communications simplified.

The Container Store Group, Inc.

First Quarter Fiscal Year 2018 Earnings Conference Call

July 31, 2018

CORPORATE PARTICIPANTS

Shannon Devine, *Investor Relations, ICR LLC*

Melissa Reiff, *Chief Executive Officer*

Jodi Taylor, *Chief Financial Officer and Administrative Officer*

CONFERENCE CALL PARTICIPANTS

Steven Forbes, *Guggenheim Securities*

Kate Howard, *Barclays*

Matt Fassler, *Goldman Sachs*

PRESENTATION

Operator:

Greetings, and welcome to The Container Store First Quarter 2018 Earnings Conference 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. Thank you. You may begin.

Shannon Devine:

Thank you, Operator. Good afternoon, everyone, and thanks for joining us today for The Container Store's First Quarter Fiscal Year 2018 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 May 31, 2018. 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.

I will now turn the call over to Melissa. Melissa?

Melissa Reiff:

Thank you, Shannon, and thank you all for joining our call today. I will first share the highlights of our fiscal Q1 performance and then review the progress we're making against our strategic initiatives. Jodi will then review our financial results in more detail and discuss our fiscal 2018 outlook.

We had a strong start to fiscal 2018, with our fourth quarter momentum continuing into fiscal Q1. Total sales for the first quarter were $195.8 million, up 6.9%, compared to the prior year period. Comp store sales were up 4.7%, led by our Custom Closets business, which contributed significantly to our Q1 comps. Approximately 1.9 percentage points of this comp performance was driven by the recognition of Q4 deferred sales resulting from Custom Closets orders that were taken in Q4, but delivered and installed in Q1. Our other product categories also positively contributed to Q1 comps and our online business was up 26.2%. Elfa third-party sales were down 3.1% in local currency and down 1.9% in U.S. dollars, due to lower sales in Nordic and other markets. Our strong top line performance was accompanied by 200 basis points of Optimization Plan driven growth margin expansion. We also achieved 80 basis points of SG&A leverage, excluding final optimization plan expenses. This led to a $0.03 improvement in adjusted loss per share to $0.08 from $0.11 in Q1 last year, and that is despite a $0.05 per share headwind from incremental interest expense in this quarter's results.

Much like Q4, improved top line trends during the quarter were driven by our many sales revitalization and optimization initiatives. A great example is our marketing efforts. The reallocation of our marketing spend from traditional to digital channels continues to drive our improving results, and our fresh and reinvigorated marketing campaigns were well received by our customers. Beginning in April and into May, we had a very strong Closet Sale, as we moved from a blanket category promotion last year to a more deliberate and targeted approach this year, and customer response to our free Elfa installation promotion in May and June was also positively received.

In this fiscal 2018 year, we plan to open two new stores and complete two relocations. The first of our new stores opened on April 7 in Bridgewater, New Jersey, and we've been very pleased with its sales so far. Our second new store will be located in Oklahoma City and is scheduled to open in September. As a reminder, our Oklahoma City store, as well as our Cherry Creek, Denver and Tysons Corner, Virginia relocations will be under 20,000 square feet. We intend to build upon the success we have experienced in our smaller format Albuquerque store, and we see the opportunity for future stores in smaller sized formats. Both of our relocations are scheduled to occur in the second half of this year.

Of course, our much-anticipated Dallas flagship store redesign was completed and launched just last month. Customer feedback to the redesigned store look and feel, with new technology and fixtures, as well as visual merchandising improvements, has really been positive. Our research has shown us that our customers' biggest hurdle in beginning a project is feeling overwhelmed. Therefore, the focus of our technology tools, in-store merchandising and overall layout in our redesigned Dallas flagship store is to make it easier and more convenient for our customers to accomplish their projects. We look forward to leveraging the learnings from this store to inform our decisions regarding existing and new stores.

Now, let me turn to a brief update on our Optimization Plan. We have made good progress with our cost of goods project and the associated savings are flowing through as expected. We have also completed the initial work on our pricing initiative, which I'll discuss in more detail in just a minute, and as we have shared before, the SG&A portion of our Optimization Plan savings were largely realized in fiscal 2017, so we don't anticipate incremental SG&A benefits for the remainder of fiscal 2018.

