The Container Store Group, Inc.

Third Quarter Fiscal Year 2018 Earnings Conference Call

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CORPORATE PARTICIPANTS

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Melissa Reiff, *Chief Executive Officer*

Jodi Taylor, *Chief Financial Officer and Administrative Officer*

CONFERENCE CALL PARTICIPANTS

Steven Forbes, *Guggenheim Securities*

Kate Howard, *Barclays*

PRESENTATION

Operator:

Greetings and welcome to The Container Store Third 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, Farah Soi, Investor Relations. Thank you. You may begin.

Farah Soi:

Thank you. Good afternoon, everyone, and thanks for joining us today for The Container Store's Third 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, Farah, and thanks to all for joining our call. Let's begin by reviewing the drivers of our Fiscal Q3 2018 results, and then I'd like to update you on the progress we are continuing to make against our strategic initiatives. Jodi will then review our financial results in more detail and discuss our outlook for the year.

For the third quarter we reported net sales of $221.6 million and a comp store sales decline of 0.8%. Our comp store sales shortfall was driven entirely by our three holiday departments which represent a disproportionate amount of our sales in Q3, but only a small portion of our annual sales. These departments underperformed versus our expectations, declining by 15.8% as compared to Q3 last year, and cost us three percentage points of comp store performance. Our Elfa third-party sales were down 12.6%, primarily due to foreign currency translation. Adjusted EPS came in at $0.07 compared to $0.11 in Q3 last year.

While the sales from our three holiday departments were disappointing, we were very pleased with our continued strong performance in Custom Closets. In fact, Custom Closets contributed 180 basis points to our overall comp sales results, increasing by 4.5% compared to Q3 last year.

All other categories, excluding holiday departments and Custom Closets, also comped positive for the quarter, a direct result of our sales revitalization and optimization initiatives that encompass, among other things, merchandising and marketing improvements. We have great optimism as we move forward, continuing to execute our strategic initiatives that I will update you on more in just a moment.

Before I do that, though, I wanted to share what we've learned from the performance of our holiday departments in Q3. As we discussed, based on the performance of our holiday categories last year, we implemented a number of changes this year. These included using a reduced holiday product presentation in many stores so that our everyday storage products were less displaced, also incurring lower investment in payroll and visual expense. We also had more stocking stuffer assortment devoted to kids and men, as well as more price points at $10 or below. Third, we had more focus on convenience and value by offering gift packaging grab-and-go value packs.

We believe these changes drove better performance than we would have seen absent them, however, it is clear to us that our customers' interest in our traditional holiday offerings continues to decline and we will deemphasize our holiday categories going forward. With that said, it is a meaningful portion of sales for us in the third quarter, so we must be prudent and smart in how we tailor this offering and how we allocate our marketing spend going forward. Our teams are already working on updated plans for holiday 2019 that include less emphasis on traditional holiday products and more focus on Custom Closets and our Other Product categories, which, again, did perform well throughout our third quarter.

With the holidays behind us, I am very pleased with the overall momentum in our business. We started our Annual elfa Sale on December 19 and are happy with the results so far, especially the sales we're experiencing around our Other Product categories during this campaign. For Q4 to date fiscal January, which is through January 26, our comp store sales were up 9.4%. While we are encouraged by the strong start to Q4, we do have a number of high-volume weeks ahead of us still. However, given our year-to-date performance, we are updating our outlook accordingly, and Jodi will review that shortly.

Let me now just take a moment to review the progress we're making with our strategic initiatives. First, to own Custom Closets. As I mentioned, we are seeing strong momentum in our Custom Closets business which gives us confidence in our go-forward plans to drive market share and achieve our goal of closet domination. Our plan is to continue to grow the space allocation in our stores that is devoted to Custom Closets. A key part of this growth is expected to come through a new Custom Closets line and new product introductions. where we have an exciting roadmap that we are executing against. In fact, we will be unveiling more about this next month.

Our remodeled Dallas flagship store has also generated valuable learnings and we are eager to build upon them with a test in two existing stores that we plan to complete this summer. These stores will be far more heavily Custom Closets-focused than our typical store, but will also include products dedicated to other space solutions to help our customers accomplish their projects. We've also introduced this as a new strategic initiative we are executing against to ensure maximum success.

