HD **Q4 2020 Stitch Fix Inc Earnings Call - Final**

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OPERATOR: Good day, everyone, and welcome to today's **Stitch Fix** Fourth Quarter 2020 Earnings Call. Today's conference is being recorded.

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At this time, I'd like to turn the conference over to Mr. David Pearce, Vice President of Investor Relations. Please go ahead.

DAVID PEARCE, VP OF IR, **STITCH FIX**, INC.: Thank you for joining us on the call today to discuss the results for our fourth quarter and full fiscal year for 2020. Joining me on today's call are Katrina Lake, Founder and CEO of **Stitch Fix**; Elizabeth Spaulding, President; and Mike Smith, President, COO and Interim CFO.

I would also like to mention that we are joining you remotely today from our home offices. We have posted complete Q4 and full year financial results in our shareholder letter on the IR section of our website, investors.stitchfix.com. A link to the webcast of today's conference call can also be found on our site.

We would like to remind everyone that we will be making forward-looking statements on this call, which involve risks and uncertainties. Actual results could differ materially from those contemplated by our forward-looking statements. Reported results should not be considered as an indication of future performance.

Please review our filings with the SEC for a discussion of the factors that could cause our results to differ. Also, note that the forward-looking statements on this call are based on information available to us as of today's date. We disclaim any obligation to update any forward-looking statements, except as required by law.

During this call, we will discuss certain non-GAAP financial measures. Reconciliations to the most directly comparable GAAP financial measures are provided in the shareholder letter on our IR website. These non-GAAP measures are not intended to be a substitute for our GAAP results.

Finally, this call in its entirety is being webcast on our IR website, and a replay of this call will be available on the website shortly.

I'd now like to turn the call over to Katrina.

KATRINA M. LAKE, FOUNDER, CEO & DIRECTOR, **STITCH FIX**, INC.: Thanks, David, and thank you for joining us. After the market closed today, we issued our quarterly shareholder letter with more details on our results and strategies. As you'll hear today, our business ended Q4 in a position of strength, and we're excited about the opportunities that lie ahead in fiscal 2021.

Specifically, there are 4 themes on today's call. First, we navigated the COVID trough and have emerged even stronger. Second, our business is healthy with strong underlying fundamentals. Third, we are well positioned strategically and financially to take market share and play offense in 2021. And finally, we are accelerating the expansion of our consumer experience due to the momentum we've seen across our Fix and direct buy offering. Combined, these themes give us confidence and optimism for the year ahead.

With that, I'd like to rewind the script to talk about the first point and paint a picture of where we were when we last met in June. Our distribution centers were recovering from significant disruption due to the COVID crisis. At one point, half of our warehouse nodes were closed, and we were operating at nearly 30% fulfillment capacity. Our supply constraints were not limited to our warehouses. As we spoke about last quarter, we had also pulled back on inventory, both in the interest of conservatism as well as relevance as we anticipated and would see very significant changes in the types of apparel that consumers were looking for.

Given this constrained environment, we dramatically reduced our marketing spend from late March, April and into May, to ensure our limited capacity could be used to serve the demand we are seeing from existing customers as well while minimizing the risk that we would spend to acquire new customers into a suboptimal and potentially disappointing supply environment. While we recognize that the decision to limit new clients during the time would impact our subsequent Fix demand in the quarters that followed, it was the right decision that prioritized the long-term success, happiness and profitability of our client cohorts.

Emerging from the peak of the crisis in the spring, we began to play offense. We rapidly strengthened our foundation and adapted to the consumer. In the new work-from-home backdrop, we realigned our assortment to what was relevant and joyful for our clients. We unveiled new experiences to our active Fix clients with direct buy. And we ramped up our marketing spend in June as we gained confidence in our fulfillment strength and in consumer sentiment.

With that backdrop, we are really pleased that we didn't just manage to survive the deepest trough of the crisis, but that we delivered results that we are very proud of. In Q4, we returned to positive year-over-year top line growth, grew gross margin by over 400 basis points from Q3 and delivered over $50 million in free cash flow.

These results are all the more notable when compared to many apparel retailers reporting double-digit declines for the same time period. We are particularly excited about our new client demand. As our distribution center capacity rebounded in late June, we dialed marketing back up. In July, we saw a 50% year-over-year increase in our first Fix shipments, and we saw elevated growth continue through the month of August. This is the highest sequential first Fix growth rate we've seen in the last 3 years, so much so that we've had some higher-than-average Fix wait times as we catch up to support this windfall of new client demand.

We believe this elevated first Fix demand will also drive incremental subsequent Fix volume in the quarters ahead, given that the majority of our clients choose to receive fixes on a recurring basis. The flexibility in our model allowed us to meet the consumer in this moment, with our overall value proposition anchored on the convenience of shopping at home and by adapting our inventory to what is most relevant today.

We will continue to pursue this path of adaptability and personalized relevance, which has been central to **Stitch Fix** since the beginning. Now more than ever, it will help us capitalize on a forever changed apparel retail environment.

Before I discuss our Q4 results, I want to provide a quick reminder that Q4 '19 consisted of 14 weeks, which resulted in fiscal 2019 being a 53-week year. As such, when we reference adjusted growth rates in this call, we're noting that we've removed the impact of the extra week in a given month, quarter or year to show you a comparison that we believe more accurately reflects our performance.

With that, I'm pleased to share that in Q4, we generated net revenue of $443 million, reflecting 11% adjusted year-over-year growth and 19% sequentially from Q3. We delivered a net loss of $44.5 million and adjusted EBITDA loss of $8.3 million. Our adjusted EBITDA, excluding SBC, was positive $11.8 million.

During the quarter, we grew our active client count to 3.5 million. This represents a year-over-year increase of 286,000 clients and 9% growth. In addition, net revenue per active client increased 2% year-over-year on an adjusted basis.

Now turning to our second theme, I'd like to share more color on how we delivered this Q4 performance and the strength we're seeing across our business. Over the last few months, our business has exhibited some of the strongest levels of performance we've seen since going public. Each of our major categories performed well, and we saw notable tailwinds in demand, including increased adoption of our offerings. Our first Fix shipments accelerated, and we saw continued strong retention of our auto ship consumer base.

