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The Children's Place, Inc. (PLCE)

Q1 2019 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Ladies and gentlemen, thank you for standing by, and welcome to The Children's Place First Quarter 2019 Earnings Conference Call. This call is being recorded. If you object to our recording of this call, please disconnect at this time. All participants have been placed in a listen-only mode and the floor will be open for your questions following the presentation. After the speakers' remarks, there will be a question-and-answer session. [Operator Instructions]

It is now my pleasure to turn the floor over to Anthony Attardo, Director of Investor Relations, to begin.

Anthony Attardo
Director, Investor Relations, The Children's Place, Inc.

Good morning, and welcome to The Children's Place conference call. On the call today are Jane Elfers, President and Chief Executive Officer; and Mike Scarpa, Chief Operating Officer and Chief Financial Officer. The Children's Place issued press releases early this morning and copies of the releases and presentation materials for today's call have been posted on the Investor Relations section of the company's website. After the speakers' remarks, there will be a question-and-answer session.

Before we begin, I would like to remind participants that any forward-looking statements made today are subject to the Safe Harbor statement found in this morning's press release as well as in the company's SEC filings, including the Risk Factors section of the company's Annual Report on Form 10-K for its most recent fiscal year. These forward-looking statements involve risk and uncertainties that could cause actual results to differ materially. The company undertakes no obligation to publicly release any revisions to these forward-looking statements to reflect events or circumstances after the date hereof.

After the prepared remarks, we will open the call to your questions. We ask that each of you limit yourself to one question so that everyone will have an opportunity.

And with that, I'd like to turn the call over to Jane Elfers.

Jane T. Elfers

President, Chief Executive Officer & Director, The Children's Place, Inc.

Thank you, Anthony, and good morning, everybody. After briefly reviewing the Q1 highlights, I will focus my remarks on four topics: First, I will cover how the multi-year strategic positioning of our real estate portfolio allows us to capture a greater portion of the incremental market share donated by poorly positioned retailers now and in the years ahead. Second, I'll update the status of our digital transformation including the upcoming launch of our personalization initiative which follows our accelerated digital investment in 2018. Third, I'll provide an update on our progress with respect to the Gymboree integration. And finally, I'll provide an update on our private label credit card program.

Starting with Q1 results, despite a later Easter and the liquidation of approximately 800 Gymboree and Crazy 8 stores, our sales and EPS results significantly exceeded our expectations. Strength starting in mid-March and through the month of April helped to offset significant weakness in the first six weeks of the quarter when as anticipated the Gymboree liquidation event and delayed tax refunds weighed on our results. Our Easter dressy assortment was very well received and drove significant outperformance, resulting in a comp sales increase in excess of 20% for the month of April. As a reminder, I reassumed day-to-day direction of merchandising, starting with this delivery.

Let's move onto our real estate strategy, our portfolio of brick and mortar locations provides us with a meaningful competitive advantage in securing market share. We continue to execute our fleet optimization strategy with the objective of maintaining maximum flexibility and leverage in the current retail environment. The U.S. has experienced a marked increase in retail bankruptcies and store closures with nearly 6,500 retail closures already announced in 2019, exceeding the total store closures for all of 2018. As the digital disruption continues, we expect to see more bankruptcies and store closures from retailers that are unwilling or incapable of investing in digital initiatives. We expect continued bifurcation of winners and losers in the space. Within brick-and-mortar retail, we expect additional bifurcation as the higher-quality center strengthens at the expense of the lower-quality centers.

TCP has been strategically ahead of the curve for several years, as we've dramatically slowed down openings, accelerated store closures in low-quality centers and significantly shortened lease term to allow for maximum flexibility within the portfolio. Our multi-year real estate strategy strongly positions us to capture the benefit of meaningful market share redistribution as we believe competitors will continue to donate sizable market share in the coming years.

We estimate approximately 40% of the U.S. children's apparel market revenue is generated by retailers that we classify as market share donors, and this group has ceded approximately $600 million a year in revenue over the last three years to a stronger group of market share takers. Importantly, we estimate that only 25% of the sales generated by this group of market share donors is located off-mall, which implies that retailers that are well-positioned in the mall, in the outlet and on ecommerce where most of these market share donors are located are best positioned to capture what we believe will be sizable ongoing annual market share donation. Conversely, we estimate only 8% of the sales done by the industry's group of market share takers is generated in the mall, which reinforces our strategic real estate positioning and its ability to continue to capture incremental market share.

Now, let me update you on TCP's positioning in the mall. In 2017, we shared with you that out of the approximately 1,060 malls in the United States, there are projections that up to 260 will close. We referred to these 260 malls as dying malls. We are currently not located in 80%, 208 of these dying malls, after having closed over 20% of our stores in these malls since 2017. Further, of the remaining 52 dying malls where we still have a store, our average lease term is now less than one year, and these total locations make up only approximately 2% of our total U.S. revenue.

