The Container Store Group, Inc.

Second Quarter Fiscal Year 2018 Earnings Conference Call

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CORPORATE PARTICIPANTS

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Jodi Taylor, *Chief Financial Officer and Administrative Officer*

CONFERENCE CALL PARTICIPANTS

Steven Forbes, *Guggenheim Securities*

Matt McClintock, *Barclays*

Tami Zakaria, *JP Morgan*

PRESENTATION

Operator:

Greetings and welcome to The Container Store's Second Quarter Fiscal Year 2018 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, Caitlin Morahan, Investor Relations. Please proceed.

Caitlin Morahan:

Good afternoon, everyone, and thanks for joining us today for The Container Store's Second 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, Caitlin, and thanks to everyone for joining our call. I will start with the highlights of our fiscal second quarter performance and then review the progress we are making against our strategic initiatives. Jodi will then review our financial results in more detail for Q2 and discuss our Fiscal 2018 outlook.

We had a solid second quarter overall with total sales of $224.5 million, up 2.8% compared to Q2 last year. Comp stores sales were up 1.3%, driven by our Custom Closets and our online sales. However, these results were below our expectations. As part of our test-and-learn approach we made a campaign change this quarter that impacted and weighed on our Other Product category sales performance. I will share more about that in just a moment.

Our Elfa third-party sales were down 3.1% due to foreign currency translation which negatively impacted Elfa's third-party sales by 9.3%. These sales results, when combined with 30 basis points of optimization plan driven gross margin expansion, our expected 100 basis points of marketing expense increase year-over-year from our brand marketing campaign that we launched in Q2, which equates to $0.03 in EPS, and $0.02 per share in year-over-year incremental interest expense, all resulted in an adjusted EPS of $0.10, down $0.02 from Q2 last year.

We were very happy to complete a successful repricing of our debt toward the end of Fiscal Q2 that will result in $0.03 per share of interest expense savings in Fiscal 2018 and $0.07 per share on an annualized basis. Jodi will discuss more about that shortly.

Q2 comp performance was once again driven by Custom Closets, which had a greater positive contribution than we were expecting, driven by continued strength in our Elfa performance. As you know, our number-one strategic priority is to own Custom Closets, and we are attacking the opportunity with new product innovation, organizational focus, marketing to build The Container Store Custom Closets brand awareness, as well as enhanced focus on Custom Closets in our featured smaller store formats and our redesigned Dallas flagship store.

We're also focused on newness across our assortment beyond Custom Closets, and we continued to test and learn with these efforts in Q2. We again generated positive results by leveraging our media mix model and our growing POP! database, as well as allocating more spend toward digital channels. However, as mentioned prior, unlike the last two quarters, there were elements of our test-and-learn efforts around one of our planned merchandise campaigns in Q2 that did not resonate with our customers as well as we would have liked. This resulted in Other Product category sales falling short of our expectations, representing almost our entire shortfall.

To explain further, in Q2 this year we combined our Customer Favorites and Organized Day campaigns into one campaign as compared to two last year; however, offering more SKUs this year than last year but with the campaign running this year a shorter time period. Our campaign product selection this year also had less traffic-driving and flagship products and solutions, which, in hindsight, was not the right decision. We were encouraged, however, by the fact that this year, once we cycled last year's campaign, our Other product category sales performance returned to positive comp territory and we have already dissected the campaign performance this year and have incorporated our learnings in our go-forward campaign planning for the future.

We opened the second of our two new stores planned for Fiscal 2018 in Oklahoma City in mid-September to strong customer response, and just 10 days ago we opened the first of our two Fiscal 2018 relocations in Tysons Corner, Virginia. This store, and Cherry Creek, Denver, which is planned to relocate on November 10 this year, are our smaller store formats which are under 20,000 square feet in total, as we look to replicate the success and the learnings from our smaller store, from our first smaller store which opened last year, as you'll recall, in Albuquerque, New Mexico.

These relocated stores feature certain elements of our redesigned flagship store in Dallas with appropriate modifications to product presentation given the smaller square footage. We're enhancing the customer experience in these stores with updated finishes, store layout and merchandise fixtures, as well as digital screens in the Kitchen Department, the Office Department, and our Custom Design Centers.

