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Tami Zakaria, *JPMorgan*

PRESENTATION

Operator:

Greetings and welcome to The Container Store conference call. At this time, all participants are in a listen-only mode. A brief question-and-answer session will follow the formal presentation. If anyone should require Operator assistance during the conference, please push star, zero on your telephone keypad. As a reminder, this program is being recorded.

It is now my pleasure to introduce your host, Caitlin Churchill. Thank you. Please go ahead.

Caitlin Churchill:

Good afternoon everyone and thanks for joining us today for The Container Store's First Quarter Fiscal Year 2019 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, 2019. 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, Caitlin, and appreciate everyone joining our call today. I'd like to begin by celebrating our strong start to Fiscal 2019 and sincerely thank our talented and committed employees. We are Custom Closets specialists. We design and sell ingenious closet and other storage and organization solutions and services. Solutions, not just items, based on our learnings for more than 41 years.

Our employees are experts in what they do and key to our collective success. Every little thing we do, every little detail we innovate and execute improves the living space in our customers' homes, making their life at home a little better.

We of course, are delighted to see heightened interest in our Storage and Organization category and the growing desire of our customers to simplify, declutter and organize their homes and lives. And there's nobody better than us, The Container Store, to solve their storage and organization challenges. And it's working. Our customers are enthusiastically responding to our refreshed merchandising and marketing campaigns. We have put a tremendous focus around getting newness to our sales floor as quickly as possible. This includes reworking our process around refreshes, rolling out learnings quickly once we have concrete sales results to justify, locking down exclusives, and being first to market.

We are more agile today and executing at a high level. Our teams are quick to capitalize on opportunities, whether they are marketing opportunities and partnerships, or leveraging social influencers. We are delivering unprecedented newness and innovation across our entire assortment, bringing interest and excitement by both our customers and our employees.

Our number one focus continues to be owning Custom Closets and capturing greater share of the estimated $6 billion Custom Closets market. Custom Closets was a key driver of our Q1 comp store sales results, delivering an increase of 11.1% and contributing 500 basis points of our 7.8% comp store sales. Custom Closets now represents half of our consolidated sales and we believe that mix will only continue to grow. We also continue to make significant progress with our other product categories which delivered an increase of 5.1%, contributing 280 basis points of our 7.8% comp store sales increase.

Not only was our comp store sales performance broad-based across merchandise categories, but also results were strong across all channels. Our online business had another outstanding quarter posting an increase of 29.2%, and our brick and mortar sales were strong as well.

Now, just a little more detail on our Q1 results. We delivered consolidated sales of $209.5 million, up 7% compared to the prior year period. As I mentioned earlier. TCS comp store sales were up 7.8%. Elfa third party sales were down 8.3% in U.S. dollars due to foreign currency translation as a result of the weak Swedish krona. While the success of our marketing and merchandising campaigns contributed incremental gross profit dollars, the success of these campaigns did put pressure on gross margin at The Container Store. We also absorbed higher direct material costs at Elfa.

Our SG&A performance was solid, managed very well, and we delivered earnings for Q1 better than our expectations and in line with last year on an adjusted earning per share basis. This occurred even though we made key investments in our business, with the increase of marketing spend as part of our Custom Closets brand building initiative, and the opening of our second distribution center later this fiscal year.

I know that tariffs are top of mind so I want to be clear that our outlook for this fiscal year includes the impact of 25% tariffs on Chinese imports. We believe we are well positioned to manage the higher tariffs and are taking the steps that we have previously discussed to mitigate their impact, such as sourcing options, selective price changes and vendor collaboration. While we are certainly encouraged by our results for Q1 and the momentum we have in our business, we believe it is prudent at this juncture so early in the year to leave our full outlook unchanged. We are maintaining our outlook.

The first quarter was also marked by significant progress on many of our strategic priorities and so I would like to just highlight a few briefly.