Turning to our refined strategic plan, which is providing our Company clarity on our priorities. As previously shared, 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. To achieve this, we have six current prioritized strategic initiatives being fully executed by a cross-functional team, with each being led by one of our executives. Each strategic initiative has an executive sponsor, a lead and a working team. Progress was made in many areas during our first quarter, and so I would like to discuss a few of those in just a little more detail.

Number one, to own Custom Closets. As is evidenced by the significant comp store sales contribution from Custom Closets in Q1, we're making good progress. More targeted campaigns and marketing messages, along with new product introductions and visual merchandising improvements, continue to contribute positively. We're very focused on new products across our Custom Closets business and have an exciting roadmap for future innovations.

Number two, to deliver on accomplishing projects across all customer touchpoints; that is, how we speak to our customers about who we are and how we can help them accomplish their projects is key. We just launched an exciting new brand marketing campaign across a variety of channels based on two important objectives: acquiring new customers and refreshing our brand messaging. As we determined our brand messaging, the place to begin was with our brand's purpose; again, to help customers accomplish their projects, maximize their space and make the most of their home. So, we began our creative journey to help our customers discover the power of space. We knew it was critical that we show our customers that The Container Store understands their challenges with space and we are committed to helping them accomplish all of their storage and organization projects. We took this opportunity to sharpen our focus to become more approachable and to improve our price perception.

Our new brand campaign and tagline, "The Container Store, Where Space Comes From," is a unique campaign that we are expanding across all customer touchpoints to deliver a message that is relevant and attractive to new and existing customers. So, beginning July 23, our national branding campaign has a presence in numerous channels, including the following: national cable TV, local TV in New York, Dallas, Los Angeles, San Francisco, Washington D.C., Chicago and Houston, local streaming TV, YouTube, Facebook, Instagram, Twitter, and other social media, magazine ads, outdoor billboards, in-store applications, such as cart signs and select interior and exterior signage, and direct mail.

Our redesigned NorthPark store also delivers on this objective. With Custom Closets featured as a beacon and, among many other things, a refined organization of our product assortment, this store will better enable our store teams to assist our customers in accomplishing their organization projects. We plan to carefully evaluate the learnings from NorthPark to determine which elements warrant expansion into additional stores, based on both economic criteria and customer feedback, which is a key part of our test-and-learn strategy.

Number three, to leverage digital and data insights to enable omni-channel growth. We recently launched our new Projects & Inspiration section on our website that allows customers to use digital tools to accomplish projects, making it easier to buy now. Our NorthPark store redesign includes our new Organization Studio, which is currently only available in our NorthPark store. Its objective is to drive store traffic and assist with accomplishing projects. This tool allows our customers to go online, answer a few questions about their organization project, and set an appointment to come to our NorthPark store, where we will have curated solutions ready to reveal to them.

We continue to grow our important POP! program, ending the quarter 6.3 million POP! stars. This program allows us to be very targeted in our marketing efforts. During Q1, we launched multiple pilots as part of our comprehensive CRM strategy, with the objective to drive incremental sales and customer frequency. For example, one pilot focuses on increasing repeat Elfa purchases from customers who have already bought Elfa, using advanced analytics to identify and target them with content that's relevant to the type of space they are most likely to purchase next. This also includes testing to determine the right frequency of emails that should be sent to maximize conversion. 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 capabilities. Our strong online sales increases are the direct result of these efforts.

Number four, to close the gap on value for the money. To improve our price perception, we did the following: We completed the initial work on our pricing initiative and just implemented those changes we tested that demonstrated success. The expected benefits from this initiative are factored into our revised outlook for fiscal 2018. One of the actions from this initiative included the addition of selected opening price point products in certain product classes; for example, hangars and storage totes. We also modified pricing in our other categories based on deep data analytics and competitive consumer insight work. In some instances, prices were adjusted, and in others we refined our message to the customer as it relates to value, promotions and quality. And we're encouraged by the initial improvement in customer price perception scores that we have seen from these efforts. As a reminder, the objective of this initiative is to maximize sales and gross profit dollars, while at the same time improving price perception.