Stripping out the 260 dying malls, there are approximately 800 A, B and C malls in the U.S. Approximately 37% are A-plus and A, 51% are B, and 12% are C malls. So, of the 800 remaining U.S. malls, 88% of them are designated A or B centers. The Children's Place is currently in 451 of the remaining 800 U.S. malls. Approximately 29% of our stores are in A-plus or A, 59% in B, and 12% are in C malls. So, nearly 90% of our stores are located in A and B malls, which experience traffic growth trends that are meaningfully higher than our off-mall locations. Our lease term in the thriving A and B centers is now approximately two years which provides us with meaningful financial and strategic flexibility.

So, as we continue to hear retailers such as Gap who announced they now plan to close approximately 50% of their mall-based specialty stores, and Sears, JCPenney and Justice all announcing store closures. Our store overlap with this collective group of predominantly mall-based market shared donors is nearly 60%. This concentrated store overlap combined with our accelerated digital investments in 2018 gives us meaningful first-mover advantage to capture more than our fair share of what we believe will continue to be a large market share annuity in the coming years.

With respect to our off-mall locations being impacted by the overlap with the market share takers, it's important to note that we only have 28% store overlap with the group of market share takers versus 60% overlap with the group of market share donors. And in the centers where we overlap with the market share takers, our stores have outperformed our corporate average sales growth by 240 basis points. This speaks directly back to our real estate strategy of positioning our off-mall locations in quality centers where the network effect of having multiple options for children's apparel offsets the impact of being located in a center with a share taker.

Importantly, we are the only retailer within the group of market share takers in the children's apparel space that isn't taking share by simply growing square footage. Since 2015, we've gained share despite closing 103 stores. This speaks directly to our ability to balance top-line growth with strong margins and returns on invested capital versus most of our peers, who are pressured to choose a path of either growth or margins.

Moving onto the upcoming launch of digital personalization, we accelerated approximately $30 million of a planned $50 million of incremental digital investments into 2018, with a large portion of the investment tied to supporting personalization initiative. This investment provided TCP with the advanced data analytics and tools to segment our customer database at very low level. We now have a complete 360-degree view of our customer across both online and retail channels, with over 400 customer behavioral segments identified, which now allows us to begin to deliver personalization across channels. We anticipate the personalization will result in increased conversion, retention and engagement and help us to further optimize our total marketing spend. We expect sales, margins and ROIC benefits as we execute upon this strategy.

In the past, we've indicated that a 1 point move higher in the conversion of our digital traffic yields approximately $75 million in incremental digital revenue annually. Further, personalization will offer a significant benefit to conversion in our brick-and-mortar channels as well. We will begin to deliver personalization this quarter and, based upon the results, expect to ramp up the initiative in the back half of the year. We're excited about our upcoming digital personalization initiative, which is likely to add fuel to an already strong digital business at TCP.

Our digital business continued to lead in Q1 as we delivered mid-single-digit growth in a very difficult quarter and continue to provide our millennial mom with a stronger omni-channel offering. Ecomm penetration increased 270 basis points to 29% of net sales in Q1 versus 26% a year ago.

In the stores, our mobile POS transaction rate increased nearly 40% in Q1, which is up meaningfully from Q4, when ship-from-store adversely impacted store conversion as store associates diverted time and attention to fulfill online orders.

Our outsized digital growth is fueling our loyalty and private label credit card programs, which are key to our digital transformation. In 2019, we plan to continue to make foundational enhancements to further support our digital platform, including: moving to responsive design; adding a content management system; adding a digital asset management system; cross-device linking to drive personalization; a full POS software rollout with Save the Sale functionality; and the continued rollout of BOSS.

Now, I'll provide an update on the Gymboree integration. Although it's only been weeks since we took possession of the assets, we've hit the ground running. Our team is focused on bringing back the highly curated, elevated bow-to-toe product that the Gymboree customer loved prior to their merchandising changes. In an effort to maintain continuity with this legacy Gymboree product, we've engaged the services of Li & Fung, the original sourcing agent for Gymboree, in design as we look ahead to the launch of the Gymboree-branded product in early 2020. We are confident that the seasoned veterans in our design organization can lead the Gymboree product launch.

In addition, we have added talent below the senior leaders to supplement the Gymboree effort and we are currently working with a long-tenured executive from Gymboree to consult with us as we ramp up our efforts. We're getting encouraging early reads on our Tiny Collections products, which we have the strategic foresight to develop to fill the void left behind by Gymboree's sales merchandising strategy.

Importantly, the AUR and Tiny Collections is well above that of our TCP branded products, which is a positive signal that we have customer acceptance at higher price points. Although early days, the line has exceeded our expectations and the response on social media has been very positive. We've included examples of what Mom is saying about Tiny Collections in the Q1 Investor Presentation on our newly redesigned IR web page.

With respect to real estate, the Gymboree data allowed us to create a list of about 40 centers that we continue to study, inclusive of the 25 stores already identified as productive openings for us over the next two years. These stores will be located in thriving centers and will fill major void left behind by Gymboree's departure. As discussed, off-mall has largely been where the market share takers reside, and they have been achieving their market share gains predominantly by simply growing their square footage. However, with respect to the Gymboree customer, it's important to note that our due diligence process revealed that the higher income Gymboree customer with a family income of $95,000 per year has a very low propensity to want to shop off-mall at mass merchants, with only 5% of Gymboree customers indicating it as the preferred channel to shop.