Customer reaction to our Dallas flagship redesign completed in June this year continues to be encouraging with positive early sales results. We are actively gathering data, including customer and employee feedback. Early learnings include positive sales results in certain key merchandise categories, such as Custom Closets, and the Kitchen and Office departments. Additionally, the redesign incorporates a single queue for our register lines and we've seen strong sales of our impulse products as customers add merchandise to their cart while checking out.

As we continue to generate learnings from both our smaller stores and our redesign Dallas store, we will factor them into our future plans for new stores, as well as include certain elements in our existing stores. This also includes learnings from the SKU rationalization work we incorporated into our redesigned stores.

We made good operational progress in Q2 against each of our key strategic priorities and continue to reap the benefits of our Optimization Plan. These priorities align directly with our vision to be a beloved brand and the first choice for customized organization solutions and services, and our purpose, which is to help our customers accomplish their projects, maximize their space and make the most of their home.

Let me share some key highlights with respect to our strategic priorities. As I mentioned a few seconds ago, our number-one priority is to own Custom Closets. With greater organizational focus, product innovation, revitalized marketing campaigns and in-store changes, we continue to generate strong performance from this business which now represents a little less than half of our total annual sales. But we still see so much opportunity, from a product offering standpoint, as well as a channel perspective, creating a very attractive runway of growth for our business.

Our research shows that there is a significant market opportunity that we fully intend to capitalize on, and that we currently own a small portion of the market, with most of it being owned by builders and contractors. Even with almost half of our sales in Custom Closets today, we believe we have significant opportunity to increase our market share immediately and over time.

Our second priority is to deliver on accomplishing projects across all customer touchpoints. Clarity for our customers on who we are and how we can help them accomplish their projects is critical to our success and, therefore, a key focus for us.
As we shared last quarter, in late July of this year, we launched an exciting new brand marketing campaign, messaging in a variety of channels and based on two main objectives: acquiring new

customers and refreshing and communicating clearly our brand. The objective of this ongoing campaign is to drive awareness and consideration, and ultimately sales and profits.

As we launched our brand messaging, we began with our purpose: again, to help customers accomplish their projects and maximize their space and make the most of their home.

Our new brand campaign and tagline—The Container Store: Where Space Comes From—is being communicated across all customer touchpoints, delivering a message that it is relevant and attractive to new and existing customers. Social media feedback on the campaign has been positive with 99% of the comments either positive or neutral, and YouTube specifically has yielded a nice positive performance. We will continue to utilize our new tagline—The Container Store: Where Space Comes From—in all of our marketing.

Our strategic focus on accomplishing projects also extends to our Dallas flagship store redesign that I just mentioned. Our early reads have shown strongest sales in the areas of the store most significantly altered in the redesign, i.e. Custom Closets. The redesign objective, among others, was to make it easier for our customers to shop our store and, ultimately, accomplish their storage and organization projects.

Number three, to leverage digital and data insights to enable omnichannel growth is another key priority, and in Q2 our focus in this area helped drive an 18.4% increase in online sales (those ship directly to our customers). Our customers are responding well to our projects and inspiration section of our website that we launched last quarter, which allows our customers to use digital tools to accomplish their projects, making it easier for them to buy now. With our still growing POP! database of now 6.7 million customers, we continue to gather insights about our customers' shopping patterns and purchase details. Leveraging these insights, we are able to develop more targeted and personalized marketing messages across all mediums to entice our customers and increase their engagement with our brand.

Our media mix model has continued to be our guide in optimizing our paid media spend and we closely monitor return on our marketing investments from our paid media channels to ensure this spend continues to be optimized.

Speaking of using our deep data, this year we have tweaked our plans around our holiday assortment and related marketing and visual presentation. Our analysis of last year's results clearly showed that in certain markets we were displacing our core everyday storage and organization products and solutions too much. We did this in order to create a large gift wrap wonderland presentation, but, ultimately, we compromised sales of non-holiday merchandise and incurred incremental expenses to support set up and operation of this large holiday presentation.