So, in closing, it was a strong start to the year and we have reflected this in our revised guidance for fiscal 2018. We have seen encouraging results and learnings, as we make progress against all of our strategic priorities. Our sales revitalization efforts are making a difference and we are reaping the benefits of our fiscal 2017 Optimization Plan. Through this process, we have leveraged external expertise, as well as developed improved internal capabilities, and hired key talent across multiple areas, including pricing, consumer insights, technology, marketing, strategy and analytics, and merchandising and planning. We continue to narrow our leadership span of control for an intense focus on strategic areas of the business and we have made changes that have improved accountability and resulted in greater empowerment throughout the organization, and of course we look forward to building on our progress during fiscal 2018.

So, now, Jodi, will you go over our financial results and outlook in more detail, please?

Jodi Taylor:

Sure, and thank you, Melissa, and good afternoon, everyone. For the first quarter ended June 30, 2018, our consolidated net sales were $195.8 million, up 6.9%, compared to the prior year period. Sales for The Container Store retail business were up 7.8% to $180.1 million, driven by a 4.7% comp store sales increase, as well as new store sales. As you saw in our earnings release, this comp performance included an estimated a 190-basis-point benefit from recognition of deferred sales resulting from fiscal fourth quarter 2017 Custom Closets orders that were delivered and installed in the first quarter of fiscal 2018. Custom Closets contributed significantly to our first quarter comp store sales and we once again saw positive comp contribution from our other product categories, as Melissa shared.

We ended the first quarter with 91 stores and approximately 2.3 million gross square footage, as compared to 87 stores and approximately 2.2 million of gross square footage at the end of the first quarter of fiscal 107.

Now, turning to Elfa International AB, Elfa's third-party net sales were $15.7 million, down 1.9%, compared to the first quarter of fiscal 2017, primarily due to lower sales in the Nordic and other markets, partially offset by the positive impact of foreign currency translation during the quarter which increased third-party net sales by 1.2%.

Moving on to profitability. In the first quarter, consolidated gross profit dollars increased 10.8% to $114.8 million, and consolidated gross margin increased 200 basis points, compared to the prior year period. Gross margin at The Container Store retail business was up 140 basis points, driven primarily by lower cost of goods associated with our optimization plan. Elfa's gross margin decreased 170 basis points from the prior year period, primarily due to the impact of higher direct material costs, which were partially offset by production efficiencies. The consolidated gross margin increase of 200 basis points was primarily due to increased sales of higher margin Elfa products during the first quarter of fiscal 2018.

Moving on to SG&A, as expected, SG&A increased 160 basis points during the first quarter, due to approximately $4.9 million of final consulting Optimization Plan expenses, which contributed 240 basis points of deleverage. This increase was partially offset by an SG&A improvement of 80 basis points, primarily due to ongoing savings and efficiency efforts.

New store pre-opening expenses decreased this quarter to approximately $346,000 from $1.4 million in the first quarter last year. We opened one store in Bridgewater, New Jersey in the current year period, compared to one store opening in the prior year period. The decrease year-over-year is primarily attributable to a shift in the timing of new store openings, as the Company incurred pre-opening costs in the first quarter of fiscal 2017 for a store that opened early in the second quarter of fiscal 2017.

Our net interest expense in the first quarter of fiscal 2018 was $7.9 million, up from $4.2 million in the prior year period, due to the August 2017 amendment to the senior secured term loan which increased the applicable interest rate margins. We continue to actively monitor the debt capital markets for opportunities to reprice our term loan facility and reduce our interest expense.

The effective tax rate for the quarter was 34%, compared to 37.4% in the first quarter of last year. The decrease in our effective tax rate is primarily due to lower statutory rates as a result of the Tax Cuts and Jobs Act enacted in fiscal 2017, partially offset by a benefit for the re-measurement of deferred tax balances recorded in the first quarter of fiscal 2018, as a result of a reduction to the Swedish tax rate. On an adjusted basis, our effective tax rate for Q1 was 25.4%, compared to 37.3% in the first quarter of last year.