We are very excited about our Farmers Market store in Los Angeles which has been reimagined and redesigned to become our first "The Container Store Custom Closets" Store. The store was closed for a few weeks while we remodeled and redesigned it, reopening just 10 days ago on July 20th. We have significantly increased the square footage and linear footage displays of all four of our The Container Store Custom Closets offerings, Elfa Classic, Elfa Décor, Avera and Laren, to focus on accomplishing projects through maximizing custom spaces for the home. The store presentation includes a large variety of closets and space solutions presented within areas of the home, a powerful visual appeal to inspire our customers. The store's offerings, of course, also includes Design and Installation Services as well, and a wide selection of complementary products to offer our customers complete project solutions.

We are also on track to open our new Memphis store in September and relocate our Dallas Galleria store this fall. The Dallas Galleria store will open as our second "The Container Store Custom Closets" Store, with similar format and assortment to our Farmers Market store. As I shared last quarter, we continue to see a very long and attractive runway for new store growth at The Container Store with only 92 locations today, and the performance of our new stores continues to be strong. Our decision the last few years to moderate our new store openings was driven by capital allocation decisions, as we instead prioritized existing stores and infrastructure, which includes our second distribution center and technology investments. But as we look to fiscal 2020, with some of these key investments behind us, we envision opening more new stores than we have done in the past couple of years, while, of course, continuing to be prudent and selective in our decisions, seeking those opportunities where we expect to achieve the highest return.

With regards to our second distribution center opening in Maryland, we continue to be on track and on budget to open later this fiscal year. This facility has already begun to received product and our team in Maryland is doing an outstanding job in preparation for the opening. I do want to thank them so much for all their diligence, accountability and attention to every detail. We plan to begin limited outbound shipments during the third quarter, with full utilization expected during the fourth quarter. We're all just very excited about our second distribution center and for the benefit that it is expected to drive, both for our customers and the cost savings and efficiencies it will provide.

With regards to marketing, I wanted to point out a few of the specific areas contributing to our success. First, our POP! Program. We continue once again to see strength with customers enrolling in the program, and our total customers enrolled is now 7.7 million. New customer acquisition is so important and our POP! Program is a key component of this strategy. Our program has also proven to be an effective marketing tool to allow us to continue to be targeted in our communications and drive additional visits and spend.

Second, our branding campaign. Beginning in May, we launched our branding campaign with specific focus on The Container Store Custom Closets offerings. With the successful launch in April of our new Avera line of closets, this brings our collection to four lines—again, Elfa Classic, Elfa Décor, Avera and Laren. We believe we are now in a position to fully capitalize on this estimated $6 billion Custom Closets

market opportunity. During Q1, much of our incremental spend of approximately $1.9 million was focused on digital marketing. As we continue through fiscal 2019, we plan to utilize our marketing mediums to drive home the message that The Container Store is the only retailer that can meet all of our customers' needs when looking for a complete Custom Closet solution.

Third, our social media and influencer marketing is being leveraged to a greater degree by collaborating with the most highly influential storage and organization partners across social media. We launched our partnership with The Home Edit in May and we are thrilled with the results as it is generating social buzz, excitement and sales. The customer reaction to our exclusive The Home Edit product collection has been terrific. We plan to continue to strategically partner with leading storage and organization influencers.

A couple of comments about our merchandising initiatives. Our teams are doing an excellent job in fusing newness into our assortment and freshness in all our merchandise presentations, and our customers are responding. As I mentioned, during the first quarter we rolled out our brand new Custom Closets Avera line to complete our offering, filling that mid-range price point that customers were requesting. Towards the end of the quarter we also introduced a new beautiful grey color in our Elfa Décor line, and we are happy with the initial customer response.

In addition, we have prioritized expanding our private label merchandise offerings this year. We've already created some new cornerstone private label collections within the Closet and Kitchen departments. We see much opportunity ahead across the entire store to expand our private label.

