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The Container Store Group, Inc.

Fourth Quarter Fiscal Year 2017 Earnings Conference Call

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Jodi Taylor, *Chief Financial Officer and Administrative Officer*

CONFERENCE CALL PARTICIPANTS

Steven Forbes, *Guggenheim Securities*

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Matt Fassler, *Goldman Sachs*

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PRESENTATION

Operator:

Greetings, and welcome to Container Store Fourth Quarter Fiscal Year 2017 Earnings Call. At this time, all participants are in a listen-only mode. A question-and-answer session will follow the formal presentation. If anyone should require Operator assistance during the conference, please press star, zero on your telephone keypad. As a reminder, this conference is being recorded.

I would now like to turn the conference over to your host, Shannon Devine. Please proceed.

Shannon Devine:

Good afternoon, everyone, and thanks for joining us today for The Container Store's Fourth Quarter Fiscal Year 2017 Earnings Results Conference Call. Speaking today are Melissa Reiff, Chief Executive Officer; and Jodi Taylor, Chief Financial and Administrative Officer. After Melissa and Jodi have made their formal remarks, we will open the call to questions.

Before we begin, I need to remind you that certain comments made during this call regarding our plans, strategies and goals and our anticipated financial performance may constitute forward-looking statements and are made pursuant to and within the meaning of the safe harbor provisions of the Private Securities Litigation Reform Act of 1995.

Such forward-looking statements are subject to both known and unknown risks and uncertainties that could cause actual results to differ materially from such statements. Those important factors are referred to in The Container Store's press release issued today and in our annual report on Form 10-K filed with the SEC on June 1, 2017. The forward-looking statements made today are as of the date of this call, and The Container Store does not undertake any obligation to update their forward-looking statements.

Finally, the speakers may refer to certain adjusted or non-GAAP financial measures on this call. A reconciliation schedule of the non-GAAP financial measures to the most directly comparable GAAP measures is also available in The Container Store's press release issued today. A copy of today's press release may be obtained by visiting the Investor Relations page of the website at www.containerstore.com.

With that, I will now turn the call over to Melissa. Melissa?

Melissa Reiff:

Thank you, Shannon, and hi to everyone on our call today.

I will go over the highlights of our fiscal Q4 and our full-year fiscal 2017 performance. I will also discuss our strategic priorities for fiscal 2018 as we look to build on the progress we are making to improve productivity and profitability at The Container Store. Jodi will then review our financial results for Q4 and fiscal 2017 in more detail and discuss our fiscal 2018 outlook.

Specific to Q4, our consolidated sales increased 5.3% and we had our best quarterly comp store sales performance of the year, a comp store sales increase of up 2.7%. This is a result of strong sales from our Custom Closets business, as well as positive comp store sales contribution from our other product categories.

Q4 is the most important quarter of the year for us, as our Annual elfa Sale occurs during the quarter. We were very pleased with the results of this year's Elfa Sale campaign, and that is despite a sizable increase in our deferred sales, resulting from Custom Closets orders taken in Q4 but not yet delivered or installed. As a result, those sales cannot be recorded, and are expected to record in Q1 of fiscal 2018.

We experienced strong kitchen campaign sales in Q4 which I'll discuss more in just a moment. But that did help offset some of those deferred sales in Custom Closets. We again delivered a strong quarter of web-generated sales performance with sales up almost 21% when including our click and pickup sales and up 21.5% for direct-to-customer sales only. Elfa third-party sales were up 4.8% in U.S. dollars, with a 9% positive impact from foreign currency translation.

These improved sales are reflective of the positive work we have been doing on our sales revitalization initiatives, as well as our efficiency and optimization actions, including marketing, merchandising and organizational changes. One such example is our kitchen sale campaign that I just mentioned that occurred during the month of March for the second consecutive year. This year, we changed the strategy of the event to 25% off selected products versus last year's 15% off the entire kitchen department. This change resulted in strong kitchen department sales during March and generated incremental gross profit dollars, despite being a modest headwind to our gross margin rate.

Our strong Q4 sales performance was accompanied by a 100 basis-point improvement in our consolidated gross margin, with the improvement driven primarily by our optimization plan efforts. And Jodi will discuss that more in just a minute.

We demonstrated continued strong SG&A control in Q4, with consolidated SG&A leveraging slightly, as expected, driven by the benefits of our savings and efficiency efforts. This resulted in adjusted EPS of $0.18 for the quarter, inclusive of approximately $0.04 of incremental interest expense year-over-year.

For the full fiscal 2017 year, our consolidated sales were up 4.5% with The Container Store's comp store sales up 0.9% for the year. Adjusted EPS was $0.28, flat with fiscal 2016. This adjusted EPS includes a headwind of approximately $0.11 of incremental interest expense as compared to fiscal 2016.