Our net loss for the quarter was $6.8 million, or $0.14 per share, as compared to net loss of $7.7 million, or $0.16 per share, in the first quarter of last year. On an adjusted basis, excluding the costs associated with the Optimization Plan, our adjusted net loss was $4.0 million, or $0.08 per share, as compared to a net loss of $5.5 million, or $0.11 per share, in the first quarter of last year. Adjusted EBITDA nearly doubled, moving to $12.4 million in the first quarter this year, compared to $6.4 million in Q1 last year.

Turning to the balance sheet, we ended the quarter with $14.1 million in cash, $299.7 million in outstanding borrowings, and combined availability on revolving credit facilities and cash on hand of approximately $84.7 million. Our net debt position was down approximately $31.7 million from last year.

We ended the quarter with inventory down 0.9%, compared to the end of the first quarter of fiscal 2017, despite the increase in stores opened from 87 at the end of the first quarter last year to 91 at the end of the first quarter of fiscal 2018. On a per store basis, inventory levels at TCS were down 5.8%, with the decline largely due to improved inventory management, combined with lower product costs as a result of the Optimization Plan.

Given our stronger than expected fiscal first quarter results, we are raising our outlook for fiscal 2018. We now expect consolidated sales to be in the range of $890 million to $900 million, based on a comp store sales range of up 1.5% to up 2.5%. We expect GAAP EPS to be between $0.30 and $0.40 and adjusted EPS to be between $0.38 and $0.48 on a weighted average of 49 million diluted shares outstanding.

This raised outlook reflects the tailwinds that we discussed, as well as some headwinds that we are now facing; namely, foreign exchange and fuel. It also reflects the higher level of digital marketing spend, given we have been pleased with the results of our digital marketing efforts thus far.

We expect our tax rate for the full fiscal 2018 to be approximately 30%, and our annual interest expenses using forward LIBOR rates, but not assuming a refinancing between now and year end, to be approximately $30 million.

In fiscal 2018, we still expect to spend approximately $38 million in capital expenditures for our planned two store openings and two relocations; $11 million to $12 million of our fiscal 2018 cap ex will be invested in our second distribution center, expected to open in the Northeast in late fiscal 2019, as well as technology projects, maintenance spend on our existing stores and our Elfa business, and we would expect to incur a similar $11 million to $12 million of cap ex spend for this DC in fiscal 2019, as we complete the project and bring the new facility online in late fiscal 2019. We still plan to generate positive free cash flow once again in fiscal 2018, which we continue to expect to utilize for further debt reduction.

With respect to the second quarter specifically, here's a few call-outs.

One, we expect our comparable store sales increase for Q2 to be toward the low end of our full year comp store sales outlook range. Q1 was stronger than the full year outlook range, given the significant Custom Closets benefit to comp store sales in Q1, both from the recognition of Q4 deferred sales, as well as the closet-related campaigns that were more heavily weighted to Q1. In addition, we are making some changes in our B2B business to improve our go-to-market position to capitalize on the mid- to longer-term opportunities that we see. We expect these changes to benefit our B2B business, but they will create some near-term disruption, which we've factored into our outlook. Lastly, there's a small Q2 impact resulting from the timing of our sale campaigns, which are shifting as we test-and-learn. In some cases, we're modifying the scope of our campaign and in other cases the timing of our campaign, all with the goal of increasing our effectiveness and driving improvement in full year sales and EPS.

Number two, Q2 EPS will be burdened by incremental marketing spend of approximately 100 basis points, due to the launch of our new brand marketing campaign. So, from an earnings perspective, we would expect the year-over-year improvement in adjusted EPS to be at or below the levels seen in Q1.

Number three, we expect incremental interest expense in Q2 of approximately $1.6 million, or $0.02 per share, since the refinancing of our senior secured term loan didn't occur until mid-August last year.

