extremely thankful for all of our dedicated employees who have shown impressive collaboration and agility, day in and day out. Even with most of our teams continuing to work from home, the organization has remained laser focused on ensuring the safety of our employees and maintaining exceptional service levels for our customers while continuing to drive efficiencies throughout the business.

Now, getting into the specifics of our third quarter results... Recall that on our second quarter investor call in August, we talked about the strong pace of recovery for much of the second quarter before net sales leveled off in mid-to late June. As previously shared, our net sales in July and early August remained very slightly positive, increasing year over year in the low single digits. This modest growth trend in net sales remained consistent through the end of August. The trend changed in September with the modest growth in July and August turning to a year-over-year decline in net sales in September, the first year-over-year decline since May of this year.

For the third quarter as a whole, net sales declined 2% year over year, which is a 10-point improvement on a sequential basis compared to the 12-point decline in net sales reported for the second quarter.

While we are pleased with the 10-point sequential improvement for the quarter as a whole, we would have liked to see a stronger close to the quarter. As we look at the recent trends, there are a few things that we believe are contributing to the top-line deceleration.

First, the impact of COVID-19 and more specifically, social distancing, continues to have a significant impact on our business. Our inability to host large scale in-person events has a lagging and growing negative impact the longer we are in a COVID-19 sheltered state. While the brand marketing team has done an incredible job pivoting into livestreaming content and other avenues of engagement, it is very difficult to make up for the millions of engagement points and billions of impressions that come with our in-person events. We are excited to reverse both of these trends in what we believe will be a strong and healthy post-COVID world.

Second, competition for keywords and other forms of digital advertising increased in the third quarter, particularly on a sequential basis compared to the second quarter when online advertising rates were still recovering from the March lows. We attribute the significant increase in online advertising investment in our product categories industry wide to traditional brick and mortar retailers shifting their focus online given the unprecedented increase in ecommerce penetration driven by COVID-19.

Third, and looking at the net sales trends from the second quarter to the third quarter, it is important to note that net sales contributions from markdowns were very strong in the second quarter, helping the top line comp. While we were able to successfully work through our markdown inventory and rebalance our overall inventory levels, the significant reduction in markdown inventory entering the third quarter led to incremental top-line pressure. At the same time, a lower mix of markdown sales and shallower markdowns helped drive the very strong margins and profitability in the quarter.

Aside from the strong Q3 financial results, I am encouraged by the positive impacts from **continued operational enhancements on our platform** and the customer experience initiatives that we continue to roll out in our international markets.

Our Operations team delivered phenomenal results, as we saw the impact of lower return rates as well as efficiency gains from automation and other investments we've made over the last 18 months continue to provide benefits.

Consider that fulfillment costs per order decreased 15% year over year, all the while maintaining best-in-class service levels with a record 99% of customer orders received by Noon Pacific Time shipping out the very same day. We believe this level of performance benchmarks very favorably compared to most other ecommerce companies.

Shifting to a discussion of our International business... We had a strong third quarter in our International markets, financially and operationally. Australia, Canada and Western Europe each delivered strong double-digit growth in net sales year over year, partially offset by a decline in Asia.

One of the most important strategies we can employ in international markets is to localize the country to provide the same great experience offered in the U.S. We recently announced that, for the first time, REVOLVE customers in Canada – one of our top 5 international markets -- have access to hassle-free returns at no cost, including refunds of all applicable duties and taxes. Our launch of all-inclusive pricing for Canadian customers is very important because by including duties within the price of the product up front, we eliminate the “sticker shock” at checkout and significantly streamline the process for merchandise returns.

Now, shifting to the more recent trends in the fourth quarter to date... The softer year-over year net sales trends in September carried through to October with a high single-digit decline in net sales on a year-over-year basis. Similar to what we experienced in September, we continue to experience strength in the “at home” categories that is more than offset by the ongoing pressure in occasion-driven categories.