In summary, it was a great start to Fiscal 2019 with topline sales exceeding our expectations. I'm delighted with the progress that we, as an organization, are making around our strategic initiatives. We are seeing strength across all channels and product lines and are making great progress against our objective to own Custom Closets. And we are simultaneously making important investments in the business to position ourselves for continued long-term growth.

We do believe the Marie Kondo impact slowed somewhat in Q1, as expected, however our much-improved execution across every aspect of the business, particularly in marketing, merchandising and operations has positioned us well to deliver on our goals for the full year.

Now, I'm happy to hand it over to Jodi to go through our financial results and outlook in more detail. Jodi?

Jodi Taylor:

Thank you, Melissa, and good afternoon everyone. I'd like to now cover our first quarter financial results in more detail.

Consolidated net sales increased 7% year-over-year to $209.5 million. By segment: sales for the Container Store retail business increased 8.3% to $195.1 million, reflecting a comp store sales increase of 7.8%, as well as incremental sales from new stores. We saw broad-based strength across our Custom Closets business, which was up 11.1%, as well as strong performance from our other product categories which were up 5.1%.

Elfa third-party net sales decreased 8.3% to $14.4 million, due to the negative impact of foreign currency translation during the quarter. On an SEK basis, Elfa third party sales were flat year-over-year.

From a profitability perspective, consolidated gross profit dollars increased 4.4% to $119.8 million. Consolidated gross margin declined 140 basis points to 57.2% due to a higher mix of lower gross margin products and services sold. Gross margin at The Container Store retail business was down 50 basis points, primarily due to successful marketing and merchandising campaigns that drove a higher mix of

campaign driven sales year-over-year. This was partially offset by foreign currency tailwinds. Elfa's gross margin decreased 100 basis points from the prior year period, primarily due to higher direct material costs and a weaker Swedish krona.

SG&A as a percentage of net sales decreased 240 basis points versus last year, primarily due to Optimization Plan expenses incurred in the prior year that were not incurred this year. Excluding these expenses, SG&A as a percentage of net sales was flat to last year, despite approximately $1.9 million, or 70 basis points of Custom Closets related brand building marketing investment at TCS, which was offset by fixed cost leverage associated with the 7.8% comp. During Q1, as expected, we also incurred approximately $1.2 million, or 60 basis points of SG&A headwind due to the set up of the second distribution center.

Our net interest expense in the first quarter of fiscal 2019 decreased 27.8% to $5.7 million from $7.9 million in the prior year, due to the September 2019 amendment of our senior secured term loan facility.

The effective tax rate for the quarter was 30.5% compared to 34% in the first quarter of last year. The change in the effective tax rate is primarily due to the impact of remeasuring deferred tax balances in the first quarter of last year as a result of the change in the Swedish tax rate.

Our net loss of the quarter, on both a GAAP and adjusted basis, was $4.1 million or $0.08 per share as compared to a GAAP net loss of $6.8 million or $0.14 per share in the first quarter of last year. On an adjusted basis, excluding Optimization Plan costs and certain one-time tax related items in Q1 last year, adjusted net loss per share was flat year-over-year at $0.08 per share.

Adjusted EBITDA was $10.6 million in the first quarter this year compared to $12 4 million in Q1 last year. The decrease in Adjusted EBITDA was primarily due to planned incremental Custom Closets marketing expense and expenses associated with the opening of a second distribution center that were incurred in the first quarter of Fiscal 2019.

Turning to our balance sheet, we ended the quarter with $11.4 million in cash, $289.4 million in outstanding borrowings, and combined availability on revolving credit facilities and cash on hand of $82.7 million. Our total debt position was down approximately $10 million from last year. I should also note that we adopted the new lease accounting standard in Q1, which resulted in a gross-up of our balance sheet by approximately $350 million.

As expected, we ended the quarter with consolidated inventory up 16%, primarily due to the new product introductions, including the new Avera Custom Closets line and new grey décor from Elfa, as well as preparation for the opening of our second distribution center this year, new stores, and strong sales in key other product categories. On a per store basis, inventory levels at TCS were up 17.6%. As we shared on our year-end call back in May, we expect to carry elevated inventory levels throughout the year as we receive inventory at our new second distribution facility while continuing to ship to all stores out of our Dallas area distribution center. We continue to expect our inventory position to normalize by the end of the fiscal year when our new distribution center is fully operational.