The Gymboree customer values higher quality, elevated, head-to-toe outfitting, product that simply isn't found in the mass merchant channels. We believe that the Gymboree customer will likely stay in the mall and online as she searches for a new home. This mall and online preference along with our ability to speak directly to her and with the brand she already knows and trusts reinforces our ability to capture more than our fair share of abandoned Gymboree revenue.

Our technology organization is working on system changes across our network to accommodate the Gymboree integration. We are laying the foundation for a next-gen omni-channel model for Gymboree with over half of revenue likely generated by ecommerce and the remainder driven by a carefully selected group of 200-plus TCP store locations that were among Gymboree's strongest brick-and-mortar locations.

We're engaging a branding agency to assist with the re-launch and support engagement with the Gymboree customer until the product arrives in early 2020. We were pleased that Gymboree maintained detail database records for each brand, including over five years of transactional history, which allows us the plug-and-play opportunity into our existing digital personalization infrastructure.

Engagement with the Crazy 8 customer has already begun. Although still early in the process of contacting the former Crazy 8 customers, we're already experiencing open and click-through rates that are nearly double that of the TCP emails which is leading to earlier and stronger-than-expected conversion rates less than a month after purchasing the file. We will continue to keep you updated on the progress we are making on the Gymboree integration.

Finally, I'd like to give you an update on our private label credit card performance. In Q1, our private label credit card penetration increased to 22% of sales from 21% last year. Our private label credit card mix reflects a healthy 50/50 split of new and existing customers. Importantly, we know that any calculation of the impact of private label credit card on our sales requires assumptions to be made for the difference between what the customer spends utilizing the private label credit card over what she would have spent using another form of tender. As a result, the change in private label credit card penetration year-over-year is obviously not 100% incremental to sales, reinforcing that our private label credit card offering is only one of many drivers of sales growth at The Children's Place with market share gains the dominant driver of our comp sales increases.

With respect to the Gymboree opportunity as it pertains to our private label credit card, following our purchase of the Gymboree IP, we have direct access to a database that contains millions more unique names to whom we can now offer our My Place Reward and private label credit card loyalty programs. Gymboree did not have a private label credit card program. They had a co-branded credit card business which represented a modest low-single digit percent of sales. This provides us with a meaningful opportunity to drive incremental private label credit card revenue, further fueling our progress towards our 30% penetration goal. The addition of the Gymboree and Crazy 8 database reflects an opportunity to increase our active file by over 50%.

And now, I'll turn it over to Mike.

Michael Scarpa

Chief Financial Officer & Chief Operating Officer, The Children's Place, Inc.

Thank you, Jane, and good morning, everyone. Today I will provide an update on the Gymboree transaction, update you on our fleet optimization and our international and wholesale businesses and provide our insight into how the news on tariffs impacts The Children's Place before reviewing our financial results and our outlook. First, an update on Gymboree, on April 4, we closed the $76 million acquisition of the Gymboree assets, which was funded through cash on hand and borrowings under our ABL facility. As discussed, the funding did not disrupt our share repurchase or dividend plans for the quarter, and we remain on track to repurchase the planned $500 million in stock between 2018 and 2020. Shortly after closing the deal, we amended our ABL facility to increase the availability from $250 million to $325 million at more attractive interest rates. This facility now expires in May of 2024.

We continue to project $0.75 of adverse EPS impact from the Gymboree acquisition during 2019. Approximately two-thirds of that amount or $0.50 is related to upfront operating costs, such as people and resource adds in areas such as product development, marketing and technology. The remainder, or $0.25, is related to interest expense and purchase price amortization costs. The Gymboree acquisition is anticipated to be accretive to EPS in 2020, and we remain on track for an early 2020 rollout of the Gymboree product line.

Fleet optimization, we opened one location and closed two locations in the quarter, resulting in 213 overall closures toward our plan to close 300 locations by the end of 2020. We plan on closing between 40 to 45 locations in 2019. As a result of Gymboree's bankruptcy, we plan to open 25 stores in highly productive centers over the next two years where The Children's Place does not have a presence. We plan to add approximately 10 of these 25 stores in 2019. It's important to note, we remain a net closer of stores.

International and wholesale, in our international and wholesale businesses, we saw double-digit growth again this quarter, albeit of a relatively small basis. We opened nine new international points of distribution in the quarter. Along with our strategic partner, Semir, the number one children's apparel retailer in the Chinese market, we plan to open approximately 15 to 20 locations in 2019. In wholesale, our partners have expressed significant interest in the Gymboree brand. We'll have more to discuss on future calls.

Tariffs, we'd like to update you on how the China tariff news will impact us in 2019 and 2020. We see only minimum margin impact from the tariff increase that went into effect last Friday, and it's reflected in our current guidance. Recall the increase affects products such as backpacks, fashion bags, lunch bags and hats where we have modest exposure.