We will use what we learn to guide our go-forward plans, both on new store formats, as well as the optimal configuration and SKU offering at all existing stores. All of our consumer insights work consistently point to the opportunity that we have with owning Custom Closets despite having sold the category for over 40 years. Our marketing plan for the coming year will be even more prioritized on this opportunity, especially as we launch our new line and new products, and rebrand our Custom Closets offerings. I look very forward to sharing a whole lot more about this on our Q4 earnings call.

Our second priority is to deliver on accomplishing projects across all customer touch points. Starting with marketing, as you know, during the second quarter we launched our new brand marketing campaign with the tagline "The Container Store. Where Space Comes From." We continue to use this tagline in all our marketing in Q3 and will do so moving forward as well. Regarding our stores, as I mentioned, our Dallas flagship store redesign is providing us with many insights. We have received favorable customer feedback and continue to be pleased with the performance of this store. We will continue to utilize this store to test and learn as we work to refine our go-forward store strategy and to capitalize on the opportunities, such as the opening this summer of the two test stores that will be, again, heavily Custom Closets-focused.

Furthermore, we've selected our Dallas Galleria store to test and implement numerous visual merchandising changes to better help our customers accomplish their projects. Early reads of these changes are positive, so we plan to roll out shortly to an additional five stores, with the goal of continuing to test and learn along the way to positively impact all stores in the future.

Our third priority is to leverage digital and data insights to enable omnichannel growth. With over 7 million POP! Stars now enrolled in our POP! program, we are enthusiastic about the growth we continue to see and what we're learning about the shopping behavior and preferences of our POP! Stars. We're using this information in our monthly targeted offer campaigns to our POP! Stars, and they are responding favorably. As we test and learn, we will focus heavily on our POP! Program, with differentiated and targeted campaigns to drive incremental sales and gross profit dollars. In addition, our media mix model is our guide on optimizing our paid media spend, and we remain pleased with the increased effectiveness of our campaigns.

We've also launched additional tools, both in our stores and on our website, that will make it easier for our customers to accomplish projects and find solutions. During Q3, we were excited to launch an updated Elfa design tool in our stores. This tool allows our stores to design custom spaces more efficiently and also provides our customers with an improved overall experience, including better visual representations of their custom spaces. This tool also sets the stage for us to add new Custom Closets lines and products with ease. Our plans for Fiscal 2019 include developing this tool so that it becomes available online as well.

Fourth, we're focusing on closing the gap on value for the money. During the third quarter we continued to make pricing and visual changes that were a result of the work we completed around our pricing initiatives. As a reminder, our pricing initiative include adding opening price points in certain product classes, like hangers or storage totes; reducing and increasing prices on products and solutions using deep data analysis, including competitive and consumer insight work; and we've also incorporated the results of these tests into our go-forward plans and our annual guidance.

We've also added a few new strategic priorities as well. These include capitalizing on the significant opportunity we see to further grow our private label product offering. Our customer insights work showed us that customers believe our TCS-branded products to be of the highest quality. We think this represents a sizable opportunity, so we have formalized this initiative with a cross-functional team for swift execution. Under John Gehre's leadership, our EVP of Merchandising and Planning, we have begun with adding some new private label solutions, arriving in our stores in several categories, such as our Closet department. We believe we have one of the most trusted brands with significant opportunity to grow our private label program, which we think will yield growth margin improvement over the next few years.

We also added a new initiative under the accomplishing project strategy priority that is focused on refining our brand positioning around helping customers accomplish their projects. This includes a more curated and competitive product assortment with focus on our private label brand structure and clearly differentiated product selections within our assortments that will simplify the customer shopping experience.

Finally, we've added a formal foundational strategic initiative around our second distribution center that we plan to open later in calendar 2019 in Aberdeen, Maryland. This includes a large cross-functional team dedicated to ensuring that this project is implemented as smoothly as possible. As a reminder, this second distribution center will significantly improve our customer service delivery time for web-generated orders, as well as provide meaningful freight savings once fully operational.

Before I close, I just wanted to touch on the tariff situation briefly that I know we discussed on our last call. Since that time, the impending 25% tariff has been deferred and trade talks are ongoing. However, we remain committed to our work to mitigate any potential financial impact of further tariffs to our business. We feel good about our progress that includes reducing our reliance on third-party sourcing, negotiating with our vendors, as well as the benefit of the pricing work we had already begun prior to any trade issues. With all this in mind, we do not see a notable tariff impact to Fiscal 2018 and we are working hard to mitigate any future potential financial impact.