The key to the financial progress we made in fiscal 2017 has been the smart and thoughtful execution of our optimization and strategic plan. Regarding the direct benefits to the P&L from the optimization plan, we made progress in all areas with the SG&A savings from our May 2017 job eliminations being largely realized during fiscal 2017 and the majority of the expected savings from our cost of goods sold project and price optimization work expected to flow through in fiscal 2018. Our Optimization Plan aligns with our broader strategic plan that I discussed on our year-end call last year and which we have further refined based on our learnings of fiscal 2017.

So, now, I'd like to provide an update on our strategic priorities that we executed against in fiscal 2017.

With respect to customer experience and stores. We opened all of our fiscal year 2017 new stores by the end of the third quarter. Our most recent store opening was in April, in Bridgewater, New Jersey, which is our first new store opening of fiscal 2018. In addition to Bridgewater, we have a second store we plan on opening in late second quarter of fiscal 2018 in Oklahoma City. Our reduced 18,000 square-foot Albuquerque store continued to deliver solid performance, validating the potential opportunity we see for future stores that are smaller in size than are historical 25,000 square-foot prototype.

In fact, in fiscal 2018, the Oklahoma City store, as well as two relocations, our Tysons, Virginia store and our Cherry Creek, Colorado store will all be under 20,000 square feet. The much anticipated redesign of our Dallas flagship store is expected to launch at the end of June and the store has remained open during the remodel period. This redesign features Custom Closets as a real focal point, kind of a beacon, as we call it. It will also utilize lower profile fixtures for improved sightlines, enhanced lighting, updated technology and a refined arrangement of our product assortment to better assist customers in accomplishing their organizational projects. We look forward to the learnings that this remodel store will provide us, which will impact our go-forward plans for existing store remodels, as well as our decisions on our future store prototypes.

With regards to product and merchandising, we were very pleased with our fourth quarter acceleration in our Custom Closets business which generated a positive comp store sales contribution of 190 basis points. Our new elfa product introduced last June continued to drive comp store sales contribution, and we were very encouraged with the improvement in our other product categories which as I said, drove positive comp store sales as well. We attribute the improvement in all of the product category sales largely to merchandising updates, as well as to our digital marketing efforts. Again, I'll discuss that more in a moment.

We are now deep into our price optimization project and undergoing price testing in a dozen stores, while at the same time improving customer perception of value for their money. We are running these tests and analyzing the results to determine what elements we will implement chain-wide to maximize sales and gross profit dollars.

New product development continues to be a major focus and we are working hard to bring exciting new product introductions to market. Our first priority is our Custom Closets business. In addition, we plan to continue to introduce proprietary new products throughout the store that leverage the strength of The Container Store brand.

With customer acquisition and retention, we are excited about our progress here, including a new influencer program that allows us to tap into content creators who have a strong affinity with our brand

and who in turn introduce The Container Store to their engaged audiences. We launched this program in time to leverage our kitchen sale campaign during Q4 and are pleased with the results. We also launched a new trade program that allows accredited interior designers, decorators, architects and professional organizers to apply online for exclusive benefits including trade pricing on all products, purchase tracking and expert project support.

Our POP! program, with more than 6 million POP! Stars at the end of the fiscal year, continues to build and gain traction as we add more POP! Stars each week. We continue to deploy multiple pilots as part of our comprehensive CRM strategy that drives customer engagement and increases redemption rates for our targeted offers.

We continue to spend advertising dollars more effectively as we are optimizing our paid media spend in real time based on our Media Mix model and we are further enhancing its capability. The strong online sales increases we have seen for example, are the direct result of the work we have done and our increased spend in digital channels. Additionally, as we have shared before, we believe that partial reallocation of our marketing spend from traditional to digital channels has been a major contributor to our improving sales in our other product categories.

Pursuit of profitable growth opportunities. We continue to see opportunities for our business-to-business channel, as well as maximizing profitable Elfa third-party sales. We will of course also continue to grow through the addition of new stores, but will be strategic about where we open, as well as the size of our new stores. We continue to see numerous opportunities for new stores and have been pleased and encouraged with the results from our new stores. However, we want to be prudent in our capital allocation and ensure we are leaving free cash flow available for debt repayment. As I said earlier, in addition to Bridgewater, we are opening three more new stores in fiscal 2018, two of which will be relocations of existing stores and all three will have that smaller footprint.

Operational productivity and efficiency. During fiscal 2017, we made excellent progress toward implementing the next phase of our Manhattan supply chain management system, and will continue into fiscal 2018 with additional enhancements. We have begun work on our second distribution center, which is anticipated to become operational in late fiscal 2019. We will incur capex this fiscal year and next for this project, but once we have the facility in place we expect considerable freight savings and customer service improvements as we tighten order-to-delivery time windows.