By geography, in October, international net sales continued to remain stronger than net sales in the U.S. However, we are very cautious due to the resurgence in COVID-19 cases and the corresponding social distancing restrictions in some of our largest international regions including the U.K. and Western Europe.

Before I turn it over to Michael, I want to reiterate how pleased I am with our ability to navigate through these challenging times. So, again, thanks to all of our team members for your hard work and resilience, for staying nimble, and for your dedication to exceeding our customers’ expectations.

MICHAEL MENTE, CO-FOUNDER AND CO-CEO

Thanks, Mike, and hello everyone.

The strength of our business, the power of our brand, and most importantly, the incredible execution of our team, enabled us to deliver our most profitable quarter ever. Even surpassing our record profitability from last quarter. I'm truly proud of how much our team has accomplished during this extremely challenging period. This phenomenal execution has further strengthened our financial profile and positions us well to capitalize on the long-term opportunity ahead.

To expand on Mike's opening remarks, we are focused on building the fashion destination for the next-generation consumer. Our customer comes to us for discovery and looks to us for inspiration. Even during this unique and challenging time, these shopping behaviors remain. We continue to provide a broad, yet curated assortment of the most on trend merchandise that provides her with the ability to discover products that suit her lifestyle, whether it's travel and social occasions or, most recently, a more stay at home and active lifestyle. To complement our merchandise offering, we provide her with constant inspiration through authentic and aspirational lifestyle content. Important to this authenticity is providing content that connects with her on platforms she is engaging with and speaks to what's happening in her life. The team has done a great job of expanding into emerging social platforms and providing content centered around her current lifestyle. I am excited about the progress we continue to make on the merchandising and marketing fronts and believe that despite the challenges of the last couple quarters, we will emerge much stronger and even better positioned for the long term.

Starting with our merchandise... The ongoing reality of a more "stay at home" lifestyle has allowed us to further deepen the relationship with our customer by highlighting our offering of incredible fashion and design, in areas that were not top of mind until very recently. Our emerging categories such as beauty, intimates and loungewear are all strongly resonating.

Additionally, more than ever, our customer is demonstrating a healthy and active lifestyle, leading to greater opportunity in activewear and swimwear.

Our results for the past two quarters demonstrate our ability to serve our customer in new ways and broaden how customers perceive REVOLVE's product selection.

In the third quarter, sales in the at home and active categories of beauty, accessories, intimates, sweaters / knits and swimwear increased approximately 50% year over year on a combined basis. By further enhancing our merchandising strategy, we believe we can expand our share of her wallet over the long term. It's incredibly important to us that whatever our customer needs, she can always come to REVOLVE as her trusted source of style.

An exciting example of one of the more prominent shifts in our mix is the beauty category, with net sales increasing more than 100% year over year for the second straight quarter as COVID-19 has been a catalyst for shifting beauty sales online. Beauty is a category where the majority of customers in our demographic look to influencers for beauty product inspiration, a great fit with our global network of influencers. In fact, this month we are launching a beauty gift box with mega-influencer, actress and model, Shay Mitchell, who has nearly 30 million Instagram followers.

An important component within our long-term merchandising strategy is the expansion of our **Owned Brands**. As we discussed on previous calls, we temporarily pulled back our Owned Brand offering as a response to the uncertainty and demand pressures introduced by COVID-19. The result was a trough in the number of new styles delivered in the quarter. We have already started making the investments necessary to increase our style production and assortment with a targeted 50% increase in the number of Owned Brand styles delivered as we exit the year, as compared to the third quarter.

Additionally, we had discussed making investments into the Owned Brand division to increase the diversity and quality of our product offering. I'm pleased to report that the early results are extremely encouraging, with a significant improvement in productivity per style, as compared to the same period last year.

While we are optimistic on the trajectory of our Owned Brands, bear in mind that despite the increase in new styles delivered in the coming months, due to inventory dynamics, we still expect a sequential decline in our Owned Brand penetration in the fourth quarter of 2020, before beginning to increase sometime in mid-2021.

