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The Container Store Group, Inc.

Third 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*

Matt Fassler, *Goldman Sachs*

Dan Binder, *Jefferies*

Matt McClintock, *Barclays*

Tami Zakaria, *JPMorgan*

PRESENTATION

Operator:

Greetings, and welcome to The Container Store Third Quarter Fiscal Year 2017 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 of ICR.

Shannon Devine:

Thank you. Good afternoon, everyone, and thanks for joining us today for The Container Store's Third 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 for 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.

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

Melissa Reiff:

Thanks, Shannon, and we appreciate everyone joining our call today. I'd like to begin by sharing the highlights of our fiscal Q3 performance followed by an update on a few of our strategic priorities. Jodi will then give you a more detailed overview of our financial results for Q3 and discuss our outlook.

Overall net sales for the third quarter of fiscal 2017 were $223 million, up 3.1% compared to the prior-year period. This was driven by new store sales and offset slightly by a decrease in comp store sales of two tenths of a point. Elfa third-party sales were up 10.5% in U.S. dollars primarily due to the positive impact of foreign currency translation of 8.3%.

Specific to our comp store sales results we did fall short of our plan in Q3 largely due to soft sales in our holiday departments, which cost us approximately a full percentage point of comp store sales during the quarter. We saw continued positive comp store sales contribution from our Custom Closets business, contributing 60 basis points of Q3 comp store sales performance and this is despite the shift of one Elfa sale selling day out of fiscal Q3 and into fiscal Q4.

We were also pleased with the improvement in our other product categories outside of holiday departments as our broad sales revitalization initiatives that span merchandising, marketing, store operations and customer experience all continue to positively impact our business.

It's important to note that since Q3 is our only quarter with holiday sales, our holiday departments typically have a notable impact to that quarter’s sales. However, on an annual basis it's generally only a small percentage of our total sales that come from our holiday departments.

In addition, after analyzing the 2016 holiday season we made the decision to head into this season in 2017 with a more conservative inventory ownership and were successful in clearing through our inventory without a negative impact to our gross margin; in fact, despite our soft holiday sales we delivered healthy gross margins overall in Q3 and ended the quarter in good shape from an inventory perspective.

While we recognize we may not be a “traditional” holiday gift destination, we remain committed to maximizing our sales during the holiday season. We have a team specifically focused on speaking with our customers, analyzing our great data, reviewing our product assortment and making recommendations with a goal of improving our holiday results next year.

Let's shift gears now to what worked well in Q3. Our strategic focus on our core competency of Custom Closets continues to generate positive results for us, as evidenced by the 60 basis points comp store sales contributions from this business in Q3. We kicked off our annual elfa Sale on December 21 and were pleased with our important start to this big annual event. And as a reminder, our elfa Sale runs through February 28 with the exact same number of elfa Sale days in the campaign this year as last year.

The improvement we have been discussing for several quarter now in our other product categories (with the exception of holiday department) continued in fiscal Q3, achieving a slight positive comp store sales contribution.

We again delivered a strong quarter of e-commerce performance driven by our expanded digital efforts. Web generated sales were up 17.7% including our click and pick up sales and 21.7% for online direct to customer sales only. And as we've discussed before, these sales are not operating margin dilutive for us, so we remain relatively agnostic to the channel in which we fulfill our customer's order. Our primary focus of course is to ensure that we're meeting and exceeding our customers' expectations in any channel they shop.

And as I said, and as we communicated in our press release, we have seen a strong start to our Annual elfa Sale that has continued into the fiscal fourth quarter and expect comp store sales in the fourth quarter to improve from the third quarter, as reflected in our implied fourth quarter comp store sales outlook of flat to up in the low single-digit range.

Q3 profitability was driven by a 50 basis points gross margin improvement due in part to the anticipated cost of goods project benefit, which began to be realized in Q3. Slightly softer sales, improving gross margin and continued discipline with our SG&A, despite a headwind from the timing of certain marketing and technology expenses that we flagged last quarter, resulted in over a 10% increase in operating income year-over-year. With higher interest expense of approximately $0.04 per share, adjusted earnings per share came in at $0.11, which was towards the lower end of our Q3 expectations and compared to $0.11 in Q3 2016.