With regard to technology, in fiscal 2018, we will continue with the significant undertaking we commenced during fiscal 2017 to update and enhance our in-store and online Custom Closets design tools. Custom Closets technology investments will continue to be important to us beyond fiscal 2018.

Lastly, our most important asset, our people. Our employees are the cornerstone to our success. I'm so incredibly proud of the progress they have made throughout our business in fiscal 2017 and how we worked so beautifully together as a team. Being on the Fortune 100 Best Companies to Work For list for 19 years running was a testament to our collective efforts around our people during a time of considerable change. I thank our incredible employees very much for their support and dedication to our Company and all stakeholders.

We also strengthened our Executive Leadership Team in the area of merchandising and planning. We recently hired John Gehre, our EVP of Merchandising and Planning, reporting to me and working very closely with Sharon Tindell, our President and Chief Merchant, as well as our entire Company Leadership Team. John has amazing experience, most recently 11 years with HEB as merchant over all non-grocery business. We are confident that John will be a great addition to our team and that he will make a positive impact. John's responsible for all product categories outside of Custom Closets. Sharon, along with her amazing team, will continue their laser focus on our all-important Custom Closets business. And as I announced last quarter, Gretchen Ganc joined us last December in the newly created role of EVP of Strategy and Analytics. Gretchen has already made fantastic contributions in her short tenure.

We enter fiscal 2018 having further refined our strategic plan. Fundamental to this refined plan is the clarity of vision and purpose that it provides our organization. Our vision is to be a beloved brand and the first choice for customized organization solutions and services. Our purpose is to help our customers accomplish projects, maximize their space, and make the most of their home. We've identified four pillars that support this vision and purpose and are executing against several initiatives through cross-functional teams. Each initiative is led by an executive sponsor with an initiative lead and a working team to help ensure accountability. Our four pillars are: number one, to own Custom Closets; number two, to deliver on accomplishing projects across all customer touch points; number three, to leverage digital and data insight to enable omnichannel growth; and number four, to close the gap on value for the money.

Let me share just a little bit more on each of the four pillars and the related prioritized strategic initiatives.

Pillar one, to own Custom Closets. This includes our product portfolio and go-to-market strategies, improving the customer experience, enhanced in-store and online merchandising, and digital tool improvements. Within Custom Closets, we are also focused on growing our B2B channel.

Pillar two, delivering on accomplishing projects across all customer touch points. This pillar is focused really on two areas, updating our marketing efforts to better communicate our brand positioning of accomplishing projects to both existing and new customers; and number two, updating our visual merchandising to make it easier and clearer to our customers exactly how to accomplish their projects. Specific to this in fiscal 2018, we are excited to share that we will launch a brand marketing effort that will begin in early Q2. We currently plan to invest about the same percentage of sales on marketing in fiscal 2018 as we did in fiscal 2017, which is approximately 4% of sales at The Container Store's retail business, with ongoing reallocation of spend again from traditional to digital channels, plus this investment in brand marketing.

Pillar number three, leveraging digital and data insights to enable omnichannel growth. We're developing digital content to support our brand position online and in-store to drive more traffic to the website and optimize for conversion.

And pillar number four, to close the gap on value for the money. The extensive consumer and customer insight work performed in fiscal 2017 showed us that we have work to do to convey the reality of our price value proposition versus the perception of it. We must close the gap on perceived value for the money. The reality is we are very competitive on our pricing and carry an unparalleled assortment of high-quality products and solutions in a beautiful, visually appealing way with high affable service. We can and intend to do a much better job of communicating all of this to our customers. So during fiscal '18, we'll be working to remedy the price and value perception gap via new pricing, signage, promotion and offer strategies. This is all part of the price optimization project you've heard us discuss before.

So, it definitely is a "New, New Day" at The Container Store. We are evolving, growing and improving and our customer remains at the center of everything we do. Our 2018 strategic plan reflects our sharpened focus. We will continue to evolve our plan as our test and learn activities yield further results. We are committed to getting better, doing better and we have the entire organization rallied around these pillars and our supporting strategic initiatives.

In closing, we're really pleased to have concluded fiscal 2017 with strong fourth quarter sales performance. We executed our sales revitalization efforts and are pleased with the positive impact on our business. Our Custom Closets strategic focus continues and is driving our results. We expect to generate meaningful profit improvement in fiscal 2018 as we harvest the benefits from our Optimization Plan that we executed in fiscal 2017. We recognize however that we still have much work to do and look forward to fiscal 2018 as we build on our progress.

So, Jodi, I'm going to turn it over to you please to go through the financial results and our outlook.