Shifting to a discussion of our brand marketing strategy... We continued with a successful digital playbook in the third quarter, hosting several well-attended, virtual events. Similar to the shift in merchandising focus in this COVID period, we have also broadened our marketing message to address more aspects of her life. This was the concept behind REVOLVE U, an event we have been developing, even before COVID. Hosted in late September, REVOLVE U was a week-long virtual activation that included seven keynote speakers and over 300 influencers. This unique event increased our reach and followers across multiple social channels, and featured content focused on topics such as The Business of Social Media, Building a Brand, Career Journeys, Mental and Physical Health, and Entrepreneurship.

While we continue to expand and invest in new digital platforms such as IGTV, Instagram Reels, YouTube and TikTok, we are also excited to share that we have recently hosted a series of successful in-person events called Camp REVOLVE that included adherence to comprehensive safety precautions. Dipping our toe back into in-person events is important to build the brand and differentiating ourselves. Furthermore, our in-person events tend to capture more eyeballs, garner more press and generate more customer interactions, all of which are important drivers of traffic and new customers.

We are excited about a future that will include hosting regular in-person events with the added element of our new digital playbook, which we believe will be a very powerful combination.

We are executing well while continuing to invest in our key growth initiatives during this challenging period. At REVOLVE, we are always focused on the long term, and I am confident we are well positioned to capture further market share in the years ahead - particularly with what we believe is an accelerated and permanent shift to digital commerce.

With that, Jesse will close out with some additional detail on the financial results and trends.

JESSE TIMMERMANS, CFO

Thanks, Michael.

As our results attest, we have continued to execute well in a very difficult environment.

For the second straight quarter, we achieved record net income and record Adjusted EBITDA; we generated strong free cash flow that strengthened our balance sheet; and we drove our highest inventory turns in several years.

Now, starting with the third quarter results... Net sales decreased 2% year over year. As Mike mentioned, we began the third quarter with low-single digit growth in July and August that was offset by a larger single digit decline in September.

Occasion wear product categories faced the most significant headwinds since many special occasions remain on pause due to social distancing concerns, and as we worked through our markdown inventory in those categories in the second quarter. To provide some context regarding the impact of reduced markdown inventory on net sales in the third quarter, our largest category, dresses, is a good example. If year-over-year growth in markdown sales of dresses alone had remained consistent between the second quarter of 2020 and the third quarter of this year, our total net sales would have actually increased year over year in the third quarter.

Drilling further into the top line for the third quarter.... By segment, **REVOLVE Segment** net sales decreased 4% and **FORWARD Segment** net sales increased 9% year over year.

Active customers were 1.5 million, an increase of 5% year over year. The trend is consistent with our commentary last quarter that we expected growth in Active Customers to further decelerate as the trailing 12-month metric captured a larger number of quarterly periods impacted by COVID as compared to the high customer growth quarters of last year. With the continued pressures on traffic and demand, we expect further deceleration in this metric until we start to cycle out of the suppressed COVID period.

Orders placed were 1.1 million, a decrease of 4% year over year.

Average order value was \$232, an increase from \$204 in the second quarter of 2020, but remained 16% lower compared to Q3 of 2019. The year-over-year decline in AOV was primarily driven by a shift in net sales mix to “at home” product categories, such as beauty and loungewear with lower average price points, and a decline in net sales of dresses, which carry higher average order values. These AOV headwinds were partially offset by a higher mix of full price sales, our highest full price sales for a third quarter in over ten years, as well as a greater sales mix attributable to our higher price point luxury segment, FORWARD.

Partially offsetting the lower number of orders and the lower Average Order Value was a decrease in **merchandise returned** year over year. We attribute the lower return rate year over year to a combination of more deliberate purchasing behavior by consumers during the COVID-19 pandemic as well as a COVID-19 driven shift in mix to product categories with lower price points and lower return rates, such as beauty, and away from occasion wear, such as dresses, a category with a higher-than-average return rate. That said, we did experience a sequential increase in the return rate from the second quarter, but it remains well below the prior-year periods.