We also saw growing momentum in Women's and Plus, continued growth in Men's and notably real gains in both the scale and margin profile of our most nascent Kids and U.K. businesses. On top of all of this, our expansion into direct buy, a critical part of our future, has shown unabated growth, both pre- and post-COVID, and we believe it will unlock our total addressable market in new and very material ways.

With that, I'll now provide some updates on each of our client categories to give you a sense of the momentum we're seeing. One of the main contributors to strength in overall Fix trends has been the health and heightened demand in Women. We've seen ongoing improvement in the last few months. And in Q4, Women's first Fixes grew approximately 25% year-over-year on an adjusted basis. We've also shifted volume out of categories like workwear and blazers that have been hit harder by COVID and into more in-demand product categories like athleisure. Our Women's Activewear assortment, in particular, has surged in demand in the past few months as clients seek apparel that balances comfort and style.

In the last few years, we expanded our Activewear mix, which has allowed us to capitalize on recent trends and work-from-home mandates. In Q4, Women's Activewear revenue grew by over 350% year-over-year on an adjusted basis, benefiting from strength across both Fixes and direct buy. We also delivered year-over-year growth in success rate and client satisfaction in Q4 as key brands such as Reebok and Beyond Yoga resonated with clients, and we feel well positioned to continue serving clients' Activewear needs in the months ahead.

In Q4, our Women's category also benefited from accelerated growth in our Plus offering. While we believe Plus size has historically been an underserved market by traditional retail, it's one that we served well due to our understanding of fit and sizing and our ability to address client preferences through our exclusive assortment and strong market vendors.

As traditional Plus channels contract due to store closures, we saw higher demand in Q4 with Plus first Fix growth exceeding 35% year-over-year on an adjusted basis. Plus also benefited from year-over-year growth in success rate and average order values in Q4 and FY '20 as we broadened our assortment across price points and end uses. While Plus represents a low double-digit percent of Women's clients today, we think it comprises 40% of our Women's addressable market, and we plan to invest aggressively in Plus inventory in FY '21 to support further acceleration.

Similar to Women's, our Men's category benefited from the surge in demand for Activewear and drove improvement in first Fix demand in Q4. In particular, we saw brands like New Balance and Public Rec resonate with clients as well as our own exclusive Activewear brand, 01. Algo, and we're broadening our assortment in fiscal 2021. Beyond Women's and Men's, we drove momentum in our more nascent Kids and U.K. categories during the last quarter.

In Q4, we celebrated the second anniversary of Kids, which has been especially resilient during COVID, with Kids surpassing even our pre-COVID expectations for the year.

As Kids has scaled, we've leveraged client feedback data to improve our personalization capabilities and strengthened our inventory assortment. In the 2 years since launching Kids, we've improved success rates by over 15%. In Q4, our Kids clients kept the highest proportion of items in their Fixes since the category launched. These improved outcomes have also been a function of our enhanced exclusive brand assortment with sales of our exclusive Kids product doubling on an adjusted basis year-over-year in FY '20 and fueling the category's year-over-year gross margin expansion. While Kids is still in its early days, it is quickly scaling and on a similar profit trend line as our larger offerings, underscoring why we're so excited for this emerging category.

We also recently celebrated the 1-year anniversary of our U.K. launch. 6 months ago when we discussed the U.K., we highlighted a few of our early challenges and uncertainty around Brexit. Now 6 months later, we are optimistic about our U.K. trajectory. As with our other rollouts, we've taken a launch and learn approach in the U.K. and have focused on collecting client feedback and leveraging learnings to improve our recommendations, buying and merchandising strategies.

These enhancements resulted in U.K. success rates and average unit retail price each growing by approximately 20% year-over-year in FY '20, translating to a lift in average order value of over 40%. These improvements meaningfully strengthen our unit economics and margins, but also demonstrate how quickly we are learning and refining our U.K. offering.

In Q4, we also saw highly efficient client acquisition trends, which we believe were a function of strong organic and referral demand as well as the broader pullback in digital spend by other retailers. While our U.K. offering is still in its early innings, we believe its momentum validates the viability and strength of our personalization model in other geographies, and we remain very excited by the progress we're seeing in this promising new market expansion.

Across the board, we're excited about the health and momentum we're seeing across the business and the opportunities that lie ahead.

With that, I'll hand it over to Elizabeth to share more on our future, direct buy's ramp-up and how we plan to take share in the year ahead.

ELIZABETH SPAULDING, PRESIDENT, **STITCH FIX**, INC.: Thanks, Katrina, and hello to all of you on the line. On top of the company's success Katrina shared, this moment in history is a once in a lifetime opportunity in the shift of apparel retail, and we are playing offense. Consumers are rapidly moving their apparel buying online, approximately 3x faster than in pre-COVID periods. While overall demand for apparel is undoubtedly not what it was pre-COVID, the pandemic is completely resetting enduring client behaviors. Consumers are changing their habits, and we are here to help them establish these new shopping behaviors, providing the personalized discovery and guidance that was previously met off-line.

We are also able to rapidly toggle our inventory to what is most relevant right now. As a result, now is our moment to define the new apparel model as the traditional apparel retail sector shakes out. We saw this shift very much underway in Q4 and into Q1, with surging growth in our new customer shipments.

As traditional retailers close their doors, consumers are shifting to **Stitch Fix** as evidenced by our increased demand and growth, validating that we're taking share. When retail spend rebounds in the coming months, we expect more than $30 billion of market share to move online over a 12- to 18-month period.

We anticipate capturing more than our fair share of this given the relevance of our model, particularly with the expansion of direct buy. We will be focused on the consumer segments, categories, and elements of our offering that we believe will enable us to take disproportionate share in this time.

Now let me share how we started to play offense in Q4 with the results we delivered through direct buy and by enhancing our experience to appeal to a greater set of purchase occasion. In June, we launched Trending For You, which expands our feed-based shopping experience, enabling more shoppable looks, widening the breadth of items from which clients can choose to purchase and removing the requirement that clients have purchased with us in the past.