I'm really pleased with the progress against our strategic priorities. We have made many changes throughout our business, and our organization has responded positively with a more targeted focus and speed of decision making. We have a clear understanding of our vision, our purpose and the direction we are heading.

To share a few highlights - with regards to new stores, we opened two new stores during Q3: Livingston, New Jersey, and Staten Island, New York, and relocated our Chestnut Hill, Massachusetts store, completing all planned fiscal 2017 new store openings and the one relocation. Fiscal 2017 also included the opening of our Cleveland, Ohio store and our Albuquerque, New Mexico store which occurred in prior quarters.

Our smaller 18,000 square foot store in Albuquerque, New Mexico continues to perform well which we believe is a positive indicator for what a smaller store could mean for us. One of the locations that we have committed to open in fiscal 2018 will be a smaller size store like Albuquerque. And we'll be sharing our full lineup of new store and relocation activities for fiscal 2018 on our May earnings call.

And as we previously discussed, we are deep in the process of redesigning our Dallas flagship store. Construction began last month and we anticipate the store to remain open during this work with the completion projected in June of 2018. This is very exciting for us as we will test and learn and tweak and respond along the way and at the appropriate time apply our learnings to existing stores, from product assortment, visual merchandising, technology and training perspectives, as well as anything else we can learn to maximize the customer experience.

And speaking of product assortment, our focus on Custom Closets continues to generate positive results and our new elfa product introductions from June continue to be well received by our customers.

Product innovation with Elfa remains a priority. Our President and Chief Merchant Sharon Tindell is heavily focused on our Custom Closets business and is leading a specific team to ensure our pipeline of new elfa products remains full.

In Q3 we continued to work on our Pricing Optimization Project that we plan to continue for the rest of fiscal 2017 and into early 2018. We're eager to leverage the many insights this project will generate and have already begun testing in some stores. Again, our goal is to use our great data to ensure our retail pricing is maximizing gross profit dollars in our business.

On customer acquisition and marketing, our media mix model and subsequent increased allocation to digital spend are contributing positively to our sales. We continue to shift our allocation of marketing dollars from traditional to digital in order to optimize our marketing spend and ensure we are allocating our dollars where we can achieve maximum returns. And to further increase sales from our paid media we are testing channel exclusive offers.

Our POP! program has now reached over 5.8 million POP! Stars. To further increase the purchase frequency of our POP! Stars we have developed a comprehensive strategy that takes into consideration our customers' journey with the Container Store and leverages advanced analytics to identify the next best action to increase purchase frequency at each stage of the customers' journey. We plan to focus on a multi-touch, multi-channel direct marketing strategy to further engage or educate our customers about our brand in order to drive additional purchases. We plan to test several pilot campaigns in the coming months across various stages of the customers' journey.

In addition, we have developed an offer optimization model to further increase the redemption rate from our targeted offers. We've tested some of the activities during Q3 and saw a notable lift in redemption rates.

And our team. As previously mentioned, we lifted our wage freeze last September and updated our compensation and performance review process to ensure we are utilizing a best-in-class approach. We also have been busy assessing the talents of our leadership teams to not only ensure we are maximizing our existing talent and focus but to also identify areas where we should add talent.

In December, we did just that with the addition of our new EVP of Strategy and Analytics. Gretchen Ganc has been a senior executive over this area in much larger retailers and began her career by spending six years at Bain Consulting. We're very fortunate to have extensive and good data at our Company and believe we'll be able to effectively use that data even more to drive our business forward under Gretchen's leadership and expertise.

Lastly, with regard to the Tax Act, like all retailers we are pleased with the recent actions around tax reform. We currently expect to reinvest a good portion of our tax savings in our business specifically around strategic priorities, which may include marketing, technology and our employees. We will provide more information when we release our Q4 results in May.

So, in summary, we're pleased with the progress being made in our business including around our key strategic priorities. Given our year-to-date performance, as well as the impact of the Tax Act, we have narrowed our outlook ranges for fiscal 2017 and look forward to building on this progress as we close out the year.