In summary, we continue to see so much opportunity ahead for us and look forward to continued and focused execution of our strategic priorities. As I've said, we were obviously disappointed with our third quarter results and know that the underperformance is isolated to our three holiday departments, while our Custom Closets business and all Other Product categories performed well in Q3 and are performing well so far in Fiscal Q4. As said before, we are already working on plans to improve our positioning for the holiday quarter next year, but we believe that, overall, our biggest opportunities lie with our Custom Closets business as we help our customers accomplish their projects, maximize their space, and make the most of their home. So, this is where we will focus our marketing dollars, as well as our merchandising innovation and space allocation in our stores. We're working hard to ending this year with a strong finish and building on our progress into next fiscal year.

Finally, before I turn it over to Jodi, you may have heard that Kip Tindell, our Chairman, and Sharon Tindell, our President and Chief Merchandising Officer, will be retiring after our Annual Meeting in August. They have both put their heart and soul into building this Company into what it is today and we will be forever grateful for their many contributions, including the timing and thought they put ,into succession planning. I'm delighted to announce that John Gehre, who joined the Company last year as EVP of Merchandising and Planning will become our Chief Merchandising Officer upon Sharon's retirement. In a short time with us, just about eight months, John has already added tremendous value.

Thank you. I'll now turn the call over to Jodi to discuss our financial results and our outlook in more detail.

Jodi Taylor:

Thank you, Melissa, and good afternoon, everyone. For the third quarter ended December 29, 2018, our consolidated net sales were $221.6 million, down 0.6% compared to the prior-year period. Sales for The Container Store Retail business were up 0.5% to $204.9 million. An increase in new store sales was partly offset by a 0.8% comp store sales decline.

As Melissa shared, our Custom Closets continued to deliver very strong performance, but did not fully offset the shortfall in our three holiday departments. Custom Closets contributed 1.8% of comp store sales growth in the third quarter and our non-holiday Other Product categories contributed positively as well.

We ended the third quarter with 92 stores and approximately 2.2 million of gross square footage, as compared to 90 stores and the same growth square footage at the end of the third quarter of Fiscal 2017.

Now turning to Elfa International AB, Elfa's third-party net sales decreased 12.6% to $16.7 million, primarily due to the negative impact of foreign currency translation during the quarter which decreased third-party net sales by 7.4%, as well as lower sales in the Nordic and Russian markets.

From a profitability perspective, in the third quarter, consolidated gross profit dollars declined 0.4% to $130.1 million and consolidated gross margin increased 10 basis points compared to the prior-year period. Gross margin at The Container Store Retail business was up 30 basis points, driven primarily by lower cost of goods associated with our optimization plan, partially offset by higher promotional activities and a negative impact from FX. Elfa's gross margin decreased 390 basis points from the prior-year period, primarily due to higher direct material costs attributable to a shift in product mix and a weaker Swedish krona.

Moving on to SG&A, as a percentage of net sales, SG&A increased 240 basis points during the quarter, primarily due to deleverage of occupancy and payroll costs associated with negative comparable store sales, as well as increased marketing expense in the third quarter of Fiscal 2018. The increased marketing expense is associated with a shift in the timing of recognition of campaign-related marketing costs from the fourth fiscal quarter to the third fiscal quarter due to accounting changes, as we discussed on our second quarter call.

New store preopening expenses decreased this quarter to approximately $700,000 from $1.9 million in the third quarter last year. The decrease year-over-year is primarily driven by fewer store opening this year, as our real estate activity in the current period focused on two relocations compared to three store openings, which included one relocation, in the prior-year period.

Our net interest expense in the third quarter of Fiscal 2018 decreased 17.7% to $6 million from $7.3 million in the prior-year period due to the September 2018 amendment of our senior secured term loan facility.