Four, and finally, as a reminder, in Q2 of last year we incurred $6.7 million of consulting expenses that were recorded to SG&A that we do not anticipate this year.

It's therefore important to look at our results and performance on a full year basis, given these shifts.

In summary, we're very pleased with the strength of our first quarter top and bottom line financial performance, both of which exceeded our expectations. We are encouraged by the progress we're making and remain focused on continued disciplined execution of our key strategic initiatives. We look forward to updating you on our second quarter fiscal 2018 earnings call.

Thank you. Now, I'd like to turn the call back over to the Operator so that we can open up the lines for your questions. Matt?

Operator:

Great, thank you. At this time, we will be conducting a question and answer session. If you would 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 key. One moment, please, while we poll for questions.

Our first question is from Steve Forbes from Guggenheim Securities. Please go ahead.

Steve Forbes:

Good morning—or good afternoon.

Melissa Reiff:

Hi, Steve.

Steve Forbes:

I guess it feels like morning. I guess to start with, the flagship store, Dallas, there, obviously, looking at some of the pictures and so forth—I haven't had a chance to visit yet, but if you think about some of the merchandising changes, maybe some of the smaller ones, like the Elfa Door & Wall Rack, touchscreen display, or some of the other ones within the box, I mean, how long do you need before you can start rolling out some of these initiatives to the chain? Do you envision doing it piecemeal or do you want to sit back this year and digest the remodel as a whole and come up with a more methodical approach? Like, how are you thinking about approaching kind of the initiative in general?

Melissa Reiff:

Yes, Steve, it's Melissa, and I'm so glad that you've seen some of the pictures. Obviously, it's still so early, we just launched it last month, and we do want to take a methodical and a very strategic approach to analyzing what's working, what's not, listening to employees, listening to our customers, with all of our customer intercepts, to know what is the right thing to do to roll out to existing and new stores. So, we've got our metrics in place, we've got the economics in place, we're going to continue to be evaluating it. We're very excited about—you mentioned the Door & Wall Rack. We've also—I mentioned in my remarks about our new Organization Studio. We're just very excited to test-and-learn, and this is The Container Store of the future. As I said, too, so far, Steve, the feedback has really been positive, but there's things that we've already learned, that we've made mistakes on, that we're correcting, and then there's many things that we are really digging, but it's going to take some more time for us to really decide how we're going to roll it out, and when, to other stores.

Steve Forbes:

Then, a two-part follow-up. So, on that first question there, can you remind us, the new store in Oklahoma and the relocations in Colorado and Virginia, are those going to be next-generation formats? Then, the second part, you mentioned the goal of reducing interest expense, or the rates on the term loan. Can you help us kind of understand what you think is the potential timing of the initiative and the magnitude of the savings? I mean, is it a 2018 kind of goal to get that lower?

Melissa Reiff:

Yes, right, Steve, I'll take the first one and then Jodi can take the interest expense one, if you would, Jodi. The Oklahoma City store and the two relocations in Denver and Tysons, they will all three be less than 20,000 feet, and we will be taking some of the learnings from Albuquerque—and, yes, some from even NorthPark, if we can—and apply them to those stores where it makes sense.

Jodi Taylor:

Then, Steve, on the debt question, we are actively monitoring the debt capital markets and looking for opportunities to reprice our term loan facility. Obviously, the goal of that would be to reduce interest expense and increase EPS. We do not have any specific savings factored into outlook. Outlook is using current rates and assuming those, of course, throughout the year. However, of course, our goal would be to do it sooner than that, and we'll just have to keep you posted as we have any new information.

Steve Forbes:

Thank you both.

Melissa Reiff:

Thanks, Steve.

Jodi Taylor:

Thank you.

Operator:

Our next question is from Matt McClintock from Barclays. Please go ahead.

Kate Howard:

Good afternoon. This is Kate Howard (phon) on for Matt. So, congrats on the quarter. Even without the benefit from the 4Q shift, it looks like one of the best comps in a number of years. I know you mentioned the ongoing positive comp contribution from other product categories. Would you be able to break that out for us today?