Now I'd hand it over to Jodi to go through more detail on our financial results and our outlook.

Jodi Taylor:

Thank you, Melissa, and good afternoon everyone. Today I'll be reviewing our third quarter fiscal 2017 results and then discussing our outlook for the remainder of the fiscal year.

For the three months ended December 30, 2017, our consolidated net sales were $223.0 million, up 3.1% compared to the prior-year period. Sales for the Container Store retail business were up 2.4% to $203.9 million, driven by new store sales, offset by a slight decrease in comp store sales of 0.2%.

As Melissa discussed, softer sales in our holiday departments, combined with the shift of one elfa Sale selling day from fiscal Q3 into fiscal Q4, were the primary drivers of the comp store sales decline versus Q2. Custom Closets continue to be a positive contributor to our comp store sales, generating 60 basis points of our third quarter comp despite the just mentioned one elfa selling day shift from fiscal Q3 into fiscal Q4.

We ended the quarter 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 third quarter of fiscal 2016.

Now turning to Elfa International AB. Elfa's third-party net sales were $19.1 million up 10.5% compared to the same period a year ago with a positive impact from foreign currency translation of 8.3%, as well as growth primarily in Russia.

Moving on to profitability. In the third quarter, consolidated gross profit dollars were up 3.9% to $130.6 million.

Consolidated gross margin increased 50 basis points compared to the prior-year period primarily driven by the benefits from our Cost of Goods Sold Project, which was a key component of our optimization plans. Gross margin at The Container Store retail business was up 110 basis points, reflecting the lower cost of good associated with the Optimization Plan and the benefit of favorable foreign exchange contracts that were partially offset by higher cost of goods associated with our installation business. The 150 basis points decline in Elfa gross margins was primarily due to higher direct material costs.

As a percentage of sales, consolidated SG&A increased 30 basis points to 46.6% in the third quarter of fiscal 2017 as compared to the prior-year period, primarily due to the timing of marketing and technology expenses, as well as deleveraging of occupancy costs due to the slight comp store sales decline, partially offset by ongoing savings and efficiency efforts.

As we mentioned last quarter, we experienced a timing shift for certain marketing and technology expenses that resulted in an approximate 55 basis points shift into Q3 year-over-year with an expected benefit due to the timing shift in Q4.

New store pre-opening expenses decreased by approximately $1 million to $1.9 million in the third quarter as we opened three stores inclusive of one relocation in the third quarter this year, compared to four store openings in the prior-year period.

Net interest expense in the third quarter of fiscal 2017 was $7.3 million, up $3.2 million or approximately $0.04 of EPS from the prior-year period due to the refinancing of our term loan obligation completed in Q2.

The effective tax rate for the quarter was negative 330% compared to 39.7% in the third quarter of 2016. The change in the effective tax rate is primarily due to the initial estimated impact of the Tax Cuts and Jobs Act which was enacted toward the end of the third quarter of fiscal 2017. We recorded an estimate of the impact of the lower federal tax rates on our deferred tax balances. Since we're in a net deferred tax liability position, this resulted in an approximate $24.3 million tax benefit during the quarter. We are currently unable to calculate a reasonable estimate of the one-time transition tax on foreign earnings that we will record in a future period once available.

Our GAAP net income for the quarter was $28.4 million or $0.59 per share inclusive of a $0.50 per share provisional benefit related to the Tax Act, as compared to net income of $5.1 million or $0.11 per share in the third quarter of 2016. On an adjusted basis, excluding the $0.50 per share provisional benefit related to the Tax Act, among other items, our adjusted net income was $5.1 million or $0.11 per share.

Now turning to our balance sheet. We ended the quarter with $22.7 million in cash; $314.1 million in outstanding borrowings net of deferred finance costs, which was down $24.2 million from the end of the third quarter last year; and combined availability on revolving credit facilities and cash on hand of approximately $102.6 million.

We ended the quarter with inventory up approximately 1.3% reflecting an increase in stores opened from 86 in the third quarter of 2016 to 90 at the end of third quarter of 2017. On a per-store basis, inventory levels at TCS were down 4.2%. We're in a clean inventory position coming out of the holidays.