Including all tariffs implemented to-date, we project that our AUCs for 2019 will be down low-single digits versus last year. Including Gymboree, our exposure to Chinese imports across all categories is limited to an estimated mid-teens percent of goods in 2019 and only a high-single digit percent in 2020.

We feel we have much less exposure than many of our competitors to tariffs on Chinese imports, which now provides us with yet another competitive advantage. That said, additional tariffs on the remaining imported products from China would have an adverse impact on our profitability.

I'll now provide an update on Q1 results and discuss our forward outlook. In the first quarter, we generated adjusted EPS of $0.36 versus $1.87 last year, well above our guidance range of the loss of $0.70 to a loss of $0.40. Our adjusted EPS in the first quarter was adversely impacted by three main factors: an adverse impact of $0.95 as a result of the Gymboree liquidation we had guided to an adverse impact of $1.15 to $1.40; an adverse impact of $0.67 versus last year due to a lower stock-based compensation tax benefit, we had guided to an adverse impact of $0.92.

Operating and financing costs associated with the acquisition of Gymboree and Crazy 8 IP and related assets adversely impacted adjusted EPS by approximately $0.05 in the quarter. We had anticipated a $0.15 to $0.20 adverse adjusted EPS impact in Q1 from acquisition-related expenses. In total, these items adversely impacted adjusted EPS by $1.67 versus Q1 2018. We had originally anticipated an adverse impact of $2.22 to $2.52.

Details for the first quarter are as follows: net sales were $412 million versus last year's $436 million, down $24 million or 5.5%. We recorded a decline in comp retail sales of 4.6%, which was better than our initial guidance of a negative 12% to a negative 10% decline. Our sales began to strengthen in mid-March and continued through the end of the quarter. This helped offset a portion of the adverse impact of the Gymboree liquidation and the delayed tax refunds early in the quarter.

April comp growth was in excess of 20%, driven by better-than-expected Easter sales and earlier-than-expected closings of a substantial number of Gymboree stores and their ecomm sites in March. U.S. comps declined 4.4% and Canada comps declined 6.4%. Store traffic was down double digits in February, improving in late March before turning positive in April. Store transactions and conversions followed the same pattern. AUR was higher on stronger realized pricing in the quarter.

Adjusted gross margin decreased 30 basis points to 36.7% of sales from 37% in Q1 2018, driven by the Gymboree liquidation, the leverage of fixed expenses resulting from a decline in comp retail sales and the adverse impact of increased penetration of our ecommerce business. This was offset by merchandise margin expansion, which was driven by strong inventory management, lower product costs and higher realized pricing.

Adjusted SG&A was $127 million versus $119 million last year, and deleveraged 360 basis points to 30.8% of sales. This was a result of fixed cost deleverage based on the decline in comparable retail sales and higher incentive compensation accruals. Higher incentive compensation in connection with our associate bonus and stock programs accounted for approximately $5 million or 120 basis points of the SG&A increase in the quarter. It is important to note, as outlined in this year's proxy statement, the company did not meet its financial targets in 2018, and, as a result, did not pay incentive bonuses.

Adjusted depreciation and amortization was approximately $18 million in the quarter. Adjusted operating income for the quarter was $6.6 million or 1.6% of sales versus $25.4 million or 5.8% of sales in Q1 2018, down $18.7 million or 420 basis points, primarily as a result of the adverse impact of the Gymboree liquidation.

Moving onto the balance sheet, our cash and short-term investments for the quarter were $66 million as compared to $90 million last year. We ended the quarter with inventories up approximately 2%. We ended the quarter with $153 million outstanding on our revolver compared to $47 million last year. The increase reflects funding to support the Gymboree acquisition and our shareholder return program. We adopted the provisions of ASC 842 accounting for leases, resulting in the recognition of right-of-use assets of approximately $460 million and corresponding liabilities of $500 million. This has no impact on adjusted operating results.

Moving onto cash flow, we generated $21 million in operating cash flow in the quarter versus an outflow of $13 million last year. Capital expenditures in the quarter were $11 million.

Now, let me take you through our updated outlook for 2019. The company now expects sales for fiscal 2019 to be in the range of $1.905 billion to $1.925 billion on comparable retail sales growth of approximately flat versus fiscal 2018. We project ecommerce penetration will increase approximately 200 basis points to 30% of net sales.

Adjusted operating income is expected to range between 6.4% to 6.9% of sales as compared to 6.6% in adjusted operating income in 2018. Adjusted operating income includes approximately 100 basis points of incremental incentive compensation accruals for 2019 versus 2018, which was not assumed in prior guidance. We now anticipate fiscal 2019 adjusted net income per diluted share to be in the range of $5.75 to $6.25 versus our prior guidance of $5.25 to $5.75. This compares to adjusted net income per diluted share of $6.75 in 2018.