Melissa Reiff:

Yes, we can break that out. Custom Closets contributed what, Jodi, 4.2%, right?

Jodi Taylor:

Right. I mean, Custom Closets was the significant contributor, as Melissa said in her remarks, particularly because we had the combination of the deferred revenue benefit we spoke of, of 190 basis points, plus it is a strong selling period for us with closet campaigns, so that drove the majority of the comp, but we had 50 to 80 basis points the last quarters in other product category comps being positive, which we're very excited to see, because we had been seeing declines in those categories prior to that.

Melissa Reiff:

So, they contributed positively, the other product categories, and, Kate, we recently hired our new EVP, John Gehre, of Merchandising and Planning and his focus is on those other product categories, and Sharon Tindell, our President and Chief Merchant, her focus is on Custom Closets, so we think we've got the best of both, and, of course, they're working very closely together, because we're one store and one brand, but it was a combination of Custom Closets, other product categories, our marketing campaign, our targeted offers, our free install, it all came together beautifully, but it was strategically thought out, and, of course, we are too pleased with the results, and thank you for your congrats.

Kate Howard:

Great, thank you for that color. Also, as part of that pillar to own the Custom Closets, you've noted that the Company is focused on growing the B2B channel, and then today noted the changes for the go-to-market position. Could you give us an update on the strategy there?

Melissa Reiff:

Yes, absolutely. We always are very diligent in looking at all parts of our business continually and making appropriate changes as we think necessary for the future of the Company and all stakeholders. We just recently moved the responsibilities for our B2B channel to Gretchen Ganc, who is our new EVP—she started in December—EVP of Strategy and Analytics. We just felt like, after further digging in, that we needed to step back and more formalize our go-to-market strategy and direction for our B2B channel to really capture the full opportunity. I mean, it's mostly Elfa and we own Elfa, it's exclusive us, there's a huge opportunity there, and so we just really wanted to make sure that we've got the right strategy place with the right partners. Therefore, we probably will see some moderate growth in the next couple of quarters, so we may have to take a little bit step backwards to take—you know, short-term pain for long-term gain for the future, but we know it's an important channel and a great opportunity. But, Kate, it's really important to remember that it's a very small, tiny part of our business right now, even though it's a pretty rapidly growing business, but we're going to step back and look at it. We want our cake and eat it, too, so we're going to maximize it the right way.

Kate Howard:

Great. Thanks so much.

Melissa Reiff:

Thanks, Kate.

Operator:

Our next question is from Matt Fassler from Goldman Sachs. Please go ahead.

Matt Fassler:

Thanks so much. Good evening, almost. I have a number of follow-up questions. First of all, if you could just help us size the 190-basis-point spillover. In terms of delta in book sales that have been essentially—or delivered sales that been booked in Q4, how much bigger of impact is that than you have typically experienced in the spillover from the fourth fiscal quarter to the first? Is that the change in the contribution of that, of those deferred sales, or is it just in absolute terms 190 basis points, and if so, kindly remind us what it was last year?

Jodi Taylor:

Sure. Matt, this is Jodi, I'll take that. We did—as you may recall, at the end of Q4, we had deferred sales up about $3.3 million year-over-year. We ended at just over $11 million, compared to $7.7 million the year before. During the quarter, we did a really great job of clearing out our Elfa orders from the end of the fiscal year and with virtually all of that year-over-year increase in deferred sales in Q4 then being realized in Q1. So, to answer your question, the 190 is the net incremental impact, it's not just the impact from this year, because we have deferred sales in any given year.

Matt Fassler:

Yes.

Jodi Taylor:

One thing I think it's important for you to know is that does not in any way hurt Q2, as we had strong Custom Closets selling throughout Q1, and you'll see, when we later file our 10-Q, that we had deferred sales that were $2.4 million higher than last year at the end of Q1. So, we are—by no means did we take away from Q1 when we recorded the deferred sales coming from Q4. So, hopefully, that makes sense.

Matt Fassler:

If anything, you should talk about compares of anything that might give you a bit of a tougher comp in Q1 of next year, but depending on how your written sales track.