Jodi Taylor:

Thank you, Melissa, and good afternoon everyone. Today, I'll be reviewing our fourth quarter and full fiscal 2017 results and then discussing our outlook for fiscal 2018. For the three months ended March 31, 2018, our consolidated net sales were $232.8 million, up 5.3% compared to the prior-year period. Sales for The Container Store retail business were up 5.3% to $214.1 million, driven by 2.7% comp store sales increase as well as new store sales. Custom Closets contributed significantly to our fourth quarter comp store sales of 2.7% in large part due to strong Annual elfa Sale and our other product categories generated positive comp store sales, as Melissa discussed.

As a reminder, our Annual elfa Sale was the same total number of days in fiscal 2017 as it was the prior year, but we had one less sale day in Q3 and one additional day in Q4. While it's difficult to precisely quantify the sales benefit to Q4 given the strong deferred sales increase, our best estimate of comp store sales benefit to Q4 from the shift of the elfa Sale day is approximately 50 basis points.

We ended the quarter and year with 90 stores and approximately 2.2 million of gross square footage as compared to 86 stores and approximately 2.1 million of gross square footage at the end of the fourth quarter of fiscal 2016.

Now, turning to Elfa International AB. Elfa's third-party net sales were $18.7 million, up 4.8% compared to the fourth quarter of fiscal 2016, primarily due to foreign currency translation, which increased third-party sales by 9% and partially offset by lower sales in the Nordic markets during the quarter.

Moving on to profitability. In the fourth quarter, consolidated gross profit dollars increased 7.2% to $136.5 million, and consolidated gross margin increased 100 basis points compared to the prior-year period. Gross margin at The Container Store retail business was up 110 basis points, driven primarily by lower cost of goods associated with our Optimization Plan and the benefit of favorable foreign currency contracts, partially offset by a greater portion of sales generated by merchandise sale campaigns.

It's important to note that our improving comp store sales results were not derived by incremental discounting year-over-year. While we didn't achieve our expected level of gross margin improvement for the quarter, this was largely due to two timing factors that are expected to benefit fiscal 2018. Approximately $2.8 million of anticipated gross profit dollars were not realized in Q4, with slightly more than half of that anticipated in Q1 of fiscal 2018, with the remainder anticipated in the second half of fiscal 2018.

The first timing factor was an increase in deferred sales following a successful end to the Annual elfa Sale. The second factor was the expected savings from our Optimization Plan flowing through slower than projected early in Q4, but getting to our targeted levels later in the quarter. We had a higher proportion of Custom Closets sales in fiscal Q4 that were not delivered and installed by the end of the quarter and therefore not recognized to sale. This is reflected in our Q4 fiscal 2017 deferred sales balance of $11.1 million, a $3.4 million increase over the $7.7 million balance in Q4 of last year. From a sales perspective, this dynamic was offset by a strong kitchen sale campaign in Q4, but the mix difference did impact gross margin and when combined with the Optimization Plan benefit flow-through, resulted in an approximate 60 basis-point gross margin headwind, or approximately $0.04 EPS headwind to Q4. These timing factors that were a headwind to Q4 will be a tailwind to fiscal 2018 and are reflected in our outlook for the year that I will discuss shortly. Elfa's gross margin decreased 300 basis points from the prior-year period, primarily due to the impact of higher direct material costs.

Moving on to SG&A. As expected, we delivered slight leverage with consolidated SG&A as a percentage of sales decreasing 20 basis points to 45.0% in the fourth quarter of fiscal 2017, primarily due to the SG&A savings and efficiency efforts that were partially offset by incremental spending including costs incurred for various projects.

Our net interest expense in the fourth quarter of fiscal 2017 was $7.6 million, up $4.3 million in the prior-year period due to the August 2017 amendment to the senior secured term loan, which increased the applicable interest rate margin.

The effective tax rate for the quarter was 103.1% compared to 35.2% in the fourth quarter of last year. The increase in the effective tax rate is primarily due to the provisional amount recorded for the one-time transition tax on foreign earnings in connection with the Tax Act. On an adjusted basis, our effective tax rate for Q4 was 37.1%, compared to 35.2% in the fourth quarter of last year.

Our net loss for the quarter was $400,000 or ($0.01) per share as compared to net income of $8.4 million or $0.17 per share in the fourth quarter of last year. On an adjusted basis, excluding the one-time transition tax and cost associated with the Optimization Plan, our adjusted net income was $8.4 million or $0.18 per share, as compared to $8.7 million or $0.18 per share in the previous year. As a reminder, this year's Q4 results include approximately $0.04 per share of incremental interest expense.