We project a tax rate in the low-20s and we expect to generate strong cash flow from operations in 2019, which will fund our shareholder return program and capital expenditures. We expect CapEx to be approximately $75 million in 2019. We ended Q1 with approximately $206 million remaining on our share repurchase authorization, and we remain firmly committed to return cash to shareholders.

Q2 2019 outlook, the company expects sales for the second quarter to be in the range of $415 million to $420 million based on a comparable retail sales decline in the range of a negative 5% to negative 4% versus a 13.2% comp gain in fiscal Q2 2018. The second quarter is anticipated to be adversely impacted by several factors: One, the impact of the Gymboree liquidation event. During the Gymboree liquidation event, customers stocked up on product that likely would have been purchased in our stores in Q2. Two, a stronger April, better than planned April sales were driven by a combination of earlier closings of Gymboree stores and ecommerce sites, and strong Easter sales when she purchased this Easter dressy, but also stocked up on key seasonal items in our stores. This creates a vacuum in May sales. Three, the weather impact. We experienced a record-breaking comp gain in Q2 last year driven by one of the warmest May's on record, which is in stark contrast to this May with temperatures significantly below average in most of the country. As a result, we're seeing store comps down in excess of 20% quarter-to-date.

Adjusted operating income is expected to be in the range of 0.4% to 0.7% (sic) [1.3%] of sales as compared to 3.5% in adjusted operating income in Q2 of 2018. We anticipate second quarter adjusted net income per diluted share of $0.00 to $0.20 as compared to adjusted net income per diluted share of $0.70 in Q2 of 2018.

Looking ahead, we expect improvement in both sales and margins in the back half of 2019. In Q3 last year, revenue grew at the expense of near-term margins given the decision to compete more aggressively in light of the strategic opportunities. Largely driven by this decision, our digital business increased 38% in Q3 of 2018. As we look ahead to Q3 of 2019, the potential for reduced competition should set the stage for more profitable growth. However, the difficult ecommerce compares remain, and as a result, we are projecting a low-single digit comp gain for Q3. Also note, we estimate that the holiday selling season in Q4 of 2019 could be adversely impacted by approximately $5 million or 1% of sales from six less shopping days between Thanksgiving and Christmas in 2019.

I will now turn it back to Jane for closing remarks.

Jane T. Elfers

President, Chief Executive Officer & Director, The Children's Place, Inc.

Thanks, Mike. Several years ago, we developed a multi-pronged strategy to position the company to successfully compete in a period of rapid digital change. Fast forward to today, we're a global omni-channel retailer with a best-in-class management team. Our product offering is consistently well-received, our real estate portfolio is optimized, our digital investments have been accelerated to position us to continue to capture market share, and our diversified sourcing strategy provides us with a key competitive advantage. The successful execution of these strategic initiatives has uniquely positioned us to succeed during a period of digital disruption and unprecedented industry consolidation. We look forward to continuing to deliver for our shareholders in 2019 and beyond.

At this point, we'll open up the call to your questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] Our first question comes from the line of Dana Telsey of Telsey Advisory Group.

Dana Lauren Telsey
Analyst, Telsey Advisory Group LLC

Q

Good morning, everyone, and congratulations on the nice progress.

Jane T. Elfers
President, Chief Executive Officer & Director, The Children's Place, Inc.

A

Thanks, Dana.

Dana Lauren Telsey
Analyst, Telsey Advisory Group LLC

Q

As you think about the top line and the ability to take market share from the Gymboree closures, it certainly seems like the Tiny Collections performed well. How much of an AUR lift is it, what does it contribute to gross margin, and how do you see that share gain in sales developing through the year? Thank you.

Jane T. Elfers
President, Chief Executive Officer & Director, The Children's Place, Inc.

A

Sure. Thanks, Dana. As far as Tiny Collections is concerned, we launched it the day after Easter, and what we had said is when we saw the Gymboree line back in July, Jennifer, our Head of Design and I sat down and really saw that as an opportunity to fill a void way before we obviously knew that Gymboree was going to go out completely or that we would end up buying their IP. So, that product came in. It's really in keeping with the Gymboree strategy. We kind of call it bow-to-toe, and the product has really been terrific. If you look at the IR deck and you look at the comments we've put out there, we did not say anything in our advertising or our marketing as far as relating that product to Gymboree, but Mom has obviously done that on her own, several comments on our Facebook page saying, Oh! this is just like Gymboree, thank you so much, I didn't know where I was going to shop, now I have a place to shop. So, we feel really good about that, particularly since we will be rebranding Tiny Collections into Gymboree in early 2020.

I don't think we're going to say what percentage it is running over our typical TCP branded AUR, but it is significantly higher. And it's in line with what we're thinking the Gymboree merchandise is going to be selling at, not only ticket it, but where we see the AUR coming in. So we feel really good. We said it's early days, but we feel really good about the fact that we have permission, if you will, to sell product at a higher ticket and particularly product that's not even branded with the Gymboree label yet.

Operator: Your next question comes from the line of Adrienne Yih of Wolfe Research.

Adrienne Yih
Analyst, Wolfe Research LLC

Q

Good morning. Congratulations. Well done.