Regarding our fiscal 2019 outlook, since Q1 is both our smallest quarter of the fiscal year for sales and also a loss period for us, we are maintaining our established outlook for the year, as Melissa shared. We are certainly encouraged by our results for Q1 and the momentum we have in our business, but believe it is prudent at this juncture so early in the fiscal year to leave our full year outlook unchanged. As a reminder, for fiscal 2019 we expect consolidated sales to be in the range of $915 million to $925 million, based on a comp store sales range of up 2% to 3%. We expect GAAP and Adjusted EPS to be between $0.41 and $0.51 on a weighted average of 49 million diluted shares outstanding.

Fiscal 2019 EPS outlook includes an estimated $4 million, or $0.06 per share headwind associated with net expenses to get the second distribution center up and running. In fiscal 2020, we expect a $6 million, or $0.09 per share increase in EPS from fiscal 2019 from the second distribution center due to considerable freight savings we expect once the facility is fully operational. In fiscal 2019, we also expect to incur an incremental $6 million, or approximately 50 basis points marketing investment for The Container Store Custom Closets. We expect our tax rate for the full fiscal 2019 to be approximately 30%, and our annual interest expense using forward LIBOR rates to be approximately $22 million.

As Melissa also shared, our fiscal 2019 outlook does include the impact of 25% tariff from China.

Our current thinking around the quarterly comp store sales cadence for the remainder of the year is that we expect to see comps in Q2 slightly above our annual 2% to 3% comp store sales outlook range, moderation in Q3 as we are still planning the holiday quarter with conservatism, and low single-digit negative comp store sales in Q4 as we are also still conservatively thinking about cycling the strong 8.5% comp store sales we delivered in Q4 last year.

Specific to our second quarter, there are a few callouts. One, we currently expect our Q2 comp store sales to be slightly above our fiscal 2019 annual outlook range, as we have continued to see good sales performance early in the quarter. Two, during Q2 we expect to spend approximately $1.5 million incremental marketing dollars over last year in order to support the launch of The Container Store Custom Closets rebranding efforts, including that introduction of the Avera product line we've discussed. Three, in Q2 we also expect to incur approximately $2 million in expenses related to the second distribution center. And four, as a result, given the cadence of these investments, we continue to anticipate EPS to be down in Q2.

For the second half of fiscal 2019, here are a few key data points. First, as outlined, we expect approximately $6 million of incremental marketing expense for the year and incurred $1.9 million of that in Q1, and expect approximately $1.5 million in Q2. Our current thinking is that the remaining incremental spend will increase year-over-year as follows, with Q3 up $2 million and Q4 up approximately $500,000. Additionally, with regards to the approximate $4 million of net costs associated with our second distribution center, we continue to expect that headwinds will be realized in Q2 and Q3, and then we expect to begin to realize the associated freight benefits leading to a slight tailwind in Q4. As a result, given the cadence of these investments, we currently anticipate EPS to be down in Q2, relatively flat in Q3, and up in Q4.

In summary, we are very pleased with our Q1 financial performance. Our execution on our strategic priorities, including a strong focus on Custom Closets, is having a positive impact and becoming more evident in our results. We look forward to updating you on our progress.

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

Operator:

Thank you very much. We will now be conducting a question-and-answer session. If you would like to ask a question, please push star, one on your telephone keypad. A confirmation tone will indicate your line is in the question queue. You may push star, then two if you would like to remove your question from the queue. For participants using speaker equipment, it may be necessary to pick your handset up before pushing the star keys. One moment, please, while we poll for questions.

Your first question comes from Steve Forbes, Guggenheim Securities. Go ahead, please.

Steve Forbes:

Good evening.

Melissa Reiff:

Hi Steve.