Now turning to our full fiscal year results. Our press release issued this afternoon includes details of our fiscal 2017 full-year financial performance. Consolidated net sales increased 4.5% to $857.2 million driven by a 4.6% increase in The Container Store retail business. Elfa third-party sales increased 3.9% to $69.9 million, primarily due to the impact of foreign currency translation, which increased third-party net sales by 4.0%, partially offset by lower sales in the Nordic markets. Our comparable store sales increase for the year was 0.9%, as compared to a comp store sales decrease of 2.4% in fiscal 2016.

Consolidated gross margin declined 10 basis points year-over-year to 58% of sales. Gross margin at The Container Store increased 10 basis points during fiscal 2017, primarily due to lower cost of goods sold associated with the Optimization Plan and the benefit of favourable foreign currency contracts. This was partially offset by a greater portion of sales generated by merchandise sale campaigns and higher costs associated with our installation services business. Elfa gross margin decreased 180 basis points, primarily due to higher direct material costs.

Consolidated SG&A as a percentage of sales increased 70 basis points to 48.0% in fiscal 2017, primarily due to consulting costs incurred as part of the Optimization Plan, which contributed 80 basis points to the increase year-over-year. Fiscal 2016 also included 50 basis points of benefit to SG&A from reversal of deferred compensation due to executive contract amendments that did not occur in fiscal 2017. This was partially offset by 60 basis points of SG&A leverage. The leverage in SG&A, when excluding the Optimization Plan costs and reversal of deferred compensation in the prior year, was primarily due to ongoing savings and efficiency efforst, which includes savings associated with the Optimization Plan, partially offset by occupancy costs.

New store pre-opening expenses decreased $1.6 million to $5.3 million in fiscal 2017 as we opened five new stores including one relocation in fiscal 2017 as compared to seven openings in fiscal 2016.

Net income was $19.4 million, or $0.40 per share in fiscal 2017, compared to net income of $15 million or $0.31 per share last year. On an adjusted basis, excluding the impact of the Tax Act, costs associated with the Optimization Plan, and costs related to the closure of an Elfa manufacturing facility, adjusted net income was $13.6 million or $0.28 per share, as compared to $13.4 million or $0.28 per share in fiscal 2016. As a reminder, incremental interest expense incurred year-over-year was approximately $0.11 of EPS.

Turning to our balance sheet. We ended the year with $8.4 million in cash, $285.2 million in outstanding borrowings and combined availability on revolving credit facilities and cash on hand of approximately $90.8 million. Our net debt position was down approximately $30 million from last year and we generated free cash flow, defined as cash from operations less capex, of $34.5 million in fiscal 2017, more than double $16.1 million of free cash flow generated the previous year.

We ended the quarter with inventory down 5.6% compared to the end of fiscal 2016, despite the increase in stores open from 86 at the end of fiscal 2016 to 90 at the end of fiscal 2017. On a per store basis, inventory levels at TCS were down 10.7%, with the decline largely due to improved inventory management.

Now turning to our outlook. For fiscal 2018, we expect consolidated sales to be in the range of $880 million to $890 million based on a comp store sales range of flat to up 1%. We expect GAAP EPS to be between $0.27 and $0.37, and adjusted EPS to be between $0.35 and $0.45 on a weighted average of 49 million diluted shares outstanding.

We expect TCS and consolidated operating margins to improve, driven by meaningful gross margin expansion, as the benefits of our 2017 Optimization Plan flow through the year. These benefits are expected to flow through fiscal third quarter as we began to realize them most meaningfully in Q4 of fiscal 2017.

On the SG&A front, we expect to incur the final consulting costs associated with our fiscal 2017 Optimization Plan in Q1, estimated at $5 million, or $0.08 per share. The Optimization Plan savings from job eliminations that benefitted SG&A will continue to benefit the P&L through May 2018, as we began to reap those savings late in Q1 last year and throughout the rest of fiscal 2017. We expect our tax rate for the full fiscal 2018 to be approximately 30%, and our annual interest expense using forward LIBOR rates, but not assuming a refinancing between now and year-end, to be approximately $29 million.

In fiscal ‘18, we expect to spend approximately $38 million in capital expenditures for our planned two store openings and two relocations, a second distribution center expected to open in late fiscal 2019, technology projects, maintenance spend on our existing stores and our Elfa business.

With regards to a second distribution center, after an updated extensive network study, we have determined that we should move forward with the opening of a second DC which will be located in the Northeast. We’ve operated for almost 40 years out of a single facility in Dallas and anticipate considerable freight savings, a payback on our new DC investment of under three years, and customer service improvements for our direct ship customers once this facility is up and running. We anticipate using approximately $11 million to $12 million of cap ex spending for this facility during fiscal 2018 and fiscal 2019, respectively, as we complete the project and bring the new facility online in late fiscal 2019. We plan to generate positive free cash flow again in fiscal 2018, which we expect to utilize for further debt reduction.