Jane T. Elfers
President, Chief Executive Officer & Director, The Children's Place, Inc.

A

Thanks, Adrienne.

Adrienne Yih
Analyst, Wolfe Research LLC

Q

You're welcome. Jane, can you discuss – so for me the surprise was sort of the – what we were seeing during the quarter which was better sell-through. Can you discuss the positive merchandise margins that were initially expected to be down because of the pressure, and how aggressive can you be on the recapture, like how do you test the ceiling of that kind of what it's going to clear with that category or the product should clear at?

And then, Mike, can you just help me out with the SG&A? Should we expect that – and, I'll call it like $5 million to $7 million higher than at least I was expecting in Q1, should that be the same, like $125 million for Q2? Thank you very much.

Michael Scarpa
Chief Financial Officer & Chief Operating Officer, The Children's Place, Inc.

A

So, from an SG&A perspective, we would expect SG&A to increase in overall 2019 versus 2018, both in absolute dollars and as a percentage of sales. We'll get the benefit of the waning of some of the accelerated digital transformation – accelerated expenses we did last year. We talked about $50 million overall over a three-year period with $30 million year-one, $15 million year-two, so that looks like it's happening, but that's going to be more than offset by the incentive compensation that we spoke about in our prepared remarks worth about 100 basis points along with the start-up expenses associated with Gymboree.

And just one other point is that we're definitely feeling some wage pressure overall in our store base. So, all of that indicates that SG&A would be higher. I would expect that you'd be seeing – though we don't guide specifically to SG&A, you could see around a $125-or-so-million for Q2 SG&A.

Jane T. Elfers
President, Chief Executive Officer & Director, The Children's Place, Inc.

A

And then, Adrienne, when you look at kind of what happened in the quarter, as we said, the first six or seven weeks or so there was a ton of pressure from the Gymboree liquidations and some of the delayed tax refunds. And as Gymboree started to close their website and started to close a significant number of their doors earlier than they had alluded to in the beginning, we started to see our sales strengthen approximately mid-March and then through April. As far as merchandise, the Easter delivery was extraordinarily well received. We had great sell-throughs on that and at the same time we saw Mom picking up seasonal items with the later Easter.

Operator: Your next question comes from the line of Susan Anderson of B. Riley FBR.

Susan Anderson
Analyst, B. Riley FBR, Inc.

Q

Hi, good morning. Congrats on a very good quarter. Just a follow-up on the Tiny Collections, Jane, that looks great actually. I was wondering maybe if you could talk about are there plans to increase this for the back half and then maybe talk about just the plans of integrating it into Gymboree next year in that brand, and if you had any color on how it's going to be displayed in the stores and online, et cetera?

Jane T. Elfers
President, Chief Executive Officer & Director, The Children's Place, Inc.

A

Sure. As far as Tiny Collections, the Tiny Collections product that's currently on the floor is toddler-only, and it goes up to 5T. We will be delivering groups every other month or so. So, we have a nice presentation of Tiny Collections for the back-to-school time period. And then, we deliver a few groups of Tiny Collections for the holiday period as well. The Tiny Collections product for the balance of this year will stay limited to toddler sizes up to 5T. We have plans to introduce Gymboree with an extended size range, so we will be going above toddler. If you also saw a lot of the comments, we've done a lot of due diligence obviously on Gymboree and so we understand very clearly what sizes were important to them, and that's what we're basing our launch of Gymboree on. But as anecdotally, if you look at the Facebook comments, you can see one after the other asking for us, please make this in bigger sizes, please extend the size ranges, my older child would love to wear this product and on and on. So, I think that jibes well with what we're planning to do.

And then I think from an integration point of view, as I said, we will deliver our last delivery of Tiny Collections for holiday and then we will launch Gymboree-branded product early in 2020. They will have sections in the store dedicated to the Gymboree product. Certainly, you will be able to tell from the outside of our store for the TCP locations that we're carrying the Gymboree product and you will see that marketing on the outside of our store, and then the website. We'll have a separate tab on our website starting with early 2020 with the launch where the customer will be able to cross-shop between Gymboree and TCP.

Operator: Your next question comes from the line of David Buckley of Bank of America Merrill Lynch.

David Buckley
Analyst, Bank of America-Merrill Lynch

Q

Hi, good morning. Thanks for taking my question. Just coming back to merch margin, could you guys just talk about how much in the first quarter was – the improvement was from higher realized prices versus lower product costs, what we should expect for the rest of the year on merch margin? And then just the inventory position for 2Q, I know it's a little bit higher than you guys had expected, just your outlook there. Thanks.

Michael Scarpa
Chief Financial Officer & Chief Operating Officer, The Children's Place, Inc.

A

So, I'll start with the inventory position. We had originally guided to a flat overall inventory position at the end of Q1, and we were up approximately 2%. We made the decision as we started to see our sales increase in mid-March to accelerate some shipments of back-to-school and certain basics to ensure that we were well-positioned for the first floor set for back-to-school. Overall, we're very pleased with our inventory position as we enter Q2. Carryovers were down significantly from where they were a year ago.