This year we will use a more tailored approach in what we will be presenting in each store with regards to our Gift Wrap Wonderland and we'll also have a more tailored marketing approach based on customer affinity to holiday categories and their propensity to purchase these products. In addition, we've worked hard to address holes in our holiday merchandise assortment that our customer insights work identified for us last year. For example, this year we will include well-priced "grab-and-go" value packs, making it easier for our customers to purchase perfect holiday solutions of wrap, ribbon, and tags that complement each other beautifully. It also includes a great assortment of products at $10 or less, as well as more focus on product for kids and men.

We feel really good about our holiday plans and know that while we aren't necessarily a "gift store" we still have opportunity to be even more successful during the holiday season and offer our customers products and solutions they want and need, and in a manner that fits with who we are.

Finally, closing the gap on value for the money. To continue to improve our price perception in Q2 we did the following: we continued to roll out pricing and visual changes that were the direct result of the work we completed by late Q2 with our pricing initiative. Early results show that we are seeing incremental sales and gross profit associated with these efforts. Our customer survey work, including customer price perception scores, show we are making progress. The expected benefits from our pricing work continues to be factored into our outlook.

Before I close I just wanted to also address the topic of tariffs. Approximately 37% of our purchases last fiscal year came from China. The tariff impacted portion of those purchases would have represented an estimated 12% of our total purchases last year. Our strategy to mitigate the impact is threefold. First, we are focused on sourcing actions. John Gehre, our EVP of Merchandising and Planning is leading the charge on the sourcing front to increase our direct factory purchases and reduce our reliance on third parties. In some cases, this means sourcing from a different geography, and in others it means sourcing at a lower cost, enabling us to absorb tariff impact on certain products without compromising our brand standards.

Second, we are in negotiations with our vendors to have them shoulder some of this burden. Certainly, the depreciation of the Chinese currency helps these discussions as we pay these vendors in U.S. dollars. This also includes utilization of alternative factories to produce our products.

Third, our pricing work has generated learnings that allow us to make much more deliberate and thoughtful pricing decisions, and to pass some of these increases on to our customers where appropriate.

Net-net we remain comfortable in expecting to be able to mitigate the tariff impact this Fiscal Year and are working very hard to mitigate the financial impact beyond Fiscal 2018.

Again, we were pleased with the continued strength in our core Custom Closets sales this quarter, as well as strong omnichannel growth, realization of our Optimization Plan benefits, more effective digital marketing strategies, and our debt repricing that we completed in Q2. All of this is a direct result of the progress our entire organization is making against our key initiatives. Our willingness, our courage, to test and learn as part of the reinvigoration of sales and marketing has been key to our progress, and by its very nature, test and learn means that we shouldn't expect 100% of our changes to be successful 100% of the time. The speedbump resulting from our campaign changes curtailed our Q2 comp and profitability performance, but we have quickly regrouped and are on track and feel well-positioned to deliver on our full year outlook.

There remains substantial opportunity for growth for The Container Store, both within our product and service offerings and in newer channels, as well as significant white space nationwide for new stores. We're focused on capitalizing on these opportunities with determination and discipline,and are developing product solutions and go-to-market strategies to do so.

With that, I will now ask Jodi to go through our financial results and outlook in more detail please.

Jodi Taylor:

Thank you, Melissa and good afternoon, everyone. For the second quarter ended September 29, 2018, our consolidated net sales were $224.5 million, up 2.8% compared to the prior-year period. As we outlined in the 8-K we filed in conjunction with our debt reprice and extension, the SEK has weakened approximately 11% since we first issued our full year outlook, causing us to reduce our full year sales range by $5 million, entirely due to currency moves. In Q2, our consolidated net sales were negatively impacted by $1.5 million of this foreign currency translation headwind.

Sales for The Container Store retail business were up 3.3% to $208.9 million, driven by new store sales, as well as the 1.3% comp store sales increase. As Melissa shared, our Custom Closets performed stronger than we expected, but we did not fully offset the merchandise campaign-driven shortfall in our Other Product categories. Once we anniversaried our campaign changes that she outlined, we were pleased to see our Other Product category sales return to their previous positive trend.

We ended the second quarter with 92 stores and approximately 2.3 million of gross square footage as compared to 88 stores and approximately 2.2 million of gross square footage at the end of second quarter of Fiscal 2017.