With regards to our outlook for fiscal 2017, factoring in our year-to-date results, as well as our expectations for the fourth quarter, including the Tax Act, we are narrowing our outlook. We now expect fiscal 2017 consolidated sales to be $850 million to $860 million and comp store sales to be flat to up 1%.

We continue to expect TCS and consolidated operating margin improvement driven by our SG&A savings and efficiency program, as well as the impact of our Optimization Plan that we have discussed this year. Given the impact of the Tax Act, we now expect our effective tax rate for fiscal '17 to be approximately negative 170%. Excluding the impact of the provisional benefit recorded as a result of the Tax Act in the third quarter of fiscal '17 and the tax impact of adjustments to net income, the fiscal 2017 effective tax rate is estimated to be approximately 35%.

The estimated 35% rate does not include any impact related to the one-time transition tax on foreign earnings to be recorded in a future period as we are not yet able to reasonably estimate that amount. Factoring in our year-to-date results through Q3, we've increased and narrowed our fiscal 2017 GAAP EPS to range from $0.60 to $0.66 versus the previously expected $0.11 to $0.22 and we now expect fiscal 2017 adjusted EPS to range from $0.31 to $0.37 compared to our prior outlook of $0.30 to $0.41. EPS is still based on 49 million weighted average diluted shares outstanding. We continue to expect cap-ex for the year of approximately $30 million.

Looking to the fourth quarter, we expect an increase in operating profit dollars of approximately 30% to 50% driven by ongoing improvement in gross margin due to the Optimization Plan and flat to slight leverage in SG&A. Our narrowed full year comp store sales outlook implies Q4 comp store sales of flat to up in the low single-digit range. We continue to expect to earn approximately two thirds of our adjusted EPS in Q4.

Interest expense is expected to be a headwind of approximately $0.04 per share year-over-year, as we saw in Q3. And our effective tax rate for Q4 is projected to be approximately 35% as we anticipate a benefit from the Tax Act in Q4 of approximately $0.01 per share. The projected tax rate for Q4 also does not include any provisional amounts for one-time transition taxes on foreign earnings to be recorded in a future period.

From fiscal '18 forward, our current best estimate of an effective tax rate is the high 20% range, as we take into consideration the 21% federal tax rate, as well as partial offsets such as executive compensation limits and international taxes. As Mellissa mentioned, we expect to reinvest a good portion of these tax savings to further our strategic priorities. We'll share more information on our fourth quarter call in May when we provide our fiscal 2018 outlook.

So, in summary, while our holiday department sales were soft, continued growth of our important Custom Closets business, and improvement in our other product categories outside of holiday, combined with strong gross margins and disciplined SG&A, were our bright spots in our fiscal third quarter. We remain encouraged by the progress being made across all our key strategic priorities and look forward to updating you again on our year end call in May. Thank you.

Now I would like to turn the call back over to Omar so that we can open the line for your questions. Omer?

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. One moment please while we poll for questions.

Our first question is from Steven Forbes with Guggenheim Securities. Please proceed with your question.

Steven Forbes:

Good afternoon. Maybe if you can start, if you can expand on the performance of holiday sales during the quarter. Kind of a couple of quick questions that come up really how broad based was the underperformance, if you could touch on the categories, what percentage of sales this holiday represents in the third quarter. And then what was the performance of the category last year because I think you had a difficult compare in the first quarter of this fiscal year? Was there also a difficult compare this year or really any context on what transpired here?

Jodi Taylor:

Sure. First of all, as far as the first part of your question, Steve, let me talk about the percentage of sales that holidays represent just to make sure we're scaling it. So, for us within the quarter, you heard us talk to generalities but to be a little bit more specific, holidays represent around 20% of our total sales in Q3, and then as you go obviously into the full year, it becomes single digit percentages. So, it's really only meaningful to us in our fiscal Q3 period since for us fiscal Q3 is the months of October, November and December. So, it's an isolated timeframe, number one.