This will set the stage for new-to-**Stitch Fix** customers engaging with us through direct buy in the quarters ahead. In the first 2 weeks of introducing Trending For You, our weekly direct buy orders grew by over 30%, suggesting that as we add features and broaden ways to engage and shop, we will be able to capture a greater share of wallet with clients. This expansion is part of our robust product road map that will continue to give clients more reasons to engage with us and broaden our offering to appeal to a larger consumer set. We are preparing for more of these enhancements in FY '21 to widen product discovery for both inspiration based as well as higher intent purchases.

In July, we also introduced an algorithmic recommendation engine exclusively for direct buy clients that uses our direct buy data set to more fully capture clients' interactions and preferences. Compared to our prior Fix-based recommendations, clients purchased more items on average, bought products with higher average prices and converted at higher rates. This new engine was also built to work in real-time with clients who are onboarding directly into Shop, and we plan to test this cold start recommendation capability in Q1.

Now I'll share a few updates on direct buy's financial performance. In Q4, it continued to meaningfully outperform our expectations, driven by faster existing client adoption, higher purchase rates per client and greater levels of engagement. While we won't share direct buy penetration every quarter, we'll note that Women's penetration grew into the high teens percent, while Men's grew into the high single digits, with both categories demonstrating strong traction, but also meaningful headroom for growth.

We also achieved very high success rates driven by our ability to pair data-driven recommendations with clients' high-intent purchase decisions. As a result, return rates associated with direct buy have been less than half that found in traditional apparel e-commerce. These client outcomes have led to strong repeat purchase behavior. From the launch of direct buy through the end of Q4, nearly 2/3 of clients who completed a direct buy purchase returned to make a subsequent purchase. These factors have reinforced direct buy's impressive unit economics, with the offering delivering contribution margins that are already at parity with our Fix offering. In addition, in August, we introduced our shopping bag functionality to all direct buy clients. And we believe that this cart-like feature, which combines multiple items into fewer shipments, will drive incremental cost savings and thus further margin expansion.

Offerings like direct buy, which we believe can offer a step change in our growth trajectory, bolster our belief that the investments we're making in our people and across our business will result in outsized market share gains. Many in our industry pulled back their growth investments in response to COVID. We did the opposite and we see results, share gain and adoption of new experiences. We continued investing across engineering, data science and products to broaden our experience and innovate our personalized shopping experience that complements our unique personalized styling service. We have made significant progress in demonstrating real gains in our new direct buy platform as well as in early stages of testing and piloting of enhancements to our Fix offering, which we believe is more relevant than ever as consumers shop from home.

With our Fix form factor, we're enhancing the client experience to leverage our differentiated styling team to deliver stronger client outcomes. One initiative that is currently in flight in the U.K. enables clients to engage directly with stylists to select anchor items in their Fix and identify other ways they'd like stylist support before the Fix ships. This data has driven strong early results and we believe this approach appeals to an even broader set of clients as consumers seek higher touch engagement, especially while reducing their frequency of shopping in stores.

Based on the results of this initiative to date, we plan to introduce it to U.S. clients in the quarters ahead. Beyond product innovation, we're also investing in our distribution centers to support higher levels of demand. As we continue to expand our offering, we believe these investments will help to remove limiting factors tied to capacity constraints and allow us to fulfill higher demand in conjunction with our more aggressive marketing strategy. We're very excited about the opportunity that lies ahead, and we are confident that we're well positioned to extend our market share.

With that, I'll hand it over to Mike to provide more on our financial performance and our outlook.

MICHAEL C. SMITH, COO & INTERIM CFO, **STITCH FIX**, INC.: Thanks, Elizabeth, and hello to everyone on today's call. First, I'll share more detail on our results from the quarter and full fiscal year. In Q4, we generated net revenue of $443 million, representing 3% growth year-over-year or 11%, excluding the impact of the extra week in Q4 of '19. Fiscal '20 net revenue was $1.7 billion, growing 9% over the prior year or 11% on an adjusted basis. In the quarter, we grew active clients to 3.5 million. This represents a year-over-year increase of 286,000 clients and 9% growth. Q4 net revenue per active client was approximately flat year-over-year on a 53-week basis and grew 2% on an adjusted basis. Note that the net revenue per active client is based on the last 4 fiscal quarters, such that Q4 '20 revenue per active client of $486 is not impacted by the extra week from Q4 of '19.

Q4 gross margin was 44.9%, representing a 410 basis point increase quarter-over-quarter, driven by a reduction in our inventory reserve as we stabilized our inventory position. We're proud of this large sequential margin improvement and our ability to execute against the directional guidance we provided during June earnings. Full year gross margin was 44.1% or 50 basis points lower than last year.

Advertising was 9.9% of net revenue in Q4 compared to 9% in Q4 of '19 and was 9.8% of net revenue in fiscal '20 compared to 9.6% in fiscal '19. Other SG&A, excluding advertising, was 38.3% of net revenue in Q4 compared to 34.6% in Q4 '19, and was 37.3% for the full year compared to 33.4% in fiscal '19. This reflects ongoing investments in technology talent and the associated SBC expenses.

Q4 adjusted EBITDA loss was $8.3 million and fiscal '20 adjusted EBITDA loss was $29.1 million. This performance was in line with our expectations and reflects lower gross margins in Q3 '20 as well as ongoing strategic investments we made to support long-term growth. In fiscal '20, these investments totaled approximately $110 million and included $68 million in stock-based compensation as we invested in technology talent, roughly $25 million in supporting our U.K. category as it scales and nearly $15 million in onetime COVID-related expenses.

Adjusted EBITDA, excluding SBC, was $11.8 million in Q4 and $38.4 million in fiscal '20. Q4 net loss was $44.5 million and diluted loss per share was $0.44. For fiscal '20, net loss was $67.1 million and diluted loss per share was $0.66. And finally, in Q4, we delivered free cash flow of $51.8 million and ended the quarter with no debt and $381.6 million in cash, cash equivalents and highly rated securities.

Before I discuss our outlook, I'll note 1 change we're making in FY '21 on how we report EBITDA. As we look ahead, stock-based compensation will remain an important lever for us as we invest in growing our data science and engineering teams. We also note that most comparable companies exclude SBC from EBITDA. As a result, going forward, we will only provide adjusted EBITDA, excluding SBC, as we believe it more closely reflects our operating performance.