As far as 2Q goes, as far as inventory, we really haven't guided at this point. We want to assess our options regarding goods coming out of China and the opportunity to lessen the impact of proposed tariffs on those goods, should they be enacted. So, that's from an inventory perspective.

We were overall very pleased with our merchandise margin. It increased nicely in the quarter. We got the benefit of both higher AURs not only on our full-price, but also on our markdowns as we had less goods coming into the quarter from a markdown perspective. AUCs overall were down nicely. So, it was pretty much a balance of that.

As we look forward, we would expect that we'd continue to see some merchandise margin expansion, particularly in the back half of the year, where Q3, as you remember, we were highly promotional and fighting for market share at that point. And then Q4, where we made the decision to liquidate ahead of the Gymboree bankruptcy to ensure that we went into the first quarter in a good inventory position, so we got hit especially hard in the back half of the year last year on margins.

Operator: Your next question comes from the line of John Morris of D. A. Davidson.

John D. Morris
Analyst, D. A. Davidson & Co.

Q

Thanks. Yeah. Hey, my congratulations as well on the real strong progress that you guys are making.

Jane T. Elfers
President, Chief Executive Officer & Director, The Children's Place, Inc.

A

Thanks, John.

John D. Morris
Analyst, D. A. Davidson & Co.

Q

Thanks. Two questions for you guys, one would be – and we were talking a little bit about merch margins et cetera, and I know you don't guide to gross margin per se, but thinking in Q2 with Q1 coming in so much better, I'm just wondering directionally and qualitatively, could gross margin in Q2 actually be up year-over-year. So, it's just that qualitative question.

And then the second really is, Jane, maybe give us a little bit more color on the wholesale business, a little bit deeper there, if you can talk a little bit about what you're seeing from Amazon, but more broadly the wholesale business and what the puts and takes are there? It seems like you're pretty happy with the progress.

Michael Scarpa
Chief Financial Officer & Chief Operating Officer, The Children's Place, Inc.

A

Yeah. I would just remind you that in Q2, we had a 13.2% comp and based on the 53rd week and the shifting of the weeks around, we actually ended up with a sales increase of slightly over 20% in the quarter last year. And that had a tremendous impact on our overall margins. We were, I think, flat to maybe up 10 basis points last year, but that drove significant leverage of all of our fixed expenses. And obviously with a negative 5% to a negative 4% projected in the second quarter this year, we wouldn't expect that same sort of leverage. So, there may be some overall pressure on our margin in Q2.

As far as the wholesale business goes, we're pretty happy with the growth that we've seen. As I mentioned, we continue to see the double-digit growth business with both Amazon and TJX is progressing very nicely. And there's been significant interest from the wholesale partners regarding Gymboree and, as I mentioned on the call, more to come on that.

Operator: Your next question comes from the line of Paul Lejuez of Citi.

Paul Lejuez
Analyst, Citigroup Global Markets, Inc.

Q

Hey. Thanks, guys. Just one quick follow-up, I'm not sure if I missed this, but did you say what your comp performance was in stores that overlapped with Gymboree stores that were closing versus those that didn't? And then, just higher level, you mentioned that the Gymboree customer, I think, prefers to shop online. Does it change the way you think about your omni-channel offers and capabilities, your DC network? Just curious if there is an investment coming to cater to that Gymboree customer on the ecomm side. Thanks.

Jane T. Elfers
President, Chief Executive Officer & Director, The Children's Place, Inc.

A

Yeah. Well, what happened with the overlap, is that about 70% of our stores overlap with the approximately 800 Gymboree and Crazy 8 stores that closed in the quarter. So, overall, our results in the first half of the quarter were largely reflective of the impact of the liquidation event. But in April, when the liquidations started to calm down and more of their stores were closed earlier than they projected, we saw sales stronger at co-located stores than stores that weren't co-located, particularly as we moved beyond the liquidation event, so no surprise there.

And then, I don't think that I said that the Gymboree customer prefers to shop online. I said that she prefers to shop in the mall, and she has a very low propensity to shop off-mall at the mass channel. So I think there is obviously a propensity to shop in the mall and to shop online.

As far as what we're doing, we are going to develop a separate tab on our website for the Gymboree customer. There will be a different experience, different type of marketing that she'll be able to see on that site. But we are also going to leverage all the work that we're doing on our website this year as we move towards responsive design to make sure that that customer can cross-shop TCP and that she can share carts and obviously work towards bringing her into our loyalty and My Place Rewards ecosystem as well.

Michael Scarpa
Chief Financial Officer & Chief Operating Officer, The Children's Place, Inc.

A

And from an investment perspective regarding a DC, we had talked last call about utilizing a third-party logistics provider to assist us with excess ecomm demand, particularly around the holiday time period. So, our goal is to transition to that 3PL in the holiday timeframe and to utilize that 3PL for ecomm distribution for the Gymboree brand also.

Operator: Your next question comes from the line of Jim Chartier of Monness, Crespi & Hardt (sic) [Monness, Crespi, Hardt & Co.]