The effective tax rate for the quarter was negative 72.8% compared to negative 330.1% in the third quarter of last year. The change in the effective tax rate is primarily due to the impact of the Tax Cuts and Jobs Act enacted in Fiscal 2017 in both periods. In the third quarter of Fiscal 2018 we recorded a $5.9 million tax benefit as a result to the finalization of the one-time transition tax on foreign earnings. In the third quarter of Fiscal 2017, we recorded an estimate of the impact of a lower Federal income tax rate on our deferred tax balances, which resulted in an approximate $24.3 million tax benefit during the third quarter of Fiscal 2017. On an adjusted basis, our effective tax rate for Q3 was 29.3% compared to 30.9% in the third quarter of last year.

Our net income for the quarter was $9.3 million or $0.19 per share as compared to $28.4 million of $0.59 per share in the third quarter of last year. On an adjusted basis, excluding a gain on disposal of real estate at Elfa this year, costs related to an Elfa manufacturing facility closure and the optimization plan last year, and certain one-time tax related items in both periods, our adjusted net income was $3.5 million or $0.07 per share as compared to $5.1 million or $0.11 per share in the third quarter of last year. Adjusted EBITDA was $21.8 million in the third quarter this year compared to $25.6 million in Q3 last year.

Turning to our balance sheet, we ended the quarter with $21 million in cash, $304.9 million in outstanding borrowings, and combined availability on revolving credit facilities and cash on hand of approximately $90.1 million. Our total debt position was down approximately $9.2 million from last year.

We ended the quarter with consolidated inventory up 5.1%, primarily due to new stores and new product introduction. On a per store basis, inventory levels at The Container Store were up 0.6%.

Regarding our Fiscal 2018 outlook, as Melissa mentioned, given our year-to-date performance, we now expect adjusted earnings per share at the low end or slightly below our prior guidance range, but comparable store sales at the higher end of our guidance. We revised our GAAP earnings per share to incorporate the finalization of the one-time transition tax on foreign earnings during third quarter. Also, given foreign currency moves, we now expect our consolidated sales to be toward the lower end of our prior guidance. Please refer to our press release for further details on our Fiscal 2018 annual outlook.

Specific to our fourth quarter, there are a few callouts. One, our fourth quarter comp sales through January 26 are up 9.4%, as Melissa said. While it is not our practice to discuss inter-quarter comp sales performance, given the dramatic improvement and the underlying trend of the business since exiting holiday, we felt it important to share this information. Two, we still expect meaningful operating margin expansion in Q4, largely due to pricing initiative-driven growth margin improvement that are expected to be partially offset by higher penetration of targeted offers that are resonating more with our customers. Three, we still expect some SG&A leverage in Q4 largely driven by accounting changes that shifted a large portion of our Annual elfa Sale marketing expense out of Q4 and into Q3.

In summary, while our holiday performance was not what we expected, this performance was isolated to those seasonal categories while the rest of our assortment drove positive comp store sales results, led by Custom Closets. We've had a strong start to the fourth quarter and have large selling weeks ahead of us. We are focused on delivering against our goals and ending the year on a strong note.

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

Operator:

Thank you. If you would like to ask a question 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'd like to remove your question from the queue. For participants using speaker equipment, it may be necessary to pick up the handset before pressing the star keys.

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

Steven Forbes:

Good afternoon.

Melissa Reiff:

Hey, Steve.

Jodi Taylor:

Hello.

Steven Forbes:

Maybe regarding the fourth quarter comp to date, right, can you help us understand the significance of Custom Closets in the fourth quarter, maybe not just for the January period but the fourth quarter as a whole? Then, how is Custom Closets performing quarter-to-date? So you take that 9.4%, what is Custom Closets doing and how is that non-holiday category doing quarter-to-date?

Jodi Taylor:

Hi, Steve. As it relates to Q4 and Custom Closets, we do over-index Custom Closets to the quarter just because of the Annual elfa Sale, so Custom Closets represent a greater portion of our total sales in Q4 than they do in other quarters. As it relates to the interim comp that we've reported for fiscal January, that comp is relatively split between Custom Closets and Other Product categories, so we have seen acceleration throughout the store affecting both of those areas of the business.

Steven Forbes:

Perfect. Then just a quick follow-up, right; you mentioned the new DC in Maryland, so maybe can you talk about the model implications as we think about next year and the potential margin drag after it goes live, and the timing for maybe the savings capture?

Jodi Taylor:

Sure. I'll start and Melissa, if you want to chime in with anything else.

Melissa Reiff:

Sure.