International net sales increased 18% year over year, outperforming the 6% decline in net sales in the U.S. As Mike mentioned, we experienced strength in western regions and emerging markets, partially offset by weakness in Asia.

Moving to gross profit... Consolidated gross margin was 55.3%, the highest ever reported for a third quarter and an increase of approximately 160 basis points over the prior year. This performance was much better than we anticipated, and reflects healthy increases in margin across both segments.

Within the REVOLVE Segment, we delivered gross margin of 57.2%, up approximately 180 basis points year over year. The REVOLVE Segment margin benefited from meaningfully improved inventory dynamics exiting the second quarter of 2020 that contributed to a healthy inventory balance, leading to a year-over-year increase in the percentage of REVOLVE Segment net sales at full-price, and a decrease in the depth of markdowns. These positive contributors to gross margin were partially offset by a year-over-year decrease in the mix of Owned Brands as a percentage of REVOLVE Segment net sales, consistent with the outlook we shared on recent investor conference calls.

Within the FORWARD Segment, we delivered gross margin of 42.9%, an increase of approximately 190 basis points year over year. The increase reflects a healthy inventory balance, shallower markdowns and a favorable mix of merchandise sold. We were encouraged to see an easing of promotional activity across the luxury space in Q3.

And now moving to the cost structure, where we delivered highly efficient results... For the second straight quarter, we achieved leverage on every major expense line item on the P&L.

Starting with Fulfillment, Fulfillment costs were 2.8% of net sales, an improvement of about 60 basis points year on year.

The team did an outstanding job driving efficiencies while maintaining our top priority of protecting the health and safety of our employees and delivering a best-in-class experience for our customers. The automation launched last year was further expanded during the second quarter and is delivering a compelling return. We also continued to benefit from cost efficiencies resulting from a lower return rate year over year.

Selling and distribution costs were 13.8% of net sales, an improvement of approximately 80 basis points year over year. Once again, we benefited from reduced shipping costs due to lower returns and, to a lesser extent, efficiencies in payment processing and customer service costs.

Marketing costs were 12.5% of net sales, a decrease of approximately 250 basis points year over year. Marketing efficiency primarily reflects reduced brand marketing investments since hosting in-person REVOLVE events remained on pause. Our investment in brand marketing decreased by \$3.2 million year over year and performance marketing investments decreased by the remaining \$1.1 million in Q3.

It is important to note that our brand building investments will remain a key component in our long-term growth algorithm, so we do not expect the total marketing expense as a percentage of net sales to remain at the reduced levels we have reported for the past two quarters.

General and administrative costs were 11.7% of net sales in the third quarter, an improvement of approximately 60 basis points year over year. The reduced G&A cost reflects lower headcount and our COVID-19 cost containment efforts that were in place for a portion of the third quarter. In addition, as part of the Owned Brands reset that was accelerated due to COVID, we reduced costs in this area. As we start to rebuild and design into new product categories and get ahead of an anticipated return of demand, we will re-invest in this area over the coming quarters.

For the third quarter of 2020, we achieved record **net income** of \$19 million, or \$0.27 per diluted share, more than doubling the \$0.13 in diluted EPS in the prior year. In addition to our strong operating results, our EPS comparison benefitted from a lower tax rate in 2020, primarily due to excess tax benefits realized as a result of stock option exercises. Even when excluding these discrete tax benefits, our net income and diluted EPS would have each increased more than 65% year over year.

We also reported record **Adjusted EBITDA** of \$24 million, an increase of 66% year over year, for a margin of 15.9%.

Moving to the cash flow statement, we had another outstanding quarter for cash flow generation. Free cash flow was \$14 million, a year-over-year increase of 86%. For the 9 months ended September 30, 2020, free cash flow was \$74 million, more than doubling our free cash flow reported for all of 2019.