And specific to first quarter of fiscal 2018, we expect to record that $5 million or $0.08 per share of the last of our planned consulting expenses related to the Optimization Plan. These expenses will record to SG&A, but will not be included when calculating adjusted EPS.

While we do expect the timing headwinds of Q4 to partially benefit Q1, we expect that to be partially offset by SG&A, which, excluding consulting expenses, is expected to be flat to delever slightly in Q1 this year when comparing to Q1 last year. And since we did not conclude a refinancing of our debt until August of 2017, we expect to continue to incur incremental interest expense in Q1 of approximately $3.2 million, or approximately $0.05 per share, and in Q2 we expect to incur approximately $1.4 million, or approximately $0.02 per share of incremental interest expense with the remainder of the year relatively comparable to last year.

There are also a few callouts to mention specific to second quarter fiscal 2018. As a reminder, in Q2 of fiscal 2017, we incurred approximately $6.7 million of consulting expenses that recorded to SG&A and we do not expect such expenses to be incurred in fiscal 2018. However, in second quarter of fiscal 2018, we do expect incremental marketing spend of 60 basis points to 70 basis points due to the launch of our brand marketing. For full fiscal 2018, however, our annual marketing expenses at TCS are expected to be approximately the same as last year as a percentage of sales. We currently expect to spend slightly less on marketing as a percentage of sales in the other quarters of fiscal 2018.

In closing, we are very pleased to have finished the year with much improved Q4 sales as all of the progress we’re making on our key strategic initiatives positively impacted the business. We look forward to building on this progress in fiscal 2018 while realizing profitability improvements as we harvest the benefits of our 2017 Optimization Plan. We look forward to updating you on our first quarter call.

Thank you. So, now, I would like to turn the call back over to the Operator so we can open the lines up for your questions. Devon?

Operator:

At this time, we’ll be conducting a question-and-answer session. If you'd like to ask a question, please press star, one on your telephone keypad. A confirmation tone will indicate your line is in the question queue. You may press star, two if you would like to remove your question from the queue. For participants using speaker equipment, it may be necessary to pick up your handset before pressing the star keys.

Our first question is from the line of Steve Forbes with Guggenheim Securities. Please proceed with your question.

Steve Forbes:

Good afternoon.

Melissa Reiff:

Hi, Steve.

Steve Forbes:

So, you mentioned the price perception, and I think you said study, but maybe correct me if I’m wrong there. But, how broad was that? Right? So, if you think about the difference between what the perception was and what you believe reality is, is it broad throughout the categories or is it specifically non-closet categories? Really, any color on how you think about the results of those—of that perception study?

Melissa Reiff:

Yes. I mean, Steve, we did that really deep consumer and customer insight work and we really were not surprised that we do have and we recognize a price perception issue that we feel we can overcome. I think, because we—our store is very clean, our stores look good, there is high service, people think gosh, is the pricing inflated in any way, and actually it is not. And we have tried for the last 40 years to really work on that, but we're going to be more aggressive now and we're really addressing it in kind of a multipronged approach, if you will, that's really going to include visual merchandising changes and signage, we're going to be incorporating new price—new opening price points on products where we think that we have higher quality, we're going to be doing some bundling of products at a special value. So, it's going to be across all customer touch points. And it's not going to happen overnight. This isn't something that you can just do a campaign and change it. But we want to communicate to existing and new customers that we have very competitive sharp pricing, in addition to offering everything they need to help them accomplish their projects.

Steve Forbes:

Because I guess it relates to the brand marketing campaign, right, in the second quarter, are you also thinking about how you communicate with your customers, I mean, more educational type of communication versus strictly promotional or how is that going to change the email distribution or if you think about kind of the annual events you do throughout the year? Is it going to tie—is the campaign going tie into all that? I mean, should we expect changes in the cadence of the annual events or type of annual events?

Melissa Reiff:

I mean, we're always looking at our merchandising campaigns and the cadence of our events and making appropriate changes as we did with this year's kitchen sale. So this branding campaign, Steve, is something that we've been wanting to do for years and I don't think I have ever been more excited about something. It is a campaign that is a longer term commitment that we're investing in and we are definitely, just as you said, going to be communicating to existing and new customers what our vision is, what our purpose is, how we are going to help them accomplish their projects. And it's going to be a relevant message for all customers, across all touch points, emphasizing all of our differentiators.

Now, again, like with any branding campaign, you don't stop and start it, you continue on. And we don't know what the impact immediately is going to be. But we are obviously wanting to improve awareness, consideration, and ultimately acquire new customers. So, we're going to be monitoring this through customer acquisition via all of our POP! Star data base. So we're excited about it and I hope it's really well received obviously.