Now turning Elfa International AB, Elfa's third-party net sales were $15.6 million, down 3.1% compared to the second quarter of Fiscal 2017 due to the negative impact of foreign currency translation during the quarter which decreased third-party net sales by 9.3%, partially offset by higher sales in the Nordic markets.

Moving on to profitability. In the second quarter consolidated gross profit dollars increased 3.3% to $130.6 million and consolidated gross margin increased 30 basis points compared to the prior-year period. Gross margin at The Container Store retail business was up 70 basis points, driven primarily by lower cost of goods associated with our Optimization Plan, partially offset by higher promotional activities and increased costs associated with shipping services. Elfa's gross margin decreased 330 basis points from the prior-year period, primarily due to the impact of higher direct material costs attributable to a shift in product mix and a weaker Swedish krona.

The magnitude of gross margin improvement was less than we expected, primarily due to a greater customer response to our successful targeted offers which resulted in incremental sales but at a lower gross margin, as well as a greater portion of online orders resulting in multiple shipments than is typical, thus leading to higher costs.

Moving on to SG&A. As a percentage of net sales, SG&A decreased 160 basis points during the quarter, primarily due to the comparison against Q2 last year when we incurred over $6 million, or approximately 310 basis points, in Optimization Plan costs. Partially offsetting this decrease was 150 basis points increase in SG&A expense as a percentage of sales, primarily driven by increased marketing expense associated with our branding campaign launch in Q2 that contributed 100 basis points of deleverage, as well as higher payroll and self-insurance costs.

New store preopening expenses decreased this quarter to approximately $881,000 from $1.4 million in the second quarter last year. We opened one store in Oklahoma City in the current year period compared to one store opening in the prior-year period. The decrease year-over-year is primarily a result of the incurrence of preopening costs in the second quarter of Fiscal 2017 for two stores that opened early in the third quarter of Fiscal 2017.

Our net interest expense in the second quarter of Fiscal 2018 was $7.4 million, up from $5.9 million in the prior-year period. In September we announced the amendment of our senior secured term loan facility which decreased the applicable interest rate margin to 5% for LIBOR loans and 4% for base rate loans and includes a leverage-based step down of this interest rate margin. We also extended the maturity date to September 2023.

As we disclosed in the associated 8-K filed on September 17, we expect this amendment to result in interest savings of approximately $5 million per year, or $0.07 per share on an annualized basis. This year we expect to realize approximately $2 million, or $0.03 in interest expense savings, which is reflected in our outlook.

The effective tax rate for the quarter was 30.4% compared to negative 144.4% in the second quarter of last year. The increase in our effective tax rate is primarily due to the impact of a pretax income position in the second quarter of Fiscal 2018 as compared to a pretax loss position in the second quarter of Fiscal 2017. On our adjusted basis, our effective tax rate for Q2 was 29.5% compared to 40.5% in the second quarter of last year, as a result of lower statutory rates due to the Tax Cuts and Jobs Act enacted in Fiscal 2017.

Our net income for the quarter was $3.2 million or $0.07 per share as compared to a net loss of $875,000 or $0.02 per share in the second quarter of last year. On an adjusted basis, excluding loss on extinguishment of debt in both periods, as well as the cost associated with the Optimization Plan and other one-time items last year, our adjusted net income was $4.7 million or $0.10 per share as compared to $5.5 million or $0.12 per share in the second quarter of last year. Adjusted EBITDA was $24.3 million in the second quarter this year compared to $26.5 million in Q2 last year.

Turning to our balance sheet, we ended the quarter with $7.2 million in cash, $290.5 million in outstanding borrowings, and combined availability on revolving credit facilities and cash on hand of approximately $80.8 million. Our net debt position was down approximately $17 million from last year.

We ended the quarter with inventory up 1.4% primarily due to new stores, compared to the end of the second quarter of Fiscal 2017. On a per store basis, inventory levels at TCS were down 3% with the decline largely due to improved inventory management combined with lower product costs as a result of the optimization plan.