Now on to our outlook. As Katrina mentioned, we've been very pleased with first Fix demand trends in July and August, which we believe will bolster our active client growth in the year ahead. One prevailing trend she also mentioned is lower subsequent Fix volume impacted by our demand side pullback in Q3 of '20.

Let me explain this temporary phenomenon in greater detail. As we shared in Q3 '20, our COVID-related fulfillment challenges led us to pull back significantly on marketing for nearly 8 weeks, which we knew would lower our active client count and the subsequent base of clients we served in the quarters thereafter. Given the fact that repeat clients comprise such a large portion of our business, we expect the loss of those new March through May clients who would, on average, receive multiple Fixes and spend hundreds of dollars with us in their first year will roll forward and particularly impact subsequent Fixes in the first half of fiscal '21.

However, as we enter the second half, we expect the effects of the temporary pullback in marketing to subside giving us confidence in our accelerating growth for the year ahead. In addition, as Katrina referenced earlier, we're playing catch up to support the renewed surge in client demand. As such, in Q1, we expect to deliver mid-to high single-digit revenue growth, which reflects robust recent demand trends, offset by lower subsequent Fix volume I just mentioned.

It also reflects some of the benefit from our new client growth moving into Q2. Given the uncertain macro environment, we also think it's prudent to hold off on providing specific full year guidance at this time. However, we do expect year-over-year revenue growth to accelerate meaningfully in the second half of fiscal '21 as the impact of COVID stay-at-home orders subside.

Now I'll share how we're thinking about our investments and implied margins in FY '21. Fiscal 2019 and 2020 were heavier investment years for us as we invested in initiatives that will fuel long-term growth such as our Kids and U.K. categories as well as data science and engineering talent.

In fiscal 2021, we plan to continue investing in growth opportunities like the U.K., but at lower levels than last year as the category continues to gain traction and scale. Even with this continued investment, we plan to begin showing expense leverage in our adjusted EBITDA, excluding SBC.

I'll only caveat this by saying that we'll be flexible in how we allocate marketing dollars in FY '21. And if we see the opportunity to invest to drive outsized share gains, we may take advantage of that. In line with Elizabeth's earlier comments, we plan to invest higher levels of CapEx in FY '21 to increase our operating capacity, which should mitigate growth constraints and also drive leverage in our model over time. CapEx has historically comprised less than 2% of revenue. And in FY '21, we expect it will increase by 100 to 200 basis points over historical levels. This is part of our longer term investment in our inventory management strategy, which we will share more about in the quarters to come.

In summary, we're proud of the results we delivered in FY '20 and our ability to return to generating positive top line growth in Q4. We have a healthy cash position, no debt, an undrawn revolving credit facility, and we're generating cash flow. As we look into 2021, we believe that our strategic and financial position will allow us to capture outsized share gains while we also deliver accelerated year-over-year growth and continued profitability.

With that, we're ready to open it up for questions. Operator, over to you.

Questions and Answers

OPERATOR: (Operator Instructions) We'll hear first today from Edward Yruma with KeyBanc Capital Markets.

EDWARD JAMES YRUMA, MD & SENIOR RESEARCH ANALYST, KEYBANC CAPITAL MARKETS INC., RESEARCH DIVISION: I guess, first, on the success of direct buy. Obviously, lots of great commentary, we appreciate that. With the basket sizes, wondering if that's changed now that you have the shopping bag capability, where you've seen kind of the benefit, I think, in August and post that? And then as a follow-up, Mike, I think you had mentioned in the release about the inventory reserve release that help gross margin. As you rebuild inventory, does that weigh in the P&L?

KATRINA M. LAKE: Thanks for the question, Ed. We'll have Elizabeth probably answer the question on direct buy. And then Mike, you can take the one on inventory.

ELIZABETH SPAULDING: Yes, hi there, Ed, this is Elizabeth. I think we've been really pleased to see the momentum, as you mentioned, with direct buy. And in terms of the shopping cart, we had it in a beta mode for a few months and we just very recently launched it to our full client set. So in terms of the kind of incrementality that I think you're asking about, a little bit early days to share that. I mean I think one thing that's interesting is even pre having the shopping cart, we had clients converting to multiple purchases even through the buy now feature. And so I think we'll know more in the months to come. I think what we're excited about is that the gross margins of direct buy were already at parity with our Fix offering and now with the kind of benefit of consolidated shipping that we'll be incorporating, we would expect to see margin enhancement as well as other new features that we're launching with the cart where something ends up being out of stock, we can help recommend items that are buy similar to consumers. So more to come as the cart is in place for a longer period of time, but we were seeing people buy multiple items pre cart as well.

MICHAEL C. SMITH: And Ed, this is Mike. Yes, the inventory reserve, we feel pretty confident about where we are relative to managing inventory. There's a couple of things I'd note. One, is just given the surge in demand what we're seeing is, there's a chance we'll chase into more inventory to accomplish kind of meeting client demands. And -- but I would say that where we are from a gross margin perspective, without guiding to gross margin, we feel really good about sort of what we did in Q4. And in and around that number for the rest of the year, and we feel inventory is in great shape.

OPERATOR: We'll move next to Ross Sandler with Barclays.

ROSS ADAM SANDLER, MD OF AMERICAS EQUITY RESEARCH & SENIOR INTERNET ANALYST, BARCLAYS BANK PLC, RESEARCH DIVISION: Katrina, I just had a question about the first Fix, up 50% versus the repeat. So are these new first Fix customers? Are they comparable to customers you brought in at other time periods? And are you guys having the same success converting them to auto ship? Or is there like a propensity, given the environment that has kind of more of a one-and-done phenomenon? I'm just trying to kind of reconcile that with the guidance that Mike gave on first half and second half? And then, Mike, on CapEx. So is this investment going into automation? And if so, I guess what will that allow **Stitch Fix** to do today or on the future that you're not doing today in terms of just improving processing time and dealing with inventory?