Steve Forbes:

And then a quick follow-up here regarding the fourth quarter comps. So you mentioned the 50 basis points due to the day shift. But if we just think about the Custom Closets impact holistically for the quarter, can you quantify—I know you mentioned non-closet was positive, but what was the Custom Closets impact?

Melissa Reiff:

Yes. I mean, our Elfa Sale was quite successful. And yes, that one day, we think was about, as Jodi said, about 50 bps.

Jodi Taylor:

Custom Closets, Steve, as an overall comp contribution, it was 190 basis points.

Melissa Reiff:

Yes. And then, the other product categories, Steve, were about 80 bps.

Steve Forbes:

Perfect. Thank you very much.

Operator:

Our next question is with Matt McClintock with Barclays. Please proceed with your question.

Matt McClintock:

Hi. Good afternoon everyone. I was wondering if we could focus on the DC that you plan on opening. Can you help us think about how that DC will ramp in terms of efficiency over the coming years after that or in terms of optimization? And then, secondly, just on a reduced store expansion plan this year relative to prior years how we should think about the DC impact on your business over time, should you not decide to ramp up store expansion from where we're at today? Thanks.

Jodi Taylor:

Hi, Matt. Sure, I'll take that. The way we're thinking about this DC is we have run—updated and run numerous logistic studies, and in each case it's pointed to a need to do one in the Northeast and we've really kind of put that off as long as we feel like it's prudent to do so because we are at the point, as you heard me mention in my remarks, where we expect to see considerable freight savings and a payback of under three years on a distribution center. And it will also have a significant improvement on service levels because for over 40 years we've serviced every customer and every store, and we're of course coast-to-coast here in the U.S. out of the single distribution center in Dallas.

So, the plan is—the capital is split relatively evenly between '18 and '19 at $11 million to $12 million each. For fiscal '18 it's primarily a capital discussion. We don't expect expenses incurred to be of any relevance to this fiscal year. However, in fiscal '19, the facility is expected to come on line later in fiscal '19. And so, the full operational impact of savings from those freight savings that we—that is quite meaningful will not actually be felt until we get to fiscal 2020. So, for fiscal '19, we do expect that we'll incur some—in addition to the capital I mentioned, we'll incur some expenses associated with occupancy, training of employees, receiving of inventory, those types of things in advance of the facility opening. We don't expect that to be hundreds of basis points, we expect it to be something that's more like tens of basis points and we will obviously work very hard to try to offset that through any other efficiencies in our business that we can glean. But we think this is something that we thought hard and long about. We have a very, very good execution plan. We have a track record of taking on large projects; for example automation in our distribution center, a whole new supply chain system in our Company, all of which came in on time and on budget. And we already have a new leader chosen who is an existing leader in our distribution operations to make sure from a cultural and company perspective that that's a real smooth transition. So, we're thinking through it real carefully and feel really good about our plan.

Matt McClintock:

Thanks for that color. And then a second question, just you talked about launching further into proprietary new products throughout at store. At the same time, you're talking about sharper pricing throughout the store. And I just want to kind of understand the combination of both of those. Should we expect a lot of the newness to come in at a lower price point or sharper price point than in the past? Is that where some of this pricing optimization will flow through or is that more of the existing product mix that you have probably better data of to drill down on where the pricing should be? Thanks.

Jodi Taylor:

Matt, I'll start and I know Melissa is going to want to add in. We definitely looked at this is very, very granularly in terms of literally by SKU and it spans the globe in terms of options for our products. The overarching goal of this price optimization project is really simple. It's to increase sales and to increase gross profit dollars. Along the way, like with any company who does these projects, there are going to be some pricing ups and some downs in the process. And as Melissa talked about, changes to messaging, changes to visual presentation, changes to perhaps introducing an opening price point to make sure that the value equation is there; in some cases changing the package quantity for a customer so that it's more convenient and therefore not value perception. It's a wide-ranging product—process that we're in testing right now.

Melissa Reiff:

Exactly, we're in the testing phase. And we expect, Matt, to have some statistical significance probably by the end of Q1 of fiscal '18. And as we continue to develop our private label brand, because we know from our work, from our consumer work that the TCS brand, The Container Store brand, customers really, really respond to and resonate. Obviously, we'll be looking at that sharp pricing on that as well.

Matt McClintock:

Perfect. Thank you very much.

Operator:

Our next question is with Matt Fassler with Goldman Sachs. Please proceed with your question.

Matt Fassler:

Thanks so much and good afternoon.

Melissa Reiff:

Hello.