Number two, in terms of looking across holiday for us, we saw declines across all of our holiday categories, the three departments that we specifically have that we devote our holiday products into. So, it really wasn't any specific category that drove the decline per se, it was more broad. And then you are correct, that's why Melissa referred to it in her script, I don't know if you want to speak more to that, Melissa, but we have seen a pressure in holiday sales for a few years now and that is why we are very devoted to our team really digging in to our great data and talking to customers to make sure we're reacting appropriately.

Melissa Reiff:

Exactly Jodi. And Steve, don't forget, it did contribute one full point of comp store sales in a negative way, and so we were down for the quarter, that two tenths of a point, and so holiday was a drag, but Custom Closets contribute positively, all the other product categories that are so important contributed positively and we have now begun Q4 with a very strong, strong Elfa sale, start to the Elfa sale and we do expect that it's going to continue to increase and we're going to have a good Q4.

Steven Forbes:

And then as a follow up maybe on that topic with Elfa, right, so maybe regarding the Elfa sale bonus that is currently live, you go on your website and obviously the emails and so forth. Can you touch on I guess maybe the thought process or the anticipated outcome of this sale? I don't know if you've done it before but there's obviously multiple scenarios where it could either be—it could drive Elfa sales or incremental Elfa sales or you could drive sales within the non-closet categories. Was there a particular thought process for the sales bonus or is the idea here really just to drive greater share of wallet? Any color on that would be helpful.

Melissa Reiff:

Well first of all I just want to make sure that you understand that the annual Elfa sale has the exact same number of days this year as it did last year, it's just that one shift from Q3 to Q4 that one day, and we did the Elfa bonus last year as well. And so we are repeating it and again we are trying to drive traffic, drive closets along with selling the complete solution in all the other product categories and we continue to see improvement in that.

Jodi Taylor:

And Steve, just to clarify one other thing; that bonus is specifically designed to drive an incremental purchase between the time of purchase in the short window in February through the end of the Elfa sale which ends February 28th, so it's absolutely to try to sell both more Elfa and more of our other product categories; it's designed to do both and it successfully did that last year.

Steven Forbes:

Thank you.

Operator:

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

Matt Fassler:

Good afternoon. First question when you're commenting on the web business I think you gave one 17% number and one 21% number and I think that the 21% was all in and the 17% might have been the pure play or maybe I flipped it., but if you could just give some clarity around what those two numbers were and what that implied for I guess what would be the omnichannel or buy online, pickup at store piece of the business?

Melissa Reiff:

Yes, ecommerce sales we did show a large increase in Q3. It was up 21% compared to 17.6% in Q2 and up 20.1% in Q1 so it has been a significant improvement in the trend, and all website generated with Click and Pickup delivered 17.7% in Q3 compared to 25.7% in Q2 and up 26.7% in Q1. But we continue to see a strong online sales performance in Q3 in virtually all departments, Matt, including holiday did well online.

Matt Fassler:

I guess the question is it sounds like for first two quarters of the fiscal year your total ecommerce business was up more than the pure play ecommerce business, i.e. your buy online, pickup in store is growing. It looks like the buy online pickup in store business shrank a bit here in Q3. Just curious what that related to.

Jodi Taylor:

Matt, I'll hop in, it's Jodi. That was really driven by one thing specifically, Last year in advance of the holidays we ran a Click and Pickup offer that we did not replicate this year. We wanted to make sure that we drove that more online and really didn't want to compromise service levels in the stores. It was a little bit of a challenge from a operational perspective to run that offer and we chose not to this year.

Matt Fassler:

And no real impact, that was not a gross margin driver this quarter, it sounds like it was done purely with operational priorities in mind?

Jodi Taylor:

Absolutely

Melissa Reiff:

Yes

Matt Fassler:

Second quick question. In terms of gross margin drivers going forward and if you could comment on the tweak that you made in the timing of the cost-cutting program, what that tweak relates to and what kind of legs you think the effort has as we think about gross margin trajectory, in your next fiscal year. I know you're not going to guide it but just in terms of the color on the headway that you’re making on that. Obviously your gross margin, certainly (inaudible) to the upside this quarter, so that will suggest some headway here.