KATRINA M. LAKE: Thanks for the questions, Ross. Yes, on the first question, we're seeing really great trends on the client demand side. And we really see this as just confirmation that right now, the model of trying and buying personalized selections of clothing on at home. This way of shopping is more relevant than ever. And so when we -- in terms of like the dynamic between repeat and new client, as a reminder, in Q3, we pulled back pretty significantly on marketing. And what that means is, in our business, the clients that we acquire don't just generate revenue in the quarter that we acquire them, but they actually generate revenue over a much longer period of time. So which means that in Q3, if we acquired fewer clients, we'll see the impact of that temporarily this quarter or next quarter. But the flip side of that is that the really good trends that we're seeing on new client acquisition will also sustain for multiple quarters ahead. And so what we're seeing, where the client trends that we're seeing, while we haven't shared anything specific as to auto ship or opting in. What we have shared is that we've seen almost kind of best ever trends in terms of people retaining, staying on auto ship in terms of the dynamics we're seeing within the Fixes, and we don't see any reason to believe that, that will change. But right now, I think we're at a place where we're looking at kind of a first half that really is kind of anniversarying some of the client demand trends that we saw in Q3 and what that looks like for a temporary effects but really optimistic as we think about the trends that we're seeing now as in July and kind of what that goodness will look like in the back half of the year. Mike, why don't you take the question about CapEx?

MICHAEL C. SMITH: Yes, sure. I mean, there's a few things going on, Ross. There's one that we can add more automation to your point and improving efficiency. So that's one area that we're going to continue to invest in. Nothing other than improving the efficiency within the 4 walls. But we just -- the second thing is we need more space. I mean, given demand trends and some of the things that Elizabeth touched on in the last 2 quarters in terms of new inventory models, we need more space. So there's a combination of efficiency within the 4 walls and more square footage.

OPERATOR: We'll move next to Mark Stephen Mahaney with RBC.

MARK STEPHEN F. MAHANEY, MD & LEAD INTERNET RESEARCH ANALYST, RBC CAPITAL MARKETS, RESEARCH DIVISION: I want to ask a question about direct buy, the impact and the question about the U.K. I would have thought that the impact of the direct buy functionality would have been kind of in order, increased retention, increased spend per customer. And then only at a distance would have been kind of an impact on bringing in new customers. But it almost sounds like you're seeing it kind of evenly balanced across all 3 of those areas. Could you just comment on that? I would have thought that had been harder, there was a stretch here, I guess, to really kind of convince new people to come on, but could you just comment on the impact on all 3 levels of customer acquisition and retention? And then real quickly on the U.K., is there something new that you've been able to do there? Do you think you've just finally reached some critical mass? Is there -- I know you had some marketing issues, I think, early on. Just talk about where you think you are in terms of the playbook and reaching success in that market?

ELIZABETH SPAULDING: Great. This is Elizabeth, Mark, I can answer both of those. On direct buy and the impact of your questions around retention, relative to spend per customer and new customers. It's interesting because, as we've said, we've not yet unleashed this, so to speak, to brand new customers. We did a very small amount of testing with the influencer program that we did in June. But that was very much on a small scale relative to the big idea so far, which is just driving incremental spend of our existing customers. And I do think it's probably something another reason to stay longer or stay more with **Stitch Fix**. So I think the majority of what you're seeing is actually really more on retention and spend per customer. That new customer demand that Katrina was talking about, that 50% year-on-year Fix growth within July and into August. I mean that is clients opting into Fixes, opting into auto ship. The happy benefit is now as soon as they come in, we're very much marketing our Shop offering to them as well. But the spend per customer, I think, is really what we've seen to date and just penetrating our existing base. And then we have done some work already and beginning to do dormant reactivation of historic clients. And the early read on those tests have been quite successful. So we'll continue doing that as well as clients that we consider to be prospects, meaning those who've shared a lot of information with us in the past, but not yet converted. And so those are attractive pools that we will be going after. But that new customer idea is actually the big white space ahead of us.

And then on your U.K. question on critical mass, I mean, I think we're just seeing a lot of really good things that the learning over the last year has really benefited us. So as Katrina mentioned in the call earlier, we've seen 20% year-on-year improvements in both the average -- the AURs that we're seeing as well as keep rates per customer, and that's translating to this 40% AOV improvement. And what that means is just we're really getting on the glide path of great contribution margin and something that gets us excited about the growth. I also just think our model has really been relevant in this moment. And the customer acquisition that we saw, I'd say, starting in kind of mid- to late-April and throughout the last few months just have had great momentum, both on the organic and referral side as well as on paid acquisition, where we think a number of our -- the competitive set has probably just had to pull back. And then just on creative things, we've done to educate more about our offerings. So we introduced a stylist ambassador program, where we've helped our stylist really amass a large Instagram following. And using that vehicle to help customers really better understand this model, which I think now that it's gaining more awareness, we're just seeing greater traction.

OPERATOR: And from Piper Sandler, we'll hear next from Erinn Murphy.

ERINN ELISABETH MURPHY, MD & SENIOR RESEARCH ANALYST, PIPER SANDLER & CO., RESEARCH DIVISION: I guess I had a couple of questions. Maybe first for Elizabeth or Kat. Just following up on the surge of first Fix demand that you saw in August -- and July and August. Can you just share kind of what you're seeing from kind of what type of customers these are? Is it different from age demographic? How does the mix break down versus what you've seen historically when you've seen a surge in first Fix demand? And then a second question on the shift of stylists. I believe last quarter, you guys had plan to see a shift to about 1,400 stylists into lower cost region. Just would love an update there. How easy has that been? Has there been any sticky points or kind of challenges, I guess, as you've done that?

KATRINA M. LAKE: Yes. Thanks for the great question. I think firstly, on first Fix demand, what we're seeing, we're seeing really -- we're seeing a lot of strength on Women's and Kids. And I think in Women's, what's been really exciting is really seeing that strength in Plus size. And I see that as both just a reflection of what's happening in the Plus-size market, which was historically very dependent on physical in-store experiences and kind of our ability to be able to capture some of that demand. And I think it's also, I think, a testament to just like the convenience of our model and really being right where the customer wants. And so we're really, really thrilled about kind of what we're seeing there. I don't think that there's a time in terms of like how did these clients look different from past clients. But I mean, I think Plus size is one place that we're pretty excited about. And actually, one last thing I'd add on the Plus too is that we've really focused on inclusivity in marketing and in the imagery that you'll see, and I think that's another thing that's now helping that side of the business. And so that's kind of -- that's definitely kind of what we're excited about with first Fixes.