Regarding our Fiscal 2018 outlook, we are reiterating our outlook issued within our 8-K filed September 17 in conjunction with the amendment of our senior secured term loan that reduced the applicable interest rate and extended maturities. We expect consolidated sales to be in the range of $885 million to $895 million based on a comp store sales range of up 1.5% to 2.5%. We expect GAAP EPS to be between $0.30 and $0.40 and adjusted EPS to be between $0.41 and $0.51 on a weighted average of 49 million diluted shares outstanding. This outlook assumes annual interest expense of approximately $28 million. The amendment to the terms of our senior secured term loan is expected to result in approximately $5 million or $0.07 per share interest savings on an annualized basis, as I've mentioned.

We continue to expect our tax rate for the full-year Fiscal 2018 to be approximately 30%. In Fiscal 2018, we expect to spend approximately $38 million on capital expenditures. We still plan to generate free cash flow once again in Fiscal 2018, which we continue to expect to utilize for further debt reduction.

With respect to the third and fourth quarters, there are important dynamics to call out.

One, we expect our comparable store sales increase for Q3 to be around the middle of our annual outlook range. You'll recall that we are up against weak holiday sales from the prior year.

Two, we expect operating margin declines of approximately 50 basis points in Q3 and meaningful operating margin expansion in Q4 for the following key reasons. We expect FX headwinds in Q3 that are expected to dissipate in Q4, given the recent strengthening of the U.S. dollar against the SEK; we expect meaningful pricing initiative-driven gross margin benefits in Q4 based on the mix of products expected to be sold in that period; and, in addition, accounting changes around the recognition of marketing expenses mean a larger portion of Elfa marketing expenses that was spread over the Elfa sale campaign period last year will be loaded into Q3, resulting in substantial SG&A deleverage in Q3 and corresponding leverage in Q4. Given these quarterly shifts, it continues to be particularly important this year to look at our results and performance on a full-year basis.

In summary, while there are merchandise campaign changes in Q2 that curtailed our top and bottom line performance, we head into the second half of the year armed with learnings that we have reflected in our go-forward plan. Custom Closets strength helped offset much of the shortfall in the Other Product categories. We were pleased to see our Other Product categories return to positive territory once we cycled the campaign changes and are reaffirming our full-year outlook. We look forward to updating you on our progress on our third quarter call.

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

Operator:

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 keys. One moment please while we poll for questions.

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

Steven Forbes:

Good afternoon.

Melissa Reiff:

Hey, Steve.

Jodi Taylor:

Hi, Steve.

Steven Forbes:

Maybe to start, I wanted to focus on the campaign changes you mentioned. The two programs, the—were Customer Favorites and the Organized Day campaign? Was that based on the decision to allocate marketing dollars towards the new campaign, Where Space Come From, or is there any relation there? Then maybe just touch on your most recent thoughts around marketing spending, the levels in general, right, the 4% of revenue, just given all the strategic initiatives and the message you're trying to relate to both new and existing customers.

Melissa Reiff:

Right. Hey, Steve. Okay, well, obviously the decisions we made to combine the two merchandise campaigns that we did last year into one, we obviously thought that it was going to resonate with customers because we were offering many, many, many more SKUs, even though we did shorten the time period. But, again, in evaluating it and looking back, yes, we probably picked up some efficiencies with some dollars that we put toward brand marketing instead. We thought we could have our cake and eat it too, frankly.

But, what happened was even though we had more SKUs, they really did not resonate as well with the customers as we thought they would, Steve. In fact, in hindsight, now that we've really dissected it, as I said in my remarks, we realize that we did not have as many traffic-driving solutions and products and kind of, like, more of our flagship, what we are known for, products and solutions as we should have, which is what we had last year. So, yes; I mean, we had a comp store increase of 1.3%. I know the Street was at 1.8%, so it's 50 bps below what we wanted as well. But we've got to test and learn. I'm not making excuses for it. We own it and we're going to continue to make mistakes, but we're going to learn from them. We've got to continue to do that and really push the envelope strategically and appropriately.

Jodi Taylor:

Steve, I'll jump in on your question about the marketing spend. We spent last year at TCS around 4% of sales and expect to spend approximately the same this year, but the allocation by quarter will be quite unusual as compared to last year, in part because of the brand marketing, which put into Q2 more spend than last year as we discussed, as well as when you get the second half of the year, overall, we will leverage our marketing as compared to last year but it will be allocated unusual between Q3 and Q4 as I mentioned because of the accounting change where it will primarily hit the Elfa sale expenses in Q3 versus last year; those were largely over the campaign period of Q4.