The strong cash flow generation significantly strengthened our **balance sheet and liquidity**. Cash and equivalents as of September 30, 2020 were \$159 million, an increase of \$8 million during the third quarter, despite the repayment of \$9 million on our revolving line of credit. As we look ahead and think about capital allocation and the use of cash, our number one priority is fortifying our balance sheet to position us to invest in growth as we exit the COVID era, followed by strategic organic investments to drive long-term growth. Given our capital efficiency, we also have the opportunity to explore other investments, including opportunistic and disciplined M&A.

We are pleased with our inventory levels and the healthy inventory dynamics in the quarter. We ended Q3 with \$74 million in inventory, a year-over-year decrease of 29%, but up \$9 million from the second quarter as we started to reinvest to build a sufficient inventory level and appropriate inventory mix to support demand. By comparison, our net sales decreased year over year by only 2%, which illustrates our significant improvement in inventory turns.

Now, let me talk about the business trends since the third quarter ended on September 30th. Given the fluid and uncertain environment that we continue to operate in, we'll again skip any traditional guidance. Instead, we will share some recent trends and assumptions to help in your modeling of the fourth quarter.

Starting from the top, as Mike mentioned, net sales in October were down by a high single digit percentage year over year.

In terms of product categories, we continue to see strength in new at home categories that has been offset by continuing headwinds in occasion wear categories, such as dresses and skirts.

From a macro perspective, we see a great deal of uncertainty affecting our customer demographic. COVID-19 cases around the world are re-accelerating, leading to increased restrictions on social outings that have been a key driver for our brand. When combined with the high unemployment rates and lack of new U.S. stimulus measures, we see continuing challenges in the current environment.

Shifting to gross margin... The Q3 gross margin performance was well ahead of our initial expectations, benefiting from a higher mix of full price sales and shallower markdowns. Moving to Q4, we expect gross margin to come in more in line with the prior-year fourth quarter gross margin of 53% as a result of a lower mix of owned brand sales year over year, as well as what we expect to be a prolonged holiday promotional cadence.

For our Selling and Distribution and Fulfillment cost line items, we expect the combination of Selling and Distribution and Fulfillment expenses to be flat to slightly higher as a percentage of net sales in the fourth quarter when compared to Q4 of 2019. There are a couple factors contributing to this assumption.

First, as you have all heard, the major shippers are imposing surcharges on packages during the fourth quarter that are likely to drive higher shipping costs in Q4.

Second, Fulfillment and Selling & Distribution have each realized efficiencies from the lower return rate year over year. In Fulfillment, we incur lower labor costs due to less time spent handling the returned units that come into the warehouse. And in Selling and Distribution, where the majority of the costs are shipping related, fewer returns means reduced shipping, packaging and payment processor costs.

Since bottoming out in the second quarter of 2020, our return rate has been increasing with each passing month, so we are planning for a sequential increase in costs as a result. We do, however, expect our return rate in the fourth quarter of 2020 to remain lower on a year-over-year basis.

These cost pressures will be partially offset by continued efficiencies realized as a result of the automation and process improvements discussed earlier.

Marketing: We are planning for marketing as a percentage of net sales in the fourth quarter to remain approximately flat year over year. After two straight quarters of significantly reduced marketing spend and with our strong balance sheet, we believe it's time to start pushing our marketing investment again to continue to build the brand, drive traffic and increase customer activity.

General and Administrative: On a year-over-basis, we are planning for G&A expense to be lower in the fourth quarter as compared to the prior year. Compared to the third quarter of 2020, we expect G&A expense to increase in Q4 since the temporarily reduced salaries and wages have been fully restored to their pre-COVID levels for our active employees.

To recap, we believe we have executed well during what is a very challenging environment with a focus on safety for our employees, efficiency in our operations and building a strong balance sheet. With a healthy base of inventory and our cash balance, we are shifting back into investment mode with an increase in our marketing investments, an increase in our inventory levels and assortment, and investments into our Owned Brand capabilities.

Now we'll open it up for your questions.