On the stylist side, we -- so far, it's been great. Right now, we have a lot of open recs in the many other geographies that we hire stylists, such as Minneapolis and Texas and Ohio. And the hiring of stylist has never been a challenge for us. We really have found that there's a really, really great labor pool to draw from. And we have been used to kind of hiring at scale and hiring high volumes. And so we are currently hiring about 2,000 -- we'll be hiring about 2,000 stylists across those geographies. And we feel pretty good about our ability to onboard them seamlessly and that there'll be great demand on the stylist front for us to draw from.

OPERATOR: We'll hear next from Heath Terry with Goldman Sachs.

HEATH PATRICK TERRY, MD, GOLDMAN SACHS GROUP, INC., RESEARCH DIVISION: Great. I just wanted to dig a little bit further into the comments that you made around advertising. You mentioned the decline in advertising spend that we saw kind of quarter-over-quarter. Just if you can quantify for us kind of what you mean by that, just given the increase that we saw in absolute dollar spend? And then as we think about the second half recovery that you're seeing or expect to see as we get into next year. How much of that do you expect to be just recovery in overall average apparel spend versus a significant increase in the wallet share that you're seeing with your customers, particularly relative to kind of what you're seeing along that dynamic now of apparel spend versus wallet share?

KATRINA M. LAKE: Yes. I'll take a stab at the first part on our marketing, and the second question is really around kind of wallet share and so I'll take a stab at those 2. And I think Elizabeth, Mike if I miss anything, you can jump in. The marketing pullback was really speaking to Q3 primarily, where for about 8 weeks, we pulled back pretty significantly in marketing. And that was really because of supply side constraints that we had during that time period. And pulling back during those 8 weeks has a knock-on effect because the clients that we acquired during those 8 weeks don't just generate revenue then, but they actually generate revenue for the weeks and months and years to come. And so when we're talking about the pullback, we're really talking about that. And then we are -- as we kind of moved out of our backlog at the end of June, July, August, we've been able to turn marketing pretty fully back on, and we've been really, really pleased with what we've been seeing on that front. And we've already talked about the 50% year-over-year first Fix rate -- first Fix growth that we've seen, and that's really been the result of being able to trend that marketing engine fully back on.

In terms of our expectations around where that spend is going to come from. I mean there's definitely all the dynamics that you spoke to. I think this is undoubtedly a strange time and that people are buying less apparel for very good and obvious reasons. They are still buying apparel, however. And I think one of the really great benefits of our model is that we've been able to shift our assortment to what clients need. And you may not have thought that **Stitch Fix** could be known for Activewear and athleisure a year or 2 years ago. And now we're really able to sell that really effectively to our clients and really we're able to meet our clients where they are. And so I think as people's apparel needs change, we are able to shift the assortment appropriately to where they are. And I do think that we will continue to see people more comfortable buying clothes online and people more committed to continuing to buy clothes online. And so while this is a very challenging time for apparel retail, in general, as people behaviors are changing dramatically, and people are buying less volume today, we really do believe that the behavior shifts that are happening today are going to be permanent and that -- and those will be pretty significant tailwinds and benefits to our business long term.

OPERATOR: We'll move on to Cory Carpenter with JPMorgan.

CORY ALAN CARPENTER, ANALYST, JPMORGAN CHASE & CO, RESEARCH DIVISION: Great. So I just wanted to dig in a bit more on margins. Maybe relative to the strategic investments you called out last year, with $110 million in the shareholder letter. Could you just talk about your biggest priorities this year and how it differ from last year? And then where you expect to see the better leverage to really drive the margin expansion you guided to. And then as a follow-up, you mentioned still playing catch up on the supply side. Could you just expand some around where you're in into constraints and your ability to address those in the near term?

KATRINA M. LAKE: Yes. I can take the first one about supply constraints. And then Mike, it's so hard, we can't see each other in the room. Mike will take the question around margins, we'll do a little bit in reverse order. But on supply constraints, we've largely worked through a lot of the supply constraints that we talked about were ones that were temporary to the time period that really were COVID-related. We had shared in the prior quarters that we had given our warehouse staff flexibility with 4 weeks of additional PTO to be able to stay out of our facilities if they needed to. And now we're in a place where we feel pretty good about our ability to be able to coexist with the threat of COVID in our warehouses. And so we've really figured out how to systematize and operationalize and operate safely. And so while there, of course, could be small disruptions in the future, we don't anticipate significant disruption.

And then the second one is really around inventory. We cancelled a lot of receipts. We've moved around a lot of receipts. I mean that was really, I think, won out of conservatism that's just like not knowing how demand was going to materialize. And the second part was really around relevancy and we're quite glad that we did that. Obviously, the consumer has changed its time in terms of what he or she is looking for. And so being able to shift receipts out of things like workwear and things that we knew were not going to be relevant and into more relevant categories were super important for us, but also that takes some time. And so those are really the primary supply constraints that really we see -- those are pretty much behind us. Now we've actually been seeing such great demand on the first Fix side, that we actually see some elevated wait times which means that we're a little bit above kind of where we anticipated being. But of course, that's a really nice problem to have. And we feel good about our supply side operations. We feel good about the inventory dynamics and the inventory that we have coming in our doors right now. And so largely, I think we've worked through a lot of the supply side constraints. So Mike, why don't have you take the question about margin?

MICHAEL C. SMITH: Yes. Cory, I mean, there's kind of 3 big things. One is what we referenced accelerated growth in the back half of the year. So just expected higher revenue numbers against the cost basis from where we are today. I mean, the second one is just scale of the business. We continue, as we grow the business, the scale finds opportunities to get leverage in certain cost parts of our business. And so scale helps kind of on inventory costs as an example and other parts of our variable expenses. And the third is what we referenced on the call, which is just the way businesses like the U.K. and Kids are scaling and the improvement in contribution margins that we're seeing in those businesses as they grow, we're excited about that. And so like I said, '19 and '20 were heavier investment years, we talked about that with you guys for a long time. We knew '21 would likely be a little bit less, but we also felt like now is the time to continue to invest because of things like direct buy and things that are driving other better client experiences that it makes sense to continue to invest in those. But it's really growth, scale, and the glide path of those investments that I mentioned.

OPERATOR: From Truist Securities, we'll move next to Youssef Squali.