Melissa Reiff:

That's a really big point.

Steven Forbes:

Then just a follow-up, right, because we're heading into your holiday quarter. You mentioned the tweaks around the plans for the holiday assortment. I think, if I remember correctly, it's about 20% of revenue in the quarter for Holiday categories. Maybe just revisit those plans there what you're doing and reiterate what gives you confidence that you can see your return of growth within that category just given the commentary around the comp for the third quarter.

Melissa Reiff:

Right. Steve, you'll remember last year we were disappointed in our holiday sales and we had been for several years. So we took an immediate deep dive and put a strategic team together that really analyzed exactly what we've been doing the last several years and why. We knew we had to make some changes and we feel very, very good about the changes we are making for this year, which include being, like, one size doesn't fit all. We really took it store by store in terms of the layout, the presentation, the assortment, and the messaging. We also, as I mentioned in my remarks, we are offering value packs, kind of grab-and-goes, which we've never had before; we think are really going to resonate with our customers.

So, again, we will see, but we feel like that we have really exhausted the changes that we need to make and feel our customers are really going to respond to it. Regardless, we have mail catalogs as well that will support this and we know that, from our analytics and our data, that last year our customers purchased our core business, as well as the Gift Wrap Wonderland very strongly and so now with our headers and with our features, presentations, etc., we are focusing more on our core storage and organization solutions, as well as the Gift Wrap Wonderland and we think the combination and the tailoring by store versus kind of one-size-fits-all is going to help with sales and, again, bottom line because we're spending less in set up, which is important.

Steven Forbes:

Thank you both.

Melissa Reiff:

Thanks, Steve.

Jodi Taylor:

Thank you.

Operator:

Our next question comes from the line of Matt McClintock with Barclays. Please proceed with your question.

Matt McClintock:

Hi. Good afternoon, everyone.

Melissa Reiff:

Hey, Matt.

Jodi Taylor:

Hello, Matt.

Matt McClintock:

Just one follow up on the marketing campaign and I'll leave that one, is just how long did this take to cycle and can you just talk about the run rate of the business before this issue and then the run rate of the business after; were they the same run rates as you finally cycled it?

Jodi Taylor:

Hi, Matt. Let me talk to it. First, overall, in the quarter I think it might be helpful for me to size how the comps allocated between Custom Closets and Other Product categories because I know we weren't that specific. Then I can absolutely speak to it before and after.

We did not conclude sort of cycling the campaigns until we got to September 17. Remember the quarter ended September 29. The campaignshifting was occurring throughout all of Q2 up until the 17th of September. However, when you look at our Other Product categories, for the full quarter they were actually a comp contribution of negative 1, which was quite different than the trends we've seen for several quarters. We saw an immediate shift starting September 17 forward where we shifted from those comp categories running down actually in excess of one to where they converted to where they were running positive again. That's how we have confidence that it was directly attributable to the campaign.

Custom Closets, to answer the rest of the question and let you fill in how the comps for the quarter were comprised, that 1.3% comp was comprised of, as I said, a negative 1.0% for Other Product categories and a positive 2.3% on Custom Closets. Custom Closets was stronger than we had anticipated. Q2 is not a heavy Custom Closets selling period like you see for us in Q4 and Q1, so we were quite pleased to see that strength and, frankly, pleased for a couple of reasons that, you know, we continue to see Custom

Closets strength no matter the period of time it is, but also, historically, that bodes well then for the annual Elfa sale when Custom Closets become a much greater portion of the total selling that we do, which is why we remain optimistic in the year on the whole.

Melissa Reiff:

Matt, remember we had our Shelving sale in Q2 and that did well. Again, that also bodes well for us as Jodi said, the Elfa sale. So, consistently, Custom Closets is performing.

Matt McClintock:

Thanks. It looks like you read my mind because that was my follow-up question on Custom Closets, so I'll go with a different follow-up question and ask it on tariffs.

Melissa Reiff:

Okay. I was reading your mind, Matt.