Jodi Taylor:

That's right.

Matt Fassler:

Okay. Secondly, on gross margin drivers, can you talk about sort of the progression of where you are in the cost optimization effort as an impact for cost of goods, and also—I know this is sort of hand-in-hand perhaps with Closets, but just talk about the contribution of—you said the mix shift to Elfa within TCS was helpful to you. If you could just help size what kind of mix shift that was, how big that mix shift was.

Jodi Taylor:

I'll take the first part, the gross margin question. We, as you'll recall, really didn't start to see meaningful flow-through of our cost of goods project, the Optimization Plan cost of goods project until Q4 of last fiscal year. We saw in Q1 flow-through as we anticipated we would see, it's flowing through right on track, and we expect to continue to see that flow-through occur through third quarter of this year. So, we would expect year-over-year to see gross margin improvement through Q3 from the benefits of that project.

Matt Fassler:

Is the run rate that you just achieved sort of indicative of the run rate you should see until you cycle the launch of that initiative?

Jodi Taylor:

From the flow-through perspective, yes, but what also has to be taken into consideration, too, Matt, is the fact that when we have a strong Custom Closets quarter, which is what you see on a recognized basis in both Q4 and Q1, as compared to Q2 and Q3, they represent a higher proportion of total. Elfa is a higher gross margin product for us, because of the consolidated benefits we receive there. So, that tends to cause the lift year-over-year to be even a little bit higher, when that mix tends to be even stronger towards Elfa, with the strong Elfa selling that we are seeing, which kind of leads to your second question around Elfa.

Custom Closets is being largely driven by Elfa. Elfa still dwarves any other of the Custom Closets categories we sell. Remember, though, that Custom Closets' definition does also include the closet department , and we also had a very strong Closet Sale this year, the exact same timing as last year, but similar to how we did for kitchen, we changed the way we structured that sale, and instead of it being across the board 15% off the entire department, the entire category from April 1 through mid-May, instead we chose select items and advertised those at 25% off. So, same exact format change to what we did in kitchen we did to closet and saw—just like with kitchen, saw very positive customer response to that.

Melissa Reiff:

Matt, it's a much more deliberate and targeted approach than just a blanket discount across the department.

Matt Fassler:

Great, and then lastly, if I could. You spoke at great length about your efforts in digital and in social, in particular. Is there a way to size the social media footprint that you've launched or in the midst of implementing, relative to what you had in the past?

Jodi Taylor:

Not in terms of impressions.

Melissa Reiff:

Yes.

Jodi Taylor:

We do track the PR type impressions we get and those are definitely up, largely around both the NorthPark launch and the brand marketing that we just did.

Melissa Reiff:

The digital just continues to perform through our media mix model, as well as the social, so it's really, Matt, a combination. We are just kind of firing on all cylinders and it's all kind of coming together. We continue to evaluate it very consistently, very strategically as we move forward through the rest of the year, and we'll continue to do that into that next year, as well. Yes, I don't know how to answer that any other way, Jodi.

Jodi Taylor:

Just from a spend perspective, digital spend is definitely on the rise and represents a much greater percentage of total. If you look over the last two years, it's grown to where it's—before we know it, it's going to be more than half.

Melissa Reiff:

Right, but we're still spending, Matt, about 4% of revenue on marketing, and it's just reallocating it in, I think, a smarter and much more strategic data analytics-driven way, and it's producing the results, and so we're going to continue, but we are—as I mentioned in my remarks, we're doing a lot of this in real time, which is really wonderful and it's paying off.

Matt Fassler:

That's great. Thank you.

Melissa Reiff:

Thanks, Matt.

Jodi Taylor:

Thank you.

Operator:

Thank you. This does conclude the question and answer session. I'd like to turn the floor back over to Management now for any closing comments.

Melissa Reiff:

Okay, I think that's it. Well, great. Thank you, guys, so much for your interest and support of our Company, and we will very much look forward to talking with you in November, with hopefully similar results. Thanks so much.

Operator:

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