YOUSSEF HOUSSAINI SQUALI, MD & SENIOR ANALYST, TRUIST SECURITIES, INC., RESEARCH DIVISION: Two questions for me, please. On the $30 billion that you talked about in your prepared remarks and also in the letter that's likely to move online in the next 12 to 18 months. How much of that is truly relevant to you today? And as you look into the opportunity of taking more than your fair share, do you feel that it's more happening or it's going to happen on the Fix side, your traditional business model? Or is it going to happen on the direct buy side? And how will you be going after that on the direct side -- direct buy side. Is Trending for you kind of one of the key pieces there?

And then Mike, maybe for you. With all the cost adjustments you made for COVID, does that change your 11% to 13% long-term EBITDA margin target, which you've shared with us in the past? And I know that 11% to 13%, that's inclusive of SBC. So if we were to exclude SBC, what would that new target look like if you could provide an update?

KATRINA M. LAKE: Thanks for the question, Youssef, and I'll have -- yes, I'll have Mike take the second part of the question. On the first one of the $30 billion that's moving online. I mean, I think a large portion of that is pretty relevant to us. I mean, of course, today, as we think about where are the places that we don't play. We don't play as much in the very low-value price point and in the very high end. But candidly, a lot of where we play right now is in the accessible every day, very democratic price points. And so from that lens, I think a lot of that market share is available to us. And from a category perspective, I think we just talked about how we've been able to shift our assortment from one where jeans and tops and things for work were things that we sold a lot of to a place where we're now selling a lot of comfortable clothes and athleisure. And so I think from a category assortment perspective, we actually have a pretty wide playing field and the ability to pivot into anything that is really highly relevant and where the customer wants to be. And so I think we see that opportunity as a pretty compelling one.

In terms of how we think about the business all working together, I mean, I would love to see a future where we're really talking about **Stitch Fix** as the personalization engine and spending less time around the channel, whether it's direct buy or Fixes. What we've learned is that they really work together really well. I mean, a lot of our -- we talked about the really strong growth that we're seeing in Fixes right now. Fixes are still a really significant growth engine for us. And what we're finding right now is that Fixes are a great way to get somebody acquainted with **Stitch Fix**, get somebody to understand **Stitch Fix** and direct buy is a great way to be able to get to know them even better and to be able to fill even more of their needs. And as Elizabeth alluded to, over time, we believe that direct buy can also potentially be an acquisition vehicle, but we really see all of these as kind of building blocks on top of this personalization capability that can kind of give people a lot of different ways to be able to engage with us. And so I think right now, in the near term, we see Fixes as being a primary way that we're acquiring clients, bringing people into our ecosystem and then being able to upsell and capture greater share of wallet through direct buy, but there's so much potential with direct buy and that we could see those kind of engaging in different ways over time. So hopefully, I answered most of your question and Elizabeth, if you want to weigh in if I missed anything.

ELIZABETH SPAULDING: No, I think that was a great -- I mean, overall, exactly where we're headed. I mean, I guess the one thing, Youssef is just, historically, **Stitch Fix** has not been able to participate in things like SEO and bringing customers in, if they were looking for a particular product category. And as we expand our shopping experience to be something that customers might start with as part of that overall personalization engine that Kat is describing, that allows us to have that as an entry point rather than simply as an add-on. And that's where we get really excited about the expansion of our TAM. And really largely tapping to the majority of that $30 billion that we talked about. And so we view that as a real opportunity for us in the quarters to come as we begin to ungate direct buy to new clients.

MICHAEL C. SMITH: Yes. Youssef, I mean the changes in COVID kind of in our cost structure, while it's been hard, and we've worked through them. I don't feel -- I feel really good about kind of where we are not deleveraging our cost structure. So to answer your question directly, the 11% to 13% with SBC still represents what we believe is the long-term margin targets. There's just more tailwinds in the business that we're seeing that gives us even more confidence about those targets. We have not given sort of guidance or talk much about what that number might look like without SBC.

OPERATOR: We'll move on to Kunal Madhukar with Deutsche Bank.

KUNAL MADHUKAR, RESEARCH ASSOCIATE, DEUTSCHE BANK AG, RESEARCH DIVISION: Couple, if I may. One, looking back, as you see the -- or as we see the decline in revenue per active customer, how much of that was because you missed a couple of maybe Fixes for a few subscribers versus people kind of going dark on the subscriptions themselves? That's one. And second is with regard to or a follow-up to Youssef's question right now. In terms of your marketing message, so as you go out and you target this $30 billion opportunity, will your marketing message be more focused on the subscription side? Or will it be more focused on the direct buy side?

KATRINA M. LAKE: Yes. Thanks for your questions. And I think when you're talking about sales per active client, are you talking about sales per active client not growing as fast as it has in prior quarters just to specify because we actually didn't show a decline.

KUNAL MADHUKAR: So what I did was I looked at the proportion of direct buy. So direct buy is teens for Women and is high single digits for Men's. That means direct buy is probably about 10% of revenue. So direct buy 10% of revenue, then that means that the $486 on a comp basis would probably be more like $446 versus last year.

KATRINA M. LAKE: I see what you're saying. Right, so I mean, what we've seen in AB-test is that we've seen that giving people access to direct buy actually increases the total amount that they spend with **Stitch Fix**. To your point, this definitely can be that people -- there are some people who are spending a lot more in direct buy and less in Fixes. And there are some people that might be spending slightly more in direct buy. But net-net, what we know from the AB-test that we ran was that with statistical significance, direct buy was increasing our wallet penetration. And so we are able to serve our clients better. We are able to serve more of their needs. And so I think that's the kind of broader trend that you're talking about. And I think over time, we're not super worried, honestly. It's like there is going to be some people who are going to be spending a lot of money in direct buy. We actually see that as a really good thing, and we see those as clients that we may not have been able to serve really well with just Fixes. And so I think it's really just a testament to the model being able to be flexible to be able to serve people who want to shop in different ways.