Matt Fassler:

Hi. My questions are mostly of a financial nature. And I want to get clarification on a couple of different factors. First of all, to the extent that the closets business contributed 1.9 percentage point to the comp, what kind of comp does that imply for that business? And what does the trajectory of that look like, kind of that 1.9 percentage contribution is the biggest one from closets you have in a number of quarters?

Jodi Taylor:

Matt, you heard us mention that we estimate the additional elfa Sale day benefitted us by about 50 basis points. So that's a small portion of that strengthening. It's such a focus area for us that—and of course remember that the elfa Sale is our strongest time to sell Eefa. So that's going to drive inherently more our sales in that period of Custom Closets. But that was still a strong performance even in comparison to other Q4s from a Custom Closets perspective. So, we like to believe that our efforts around everything we're doing…

Melissa Reiff:

Everything we're doing, yes.

Jodi Taylor:

… (inaudible)

Melissa Reiff:

Getting some results, yes.

Jodi Taylor:

Yes, exactly. Not just one thing.

Matt Fassler:

Okay. And then, I don't know if you commented on transaction count versus ticket broadly speaking, and I'm curious about that both overall and then within the Custom Closets business?

Melissa Reiff:

Well, as you know, we saw comp improvement. We saw it come for both traffic and tickets. And again, everything we do, all our initiatives are all intended to drive to improve the trend. We don't—we never break down traffic and ticket, but it did come from both, Matt.

Matt Fassler:

Okay. And then, finally, if you could just again refresh us on where you stand from a total dollar accrual number in the profit Optimization Plan, kind of what the end game is, and how far along we are? I know you talked about some of that getting pushed out into the new fiscal year. Any precision you could give us about how much is left in that would be great.

Jodi Taylor:

Yes. Sure, absolutely. We expected to get annualized benefits of that $20 million from the Optimization Plan and we've realized about $12 million of those in fiscal '17. On the cost side, cost of goods side, there were minimal benefits that we realized in '17. Most of those are expected to be realized in '18 in Q1 through Q3. On the SG&A side, most of those were largely realized in fiscal '17. So, we're not expecting those to benefit us except for the first month and a half of Q1. We do expect to realize that residual like I said, largely through gross profit in Q1 through Q3, and we also expect other benefits from projects that we're working on that we think will positively impact gross profit, specifically in the second half of the year.

So, just to be real clear, all of our assumed operating margin expansion in fiscal '18 is expected to stem from gross profit improvement without the improvement coming from SG&A, but rather through gross profit.

Matt Fassler:

Thank you so much for that. Appreciate it.

Operator:

Our next question is with Dan Binder from Jefferies. Please proceed with your question.

Dan Binder:

Thank you. It's Dan Binder. So, just kind of back to the envelop math, the growth in deferred sales that you mentioned, was that a little over point to comps if you were to try and factor that growth in? And second part of my question was related to the sale itself. I mean, it seems like you generated a lot of volume around that sale. I'm just kind of curious now that you passed it, what has happened to comp trends?

Jodi Taylor:

I'll start that one. The deferred sales, your math is good. Yes. The deferred sale number that we referred to is just over a point of comp. So that's correct. And then, the sale itself, just in terms of our trends so far in Q1, we don't get specific in outlook.

Melissa Reiff:

But, we're—yes, we're quite pleased with the way Q1 has started off, knowing that of course we have a lot of the year left.

Jodi Taylor:

And still half of the quarter.

Melissa Reiff:

Yes.

Dan Binder:

Okay. And then, on the gross margin, I don't know if I missed it, but can you give us what the benefit was from FX? And it sounds like you're expecting big progress there. Do you have just a general goal for gross margin for next year, all-in?

Jodi Taylor:

I can answer the first one. Our benefit to FX in Q4 was—actually it was the same for both Q4 and for fiscal '17. It was approximately 30 basis points. So that benefit that we saw in the year because of a stronger dollar was about as I mentioned.

In terms of gross margin, again, I mentioned that we expect all of our operating profit improvement to come through gross profit, not through SG&A leverage. We had previously talked about the fact that we're doing some strategic hires, we are doing some investment in our strategic priorities, and we're investing tax savings in those items. So, that puts a little bit of pressure on the SG&A line. However, the Optimization Plan, we do think is going to have a meaningful impact to gross margin. You can see what happened in Q4 and we think that can absolutely continue and accelerate.

Dan Binder:

Okay, thank you.

Operator:

Ladies and gentlemen, we have reached the end of our question-and-answer session. And I would like to turn the call back over to Melissa Reiff for closing remarks.

Melissa Reiff:

Yes. Thank you. I just wanted to again thank everybody for joining the call. And Jodi and I will look forward to talking with you at the end of Q1.

Jodi Taylor:

Thank you.

Operator:

This concludes today's teleconference. You may disconnect your lines at this time. Thank you for your participation.