Jim A. Chartier
Analyst, Monness, Crespi, Hardt & Co., Inc.

Q

Thanks for taking my question. First for Jane, on Tiny Collections, for the new customers that you have attracted with that, are you seeing those customers shop other areas of the store? And then for Mike, what amortization period will the purchase price be amortized over? Thanks.

Jane T. Elfers
President, Chief Executive Officer & Director, The Children's Place, Inc.

A

Thanks, Jim. What I can say about Tiny Collections is I can tell you that it's definitely fueling the toddler business and definitely seeing a pop there. We're traditionally much stronger in the big kids part of the store and it's nice to see this product fueling the toddler side. They've been keeping with what we think about the Gymboree opportunity where we can bring that younger customer into our TCP stores and then not only convert them to TCP product at that age, but also convert them to TCP as they move out of the Gymboree stage.

Michael Scarpa
Chief Financial Officer & Chief Operating Officer, The Children's Place, Inc.
A

As far as the amortization – the purchase price goes, 90% of the purchase price has an indefinite life with the remainder being amortized in two pieces: one over three years and the other over four years. So, majority of the purchase price will not be amortized.

Operator: Your next question comes from the line of Marni Shapiro of The Retail Tracker.

Marni Shapiro
Managing Director, The Retail Tracker LLC
Q

Hey, guys. Congratulations and congrats on Tiny Collections. It does look fantastic. Could you just clarify – I want to make sure I have this right. I think, Mike, you just said that you're going to use a third-party for holiday distribution at Children's Place, and you're going to roll that in for Gymboree as well. So, will you launch Gymboree with third-party for distribution?

And then, Jane, are you going to also launch a Gymboree app? And I know this might sound silly, my children are old, but did Gymboree have an app before?

Jane T. Elfers
President, Chief Executive Officer & Director, The Children's Place, Inc.
A

Yeah, Gymboree did not have a lot of digital sophistication.

Marni Shapiro
Managing Director, The Retail Tracker LLC
Q

Yeah.

Jane T. Elfers
President, Chief Executive Officer & Director, The Children's Place, Inc.
A

So, that's a huge opportunity for us across the board. They didn't have certainly anywhere near the types of systems or tools that we've put in. They had no personalization and they had – didn't even really have omni-channel delivery capabilities like BOPIS and BOSS, ROPIS, save a sale and so on. So, I think an apps down the road – I think there's a lot of other things that we're going to put in earlier that I think we can get a lot of bang for, but certainly down the road, it will be under consideration.

Michael Scarpa
Chief Financial Officer & Chief Operating Officer, The Children's Place, Inc.
A

Yeah. And we'll begin to transition to the third-party logistics provider in the back half of the year, so we're up and ready for them to take some of the excess demand of the holiday timeframe. It doesn't mean that they're shipping all holiday for us, it's really the – it's a manageable portion for them as we bring them up to help us with our reduction of days to ship and to help our timing to shipments [ph] for mom (58:35). We'll continue to use ship-from-store during the year in a very limited way. We also have the omni-channel capability of [ph] OPIS (58:43) and have just launched a new capability of Buy Online, Ship to Store, which is getting some nice momentum also.

Gymboree will begin to ship in the beginning of 2020, and it's just natural that our third-party logistics provider takes that on from an ecomm perspective. Gymboree retail will be handled through our distribution center in Fort Payne, Alabama.

Operator: We have time for one more question coming from the line of Tiffany Kanaga of Deutsche Bank.

Tiffany Kanaga
Analyst, Deutsche Bank Securities, Inc.

Q

Hi, thanks for taking our questions. I know you just touched on it a bit, but would you give us an update on what are your typical shipping times to customers as we're seeing other retailers aggressively roll out options including next-day? And remind us how we might think about overall gross margin expansion potential over the next couple of years longer term in light of your pressures from your more rapidly growing online business? Thanks.

Michael Scarpa
Chief Financial Officer & Chief Operating Officer, The Children's Place, Inc.

A

So, normally, we run into a peak situation around the Black Friday/Cyber Monday timeframe which carries forward into holiday. Typically, our average times out of our DC are anywhere from 24 to 48 hours. So, there's not the tremendous pressure in terms of timing of goods to customers, except around that peak holiday timeframe, and we get a little pressure on the back-to-school timeframe also, but nothing like holiday. So, by utilizing this 3PL, we can knock close to 30% off of the overall timing of goods to our customers.

From a gross margin perspective, as I mentioned, we were under pressure last year in the back half of the year, so we should start to see some relief as we move forward. But we do expect ecomm to become a greater percentage of the overall sales percentage as we move forward. We expect it to go from basically a 28% last year to a slightly north of 30% this year. And as we've mentioned that ecomm has a lower overall gross margin, but its operating margin accretive to the company. So, as it continues to grow, we would expect the operating margins to expand with some pressure on our gross margin line.

Operator: Thank you for joining us today. If you have further questions, please call Investor Relations at 201-453-6693.