Jodi Taylor:

Absolutely, I think the tweak we made—let me take you through this separately. The tweak we made to the expected benefits for this year where we did reduce it by $1 million or $0.01 per share, so you saw that, that is completely due to the excepted flow through of the Cost of Goods Project that we did under the optimization plan. We still expect the same amount of savings, we are just seeing that flowing through a little bit slower than what we had anticipated which will cause that to shift out of fiscal '17 into fiscal '18. We don’t expect the amount to be lower. The $20 million is still very, very valid, it's just the timing of how we’re expecting that to flow through, Matt.

And then specific to how we’re thinking about gross margin, of course, we will be much more specific when we get to our outlook in May but in terms of sort of high-level headwinds and tailwinds this is how I would think about it. We absolutely see the ongoing benefits of this optimization plan and Cost of Good

Project to give us a nice tailwind as we head into fiscal '18. As you will recall, we didn't start to see those benefits really flow through until the fiscal third quarter. That was a large reason why we had our overall margin up 50 basis points.

And then in addition, we do expect that to continue to rise because it takes a bit of time for those purchases at a lower cost to become at that higher rate or that lower cost on an average basis since we use an average cost inventory system.

So that will absolutely benefit us, particularly into the first half of next year

Melissa Reiff:

And then our pricing optimization project

Jodi Taylor:

Right, which we're not really clear yet what the benefits of that will or will not bring us, but that is the last phase of our optimization plan and we anticipate that will completed in the first quarter of next fiscal year.

And then I should comment as well, Matt, I think one other quick thing to mention, just to keep in mind is, we're keeping a close eye obviously on the dollar and don't have any firm commitments for our purchases of the inventory for next year in terms of where that may cost us but that could be a potential tailwind—or headwind, excuse me, against the optimization plan benefits. Based on our visibility right now we still believe that the optimization plan benefits would be higher than what that headwind may be though.

Matt Fassler:

Understood. Thank you.

Operator:

Our next question comes from Daniel Binder with Jefferies. Please proceed with your question.

Daniel Binder:

Hi. It's Dan Binder from Jefferies. Just going back to the holiday related product and the performance there and you said now a few years of weakness. I mean, initial takes, do you think it's the content, is it the product, is it the promotion around it or the marketing of the product? What do you think is the key issue there?

Melissa Reiff:

Dan, we're not sure, that's why we put together a team that is specifically focusing on it and they're going to be talking with customers, we're going to be looking at the assortment, we're going to be analyzing the data and we're going to make appropriate changes because we definitely want to play in holiday sales. And our Gift Wrap Wonderland is beautiful. It is very comprehensive. But we're going to be looking at ways we can build on that business and the necessary changes that we need to make to get that going in the right direction.

Jodi Taylor:

And Dan, I think one thing to thing about for us versus maybe some other retailers is playing so to speak in this space isn't getting into businesses outside of our core categories we sell in. We already on—if you look at our departments and our stores we already do sell, the tower items that are offer what we're presenting in our stocking stuffer area, as well as the gift wrap items in our gift packaging department. So we do bring in items specifically for the holidays but as Melissa said we would make sure we are doing what we can to maximize that business and we don't plan to retreat from it.

Melissa Reiff:

No, build on it.

Daniel Binder:

And then, Jodi, could you give us a little bit finer detail on the gross margin impact from FX, and then from installations separately because you mentioned a higher cost for that as well, and then what the—if you can give us that detail for Q3 and then what the likely projection is for Q4 on those line items?

Jodi Taylor:

Absolutely. FX this quarter, Dan, to be real specific was a benefit of about 30 basis points. I'm going to speak to just the Container Store's improvement that I think you were enquiring about which was 110 basis points. Additionally, the offset for the service model for installation, that was a negative 20 basis points, and then the balance was around just sort of optimizing the retail assortment which largely about 70 basis points of that came from our estimate of the optimization plan benefits from the Cost of Goods Project.

Daniel Binder:

And then for fourth quarter best guesses on those items? Similar type of magnitude or greater?

Jodi Taylor:

I would expect that we should see a little acceleration in the optimization plan benefits from the Cost of Goods Project as we continue to sell through our inventory and gain some of those benefits, and then we would expect to still obtain some of the favorable foreign currency benefits. I wouldn't expect that to be significantly different than what you saw in Q3.