And then the second part of your question around marketing message as we think about how to move forward from here. We -- when we think about Fixes, we probably don't think of it as a subscription. We really think of the Fixes as being this high revenue engagement model. And so people who choose to get Fixes on a quarterly basis or on every other month basis, that's just a convenient way for them to be able to have access to the personalization that they want. Direct buy is another way that allows them to be able to engage with us in a more Ã la carte way. And of course, you can get Fixes Ã la carte as well. And so we really see all of these things as ways to drive engagement, ways to drive revenue engagement, ways to drive LTV over time. And the marketing messages really have been less about the cadence of it. And our marketing messages have really never been around the cadence and using any subscriptive language, but has really been around the personalization. And our ability to meet them where they are. And we definitely saw in the Women's business as an example, and the team was really, really on top of changing the marketing messages and the imagery to better reflect where customers are today in a work-from-home environment, in a much more casual environment, and we saw that working, and we see that working now. So of course, our marketing messages will evolve as we -- as the world changes, as we understand where customers are in their journey, but the fundamental marketing message, that's really around personalization. It's really around us really getting to know people and sending them what they want, that's definitely not going to change.

OPERATOR: We'll hear next from Dana Telsey with Telsey Advisory Group.

DANA LAUREN TELSEY, CEO & CHIEF RESEARCH OFFICER, TELSEY ADVISORY GROUP LLC: As you think about the plan for fiscal '21 of showing the expense leverage on adjusted EBITDA, what levers are you working with in order to get that leverage: investment versus spend? Or is it top line? And then on the product side, would be increasing penetration of active, how does that differentiate in terms of margins? And what percentage of the business you think it goes to?

KATRINA M. LAKE: Yes. Thanks for the question, Dana. I'll probably take your first one around active. We -- our active business actually has really great gross margins. We have -- in some of our business lines, just in Men's as an example, we have an exclusive brand called 01. Algo that's been doing really well. That's that had great margins, it's an exclusive brand of ours. And we actually -- we have a pretty good balance of branded product, EB, lesser-known active brands as well as the active brands that people know that we've talked about. And so I don't -- active, I think, will continue to contribute to the margin profile. There's nothing we're concerned about there. I'll have Mike take the kind of the first part of your question, around kind of more broadly where we're seeing that leverage come from?

MICHAEL C. SMITH: Yes. Dana, I mean, there's a few things. So you've called it out. The top line is probably the biggest driver of it, but there is just less hiring that we'll be doing in fiscal '21. It's always what we've talked about. When it doesn't -- when we don't need to hire against amazing initiatives, then we won't. But we always have like a whole steady state of amazing things to do. But I think it's mostly topline that's driving it. And just running the business better. I mean we've had leverage in past years almost every year and variable expenses we've called out before as places that we've gotten leverage, I think, every year that I've been at the company. So it's running the business better, but mostly coming out of top line.

OPERATOR: And from Baird, we'll hear from Mark Altschwager.

MARK R. ALTSCHWAGER, SENIOR RESEARCH ANALYST, ROBERT W. BAIRD & CO. INCORPORATED, RESEARCH DIVISION: I also wanted to follow-up on the marketing backdrop. Maybe first, can you talk about some of the efficiencies you're seeing in the various channels? And maybe how you're feeling about ROIs relative to earlier this summer? And then separately, just given this unique moment here with customers accelerating the adoption of online shopping, many perhaps haven't refreshed their wardrobes in a while given the pandemic and work from home. Just curious if there's any change to your approach to advertising over the fall and holiday this year versus how you've approached it historically. Then separately, just for Mike, when you spoke to leverage, you have the caveat in there that you'll be responsive to opportunities on the advertising front. Curious if your thoughts on that 9% to 11% range have changed at all? I guess you were slightly below the midpoint of that in fiscal 2020. So I'm trying to get a sense of how much of the swing factor that could be in fiscal 2021?

KATRINA M. LAKE: Yes. Thanks for the questions, Mark. In terms of anything we've seen, like this is -- the efficiencies that we're seeing in June or in July, August, I mean, this is really as we've been able to ramp up marketing again. And the spending less in June, May, and those prior months was actually not a result of efficiency, but it was really about our capacity. And so I think what we're seeing is that since the pandemic and since people see this as being kind of a less temporary way of living, that there is more and more demand for an offering like ours and that our messages around being able to have personalized selections of apparel to be able to shop from the comfort of your own home, that, that value proposition is really resonating. And we're seeing that really across kind of all of our channels. And I think -- and as Elizabeth alluded to, I think one of the opportunities even incrementally to all of this is as we think about having direct buy and having products that is kind of standing alone outside of our site that we would actually be able to use channels like SEO in ways that we haven't historically. And so those are, I think, other reasons that we're optimistic on the marketing front.

But given this -- your question around, like, are we going to change any of our approach in terms of channel shift on marketing? Every day, we're always looking at ROIs. We're always looking at where we're seeing better ROIs on different messaging and where we're seeing on different channels. And we have a big data science team that's devoted to this very exercise. And so we are always looking at our channels to understand are there channels that are doing better or worse or places we should invest more in. And so we will continue to do that. And so there will undoubtedly be shift that happens in between channels. But I don't think that there are really big significant changes that we're anticipating now. But the fact that we have a very diverse set of channels to market and to be able to choose from and to be able to shift dollars to and from means that we can always be pretty flexible to make sure that we're taking advantage of channels that are working really well for us.

Mike, I think there's a second question there around just how we're thinking about the long-range marketing spend.

MICHAEL C. SMITH: Yes. I mean, Mark, you picked up on it. I mean, I think -- and Katrina talked (technical difficulty) that we will continue to have a very ROI-focused approach to how we're spending our marketing dollars. But I think there is (technical difficulty) margins share and also I think the percent of sales needs to recover (technical difficulty) because of how profitable currently we are (technical difficulty) in the contribution margins that we've seen. So more to come. But again, it will likely be opportunistic if we're in the market, and we see opportunities to take share on a very comfortable ROI basis.

OPERATOR: And that will conclude today's question-and-answer session. At this time, I'd like to turn things back to Katrina for closing remarks.

KATRINA M. LAKE: Thank you, everybody, for joining us today. We look forward to keeping you up-to-date on our business in the quarters to come. Stay safe.

OPERATOR: And that will conclude today's conference. Again, thank you all for joining us.

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IN i64 : Retail/Wholesale | i645 : Clothing Stores | i654 : Specialty Retailing | iretail : Retail

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