Matt McClintock:

On the tariffs, you outlined three strategies to offset this pressure. As we think through the transition and the potential of you transitioning the sourcing to a different country, is there something unique about your product category that allows that product to be shifted more easily than, say, other home furnishing or furniture companies, I guess, would be my first question on tariffs.

Melissa Reiff:

Well, that's a really good question. I wish John Gehre, our EVP of Merchandising and Planning was here. He just got back from China and some other trips. I think we have possibly more opportunity with our products in terms of sourcing the different factories that we can go direct with. That's what I've been told and that's what I hear and that's what I read. But other than that, I don't know; Jodi, do you have anything else to add to that?

Jodi Taylor:

Well, I think we maybe have less lead times than maybe some of products that others may have, so that could potentially be helpful as well. I do think we probably have more alternatives in certain cases in terms of where we actually can source a product.

Matt McClintock:

That's extremely helpful. Just lastly on tariffs is you had the three buckets of potential offsets. Is there already a plan in place of a third, a third, a third across those buckets or can you give us any kind of magnitude of how you think about dealing with this issue?

Melissa Reiff:

Matt, I wish we could. I think it's too early. I can just promise you that I get an e-mail a day about tariffs, at least if not more from our own team, and so we're all over it, as I know every retailer is because it's a biggie. Of course, there was more news today in the paper about it. So, yes, it's just too early, Matt. I can't say a third, a third, a third. We're going to exhaust and make sure that we can mitigate everything we possibly can.

Matt McClintock:

That's completely fair. We're all looking for the answer right now, so I appreciate the color and good luck with it.

Melissa Reiff:

Thanks, Matt.

Jodi Taylor:

Thank you.

Operator:

Our next question comes from the line of Tami Zakaria with JP Morgan. Please proceed with your question.

Tami Zakaria:

Hi. Thanks for taking my question. I have a couple. The first question is, if I heard you correctly, I think you mentioned custom closets are now a little less than half of your total annual sales?

Melissa Reiff:

Correct.

Tami Zakaria:

So great. So, where do you see this go over time and is that a better good margin business?

Melissa Reiff:

Is it a better what, Tammy? Oh gross margin?

Tami Zakaria:

Yes. Yes.

Jodi Taylor:

I'll start, and Melissa will chime in. It's currently about 48% of our consolidated sales, so, and we are very, very focused in that area, so we would expect to continue to see that grow as a percentage of total. Of course, we're also parallel tell that, focused on making sure we're doing everything we can to maximize other product categories with a lot of great efforts around exclusivity, private label, etc. So, in theory, if that grew at a greater rate you could maybe see that percentage not grow to that degree, but the overall total grow high.

In terms of gross margin, because the majority of custom closets consist of Elfa, overall it does tend to be slightly higher margin business, Tammy, that's because for Elfa we are getting both the manufacturing gross margin at Elfa since we own them 100%, as well as the retail growth margin here at The Container

Store in the U.S. So, on the whole growing that business for us, particularly our focus around product development at Elfa, in particular, is something that's really important and is something that for us should drive incremental profitability.

Melissa Reiff:
Again, Tami, remember our number one priority is to own custom closets. So we will be doubling down and are doubling down and leveraging that in every way shape or form and Elfa, of course, is exclusive to us in the U.S. as well as other private labels because we know our customers really love The Container Store brand. We're going to continue to capitalize on that going forward.

Tami Zakaria:

Thank you so much. That's extremely helpful. The second question I had was, could you comment on traffic versus ticket growth that contributed to the 1.2% comp growth for the quarter?

Melissa Reiff:

Well, as you know, we don't really discuss traffic versus ticket, but I can tell you that excluding the shortfall we have with the campaigns, we're very pleased with our comp trends.

Tami Zakaria:

Got it. Thank you so much.

Melissa Reiff:

You bet.

Jodi Taylor:

Thank you.

Operator:

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

Melissa Reiff:

Well, thank you everyone. We really appreciate again your interest and your support of our Company and our direction and the direction that we're heading and, as Jodi said, we'll look forward to talking to you next time. Thanks again. Thanks, Hector. Thanks Liz, Caitlin.

Operator:

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