Steve Forbes:

I wanted to start with the integration of Avera into the Custom Closet portfolio. You think back to three months ago or a little less than three months ago, right, and us thinking about the potential cannibalization factor. Maybe if you can just comment on what you're seeing as it relates to your customer preferences. Are they trading down? Are they trading up? As you sell forth the value proposition of the portfolio are you seeing cannibalization of Laren? Really, just, you talk about the portfolio of the whole and the learnings thus far.

Melissa Reiff:

Hi Steve. It's Melissa. Yes, I would love to talk about Avera. First, I want to say that it is early, as you know, but the response has been enthusiastic. It was, Avera was a key component to our sales results in Q1. We just feel like it's so early to really comment on the cannibalization between the four lines but we're watching that closely. What we do know is we have heard for years that we really needed that price point that Avera offers, so we have that broad assortment. Again, so far we are very pleased with the results we're seeing in all four lines.

Jodi, do you have anything else to add?

Jodi Taylor:

No. I think just in general you can see by our results Custom Closets as a whole sold really well and it feels like it has filled the niche exactly the way we anticipated that it would with that introduction of Avera.

Steve Forbes:

Thank you. Then as a follow-up, right, if we look at the first quarter gross margin performance, I don't know if you can provide some color—and I know you did, Jodi, right, from an EPS perspective and so forth, but just on the gross margin line item, how the—whether it's the marketing initiatives and just the cadence of the gross margin pressures, if we should expect them to persist or if there's some meaningful offsets, right, as we get to the back half of the year?

Jodi Taylor:

Great question. If you look at our gross margin, first of all, if you look at gross profit dollars, we drove 4.4% more gross profit dollars, so our activities around refreshing our merchandise and marketing campaigns clearly drove incremental sales and profitability.

What we did is if you look behind the curtain at gross margin for the quarter what you would see is that Custom Closets' margin was actually up slightly. The pressure was more in the other product categories which ties directly to the refreshing we did of the merchandise and marketing campaigns. For example, we had a very strong Closet Essentials sale in the first quarter. We also took what used to our Travel Sale, which runs from May 20th through mid June, and we reinvented that sale which had a narrower

focus and created Make Space for the Summer Sale which was very well received and had broader appeal to more customers than simply travel. Then, of course, we had last year the Elfa Free Install over a certain purchase level promotion during calendar May and June and had similar events around Custom Closets this year.

So, it was largely driven just by uptake in sales from these campaigns. They exceeded our expectations on all lines, so we're thrilled with that, but as you think about the rest of the year there's probably less major campaign changes planned for the remainder of the year than there was in first quarter with that big travel sale reinvention that I spoke of. We do see some good tailwinds as we head into Q4, one of which—into the second half of the year, one of which is FX, we think that will continue to be a tailwind for us in gross margin as you've seen some of the strengthening around the U.S. dollar, and then also as we head into Q3 where we have the holiday campaign, we are thinking about that conservatively, have bought for that conservatively, so we're thinking that from a markdown perspective that we would see fewer markdowns there as well.

Steve Forbes:

Thank you.

Melissa Reiff:

Thanks, Steve.

Jodi Taylor:

You're welcome.

Operator:

Thank you. Your next question comes from Kate McShane, Goldman Sachs. Go ahead, please.

Melissa Reiff:

Hi Kate.

Kate McShane:

Hi. Good afternoon. Thanks for taking my question. I wondered if we could go back to tariffs for a minute. Can you remind us again how much your business is being impacted for Lists I to III, and I'm just curious as we've moved from 10% to 25% since we last spoke with you, can you talk about that change and how it impacts your strategy that you walk through to try and mitigate that impact?