Daniel Binder:

Okay, great. Thanks.

Operator:

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

Matt McClintock:

Hi. Good afternoon everyone. I'm sorry if I missed this but I dropped off for a second there. Just two questions on pressures, cost pressures. Number one, transport cost. Did you talk about that? Are you seeing any inflation there in terms of your transportation costs in your supply chain?

And then number two, wage inflation. Clearly you guys have a strong reputation for paying very strong wages to your employees but how do you think about wages going forward particularly as—and I know I am not trying to get ahead of your discussion on tax reform—but as you think about maybe spending that—those proceeds? Thanks.

Jodi Taylor:

Hi Matt. I'll start and then Melissa you probably want to add here. But as far as the transportation headwinds that you're hearing called out we have fortunately been able to manage through those well and really haven't seen any notable cost pressures to call out so we did not call that out on this call.

Obviously, we'll be watching it very closely and it could become more of a headwind as we move into 2018. We are able fortunately to really leverage well our relationships with Leonard Green. They pulled together their consortium groups from across their portfolio and we leveraged and negotiated as one large group and that does in fact, I think, give us a little more ability to negotiate through this than perhaps we can do—that I know we could do on our own. So, that's definitely something we'll keep an eye on.

On the wage side, you're absolutely right, we don't—some of the announcements you're seeing other retailers come out and announce their new wages, we already were at those levels for what we were starting folks at anyway, so we are not up against some of those immediately. What it does of course do is put a little less gap between us and where some are announcing. But there is not any immediate short-term cost pressures that we're facing there. But certainly, as you heard Melissa say, investing in talent and employees is part of how we believe we will prioritize some of the tax reform savings.

Matt McClintock:

Perfect. Thank you very much.

Operator:

Our next question is from Tami Zakaria with JPMorgan. Please proceed with your question.

Tami Zakaria:

Hi. Thanks for taking our questions. We have a couple of questions. The first one is, you've mentioned in the past about customers procrastinating or waiting until the final days of the Elfa sales program. So, have you seen this time that trend changing, and if so, can you comment on whether you changed any marketing strategy to drive that?

Melissa Reiff:

Yes, I can. Hi Tami. First of all, yes, historically our customers have procrastinated, there is no doubt about it, but we have seen a very strong start to this Elfa sale, more volume, more order volume. And in terms of marketing, we have been working very hard I think as we talked about in past quarters, so always improve our selling process and some changes that we've made in our store with some of our systems is really benefiting. We're having a lot more follow up with our customers in our stores as well as on the phone and it is—I believe it is, I know it is driving more order volume. I still do anticipate, we still do anticipate procrastinators to come out. Those last days of the Elfa sale are very, very huge. So, we have a lot of big volume days ahead of us.

Tami Zakaria:

Great. Thank you, that's really helpful. And my second question is, can you help us understand the store redesign that you're doing, and if you could remind us, some of the specifics around what areas in the store you're changing.

Melissa Reiff:

You bet. We started construction in January just last month on this redesign of our Dallas flagship store and it should be completed and launched in June, and as I said, the store will remain open during this week. But when we talk about the redesign we're looking at everything from new flooring, new fixturing, new signage, new technology, new cash reps. This is what we call the Container Store of the future and we're going to test and learn and understand what works and what doesn't and then we're going to want to take those learnings obviously at the appropriate time, with the proper capital allocation we want to apply that to existing stores to give them a redesign and an update. So, this is really big deal for our Company, everyone in our Company is very excited about it and we just can't wait to get it open in June and learn.

Tami Zakaria:

Thank you so much. That's really helpful.

Operator:

Ladies and gentleman we have reached the end of the question and answer session. I'd like to turn the call back to Melissa Reiff for closing remarks.

Melissa Reiff:

Thanks, Omer. And I just want to say thanks to everyone for joining the call and for your great questions and interest in our Company. We appreciate it and we will look forward to talking with you again in May and we will give you our Q4 and the full year results at that time. Have a great rest of the day.

Operator:

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