Jodi Taylor:

First, from cap ex perspective, the cap ex is split relatively evenly between Fiscal '18 and Fiscal '19 with about $11 million to $12 million hitting in each of those fiscal years. As it relates to SG&A, we do expect headwinds in Fiscal '19 as we will incur the cost to get the facility set up, with it not becoming operational until later in calendar 2019, and with the related freight savings being incurred only for a limited period of time - really Q4 of next year. So, we expect that to be a headwind to our expenses as it relates to Fiscal '19. We're not talking hundreds of basis points, but could be talking somewhere in the 50-ish basis point range, Steve. But as it relates then to Fiscal 2020, we would expect to see a very significant tailwind as it relates to freight savings that we will capture or expect to capture associated with both direct shipments to customers as well as the freight inbound and outbound from the facility.

Melissa Reiff:

So, so much better service to our customers once we get the second DC opened.

Steven Forbes:

A real quick last one, just any color on free cash flow guidance for the full year?

Jodi Taylor:

We do still expect to see positive free cash flow for the business and also to see our debt come down year-over-year, so nothing different than how we thought about the year at the beginning in terms of positive free cash flow as well as debt payment.

Steven Forbes:

Thank you both.

Melissa Reiff:

Thanks, Steve.

Jodi Taylor:

Thank you.

Operator:

As a reminder, it is star, one on your telephone keypad if you would like to ask a question. Our next question is from Matt McClintock with Barclays. Please proceed with your question.

Kate Howard:

Good afternoon. This is Kate Howard on for Matt.

Melissa Reiff:

Hey, Kate.

Kate Howard:

Hi. I have two questions related to the fourth quarter. First, with relation to the portion of Other categories seeing significant comp growth throughout January, can you parse out how much of this you think could be related to the recent success of *Tidying Up*; and if so, what things, if any, have you done to take advantage of the recent heightened interested in decluttering and organization to maybe sustain that growth? By our checks, it seems like you've been very active in the social channel, whether it be through digital advertising or through social engagement with customers, so any color on that would be really helpful.

Melissa Reiff:

Yes, Kate; and you're absolutely correct, we have been very active across all social media in leveraging this. It's just been wonderful to hear our customers talk about it, and when they're in store or whether they call or whether they're online. We certainly know that this Netflix show that Marie Kondo has done has certainly inspired, we hope, all consumers to get organized, which is great. We're going to leverage that all we can. We're certainly not going to count on it, but we're going to leverage it and we're very, very, very excited about it because we have seen an increase in mentions associated with The Container Store; the volume has increased, which is fantastic; but we also know that we can't contribute all of Q4's success to that because we have revitalized a number of actions across really all functions of the business that we've been working on for many, many, many months.

One of the things—there're several things—but, one, we had some wonderful new product introductions in January. We also were in a much better inventory level this year as compared to last year. We've made many visual and marketing changes, which I talked about in my remarks. I think our pricing initiative is having an impact. We've had online enhancements which we think have an impact, some tech innovation with our updated design tool. Then, again, the Company is just moving. Our momentum is strong and we're doing so many test and learns and reacting quickly to what we're learning.

I told Jodi, it's kind of like the perfect store. I mean, we just love Marie Kondo and we love the KonMari method because it just fits right with the organization and what we're all about. So, when our customers come in our stores or online or call us, we can help them, again, accomplish all of their projects throughout their entire home and really maximize their space.

Kate Howard:

Great. Thank you. That's super helpful. Then just the second one; in terms of the fourth quarter on promotional events, are you still planning on running the kitchen sale campaign in March as you have in the past? More specifically, I think you changed your strategy last year and just wondering if you're going to move forward this year on the same strategy of doing the more targeted percent off select products versus the blanket percent off the entire kitchen.

Melissa Reiff:

Yes. The answer is yes, Kate.

Jodi Taylor:

For both timing and discounts.

Kate Howard:

Great. Thank you so much.

Melissa Reiff:

Thanks.

Jodi Taylor:

Thank you.

Operator:

We have reached the end of our question-and-answer session. I would like to turn the conference back over to Management for closing remarks.

Melissa Reiff:

Thank you, Sherry, and thanks you all for very much for joining us. Thanks, Farah. We appreciate it and we look forward to definitely talking with you at the end of our full fiscal year. Thanks so much.

Operator:

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