Jodi Taylor:

Sure. Hi Kate, it's Jodi. As we said, all of the known tariffs at this point are included in our outlook, and as we put in our 10-K, the percentage of purchases that we have that come from China is 36% and of those about 12% is estimated to be tariff impacted. We have been working hard behind the scenes for quite some time to have our game plan around how to mitigate these. Everything from adjusting country of origin to making sure that we are seeking opportunities to reduce costs throughout the supply chain, and also, we could go direct to factory in a few places to improve margin. We've had some favorable exchange rates that have helped us as well; bringing in new vendors where needed and then as it made sense we've also utilized price. So, really just a combination strategy that we've executed that we used to

address all tariffs that have come our way, and we've tried to be extremely careful in how we've approached it, going down to the SKU level, it's not a broad-based approach at all.

Kate McShane:

Okay, that's very helpful. Thank you. You did mention private label and that you think that there could be more opportunities for you going forward. Have you laid out a target for what you think private label could be and what categories do you think lend itself best for you to expand that?

Melissa Reiff:

Hi Kate. We have not put our foot on base in terms of the dollar that we've think that it will generate, but I can tell you this. It is a priority for our company and it's across the entire assortment. We've learned, Kate, through consumer insight work that we've done in the past that customers that walked in our store or go online, they think that everything in the store is The Container Store, so there's a lot of strength in our brand. So we see a huge opportunity in our private label and we are specifically looking at Kitchen and Closet Department, but really, we're going to be address the entire store going forward.

Kate McShane:

Thank you.

Melissa Reiff:

Thank you, Kate.

Jodi Taylor:

Thank you.

Operator:

I will just remind everyone that it is star, then one on your telephone to register for a question. Your next question today comes from Tami Zakaria from JPMorgan. Go ahead, please.

Tami Zakaria:

Hi Melissa and Jodi. Congrats on a great quarter.

Melissa Reiff:

Thank you, Tami.

Tami Zakaria:

My first question is can you comment whether the Easter shift impacted your first quarter performance this year versus last year? Then I have a follow-up.

Jodi Taylor:

It had no impact on us at all, Tami. No, it was not an issue for us whatsoever.

Tami Zakaria:

Got it. Then could you comment on the moderation of Mari Kondo related to sales that you spoke of earlier in the call? Meaning any color on which categories were impacted and what was the magnitude of the slowdown and whether you expect further slowdown as we look to the rest of the year?

Melissa Reiff:

Sure. Hi Tami. Yes, we really did a deep dive as we always do, but particularly in Q1 in analyzing our business and particularly the impact of the merchandising marketing changes that we've made that we referenced earlier. The data shows us that these changes combined with our many new product introductions really had a meaningful impact to Q1 because of that 7.8% comp store increase, 5 points from the Custom Closets area of our business, which included that Closet Essential campaign that Jodi talked about, and 2.8% of it came from the other product categories which is usually where we see the Marie Kondo kind of impact. You will recall, I bet, Tami, that last quarter I think the Kondo impact was really, really evident in our other product categories and we felt like it was a big contributor to our comp last quarter, and Q4 of I think about 4.7%. Obviously the 2.8% for Q1 is lower but we really believe that it was really largely driven by our own efforts. I think it's pretty known that the Marie Kondo hasn't been as forefront out there in the market in Q1 as it was certainly in Q4, but, of course, we are—as a company, we are delighted with the heightened interest and just the overall category of storage and organization because that's certainly something that we benefit from with us being the real only retailer solely focused on storage and organization.

We'll see, Tami, how it progresses throughout the year, but we've taken a really deep dive into analyzing Q1 and those are our thoughts. We really feel like the Marie Kondo impact has waned some and that our changes in merchandising and marketing specifically, and also operationally, have impacted our 7.8% comp for the quarter.

Tami Zakaria:

Got it. Thank you so much.

Melissa Reiff:

Thank you.

Jodi Taylor:

Thank you.

Operator:

Thank you. There are no further questions at this time. I would like to hand back to Management for closing comments.

Melissa Reiff:

Thank you, Chantelle, very much, and thanks, y'all, so much for joining our Q1 conference call. Again, we're delighted with our results and we look forward to talking with you again at the end of Q2. Have a great rest of the evening.