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PLCE - Q2 2018 Childrens Place Inc Earnings Call

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OVERVIEW:

Co. reported 2Q18 net sales of $448.7m, adjusted operating income of $15.7m and adjusted EPS of $0.70. Expects FY18 total net sales to be approx. $1.945-1.955b and adjusted EPS to be $8.09-8.29. Expects 3Q18 total sales to be $504-509m and EPS to be $2.97-3.07.

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CORPORATE PARTICIPANTS

Anurup Pruthi *The Children's Place, Inc. - CFO & Senior VP*

Jane T. Elfers *The Children's Place, Inc. - CEO, President & Director*

Michael Scarpa *The Children's Place, Inc. - COO & Executive VP*

CONFERENCE CALL PARTICIPANTS

Adrienne Eugenia Yih-Tennant *Wolfe Research, LLC - MD and Senior Analyst Retailing, Department Stores & Specialty Softlines*

Janet Kloppenburg

Kate McShane *Citigroup Inc, Research Division - MD, Head of the U.S. Discretionary and U.S. Apparel and Retail Analyst*

Marni Shapiro *The Retail Tracker - Co-Founder*

Susan Kay Anderson *B. Riley FBR, Inc., Research Division - Analyst*

PRESENTATION

Operator

Good morning, and welcome to The Children's Place's Second Quarter 2018 Earnings Conference Call. On the call today are Jane Elfers, President and Chief Executive Officer; Mike Scarpa, Chief Operating Officer; and Anurup Pruthi, Chief Financial Officer.

The Children's Place issued a second quarter 2018 earnings press release earlier this morning, and a copy of the release and presentation materials for today's call have been posted on the Investor Relations section of the company's website. (Operator Instructions) 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 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 risks and uncertainties that could cause actual results to differ materially. The company undertakes no obligation to publicly release any revision for these forward-looking statements to reflect events or circumstances after the date hereof. In addition, to find disclosures and reconciliations of non-GAAP measures that we use when discussing our financial results, you should refer to this morning's earnings release and to our SEC filings that can be found on the Investor Relations site. After the prepared remarks, we will open the call to questions. (Operator Instructions)

And now I would like to turn the call over to Jane Elfers.

Jane T. Elfers - *The Children's Place, Inc. - CEO, President & Director*

Thank you, Christy, and good morning, everybody. After reviewing our Q2 results, I will review our progress on our strategic self-help growth initiatives. I will also highlight where we see additional opportunities to accelerate market share gains within our competitive set and how we intend to use our unique positioning within the kids market to leverage these opportunities over the next few years.

So let's start with Q2. We set the bar very high for Q2 and we beat it. As we discussed in detail on our Q1 call, we were severely impacted by adverse weather in Q1, with 12 out of the 13 weeks of the quarter experiencing some type of adverse weather conditions across our major markets. However, we were confident that once the weather stabilized, we would realize the pent-up demand for our spring and summer product in the second quarter.

For Q2, we delivered positive comp sales of 13.2%, our highest ever quarterly comp, and EPS of $0.70, $0.09 above the high end of our guidance range. We delivered positive comps every month in the second quarter. We delivered positive brick-and-mortar comps every month in the second quarter. We delivered positive digital comps every month in the second quarter. Our digital business was outstanding in Q2. We delivered a 41% increase as we continued to outmaneuver the competition and gain share in this important channel.

We delivered a positive 14.2% comp in the U.S., and we delivered a positive 4.2% comp in Canada. Our key metrics ADS, UPT, conversion, ADS, transactions and, most importantly, traffic were all positive for the second quarter. I'll spend some more time on our brick-and-mortar traffic results later in my remarks, as they were truly extraordinary.

I know everyone is curious as to how we performed during the critical back-to-school period, so let me spend a few minutes on that. We did a lot of research this year on back-to-school in order to set ourselves up to gain share in this key time period. After all, back-to-school only comes once a year, and if you're not prepared, you lose. According to third-party research, 62% of shoppers begin their back-to-school shopping prior to August and 64% of total back-to-school sales happens in the 4 weeks between mid-July and mid-August. Those stats closely mirror our business. However, this year July was even more important, as the 53rd week forced the key back-to-school week into Q2 this year from Q3 last year. This research also shows that the back-to-school customer is more likely to purchase from online retailers to offer free shipping. As you know, we introduced everyday free shipping back in February. We have a highly engaged mobile millennial shopper that we are now better able to communicate with through our recent mobile implementations and enhancements.

While our digital business was outstanding every month of the second quarter, we achieved a new milestone in digital penetration in the month of July, a mid-30s penetration, driven by our digital back-to-school promotional strategy, including our ownership in key categories.

The first 2 weeks of August have continued strong. And with the majority of back-to-school and tax-free events behind us, our comps are running positive low double digits quarter to date.

Moving on, as we assess the competitive landscape in the kids wear market, particularly the specialty kids players, we continue to find ourselves uniquely positioned. The more time we spend studying the competition, the more we keep coming back to the one key differentiator between us and them. We play offense and they play varying degrees of defense.

Let's talk about why this is important and how we can leverage it for market share gains for The Children's Place. For over a decade now, the kids market has shown no growth, with births down significantly since their pre-recession highs in 2007. And near term, the kids wear market is not forecasted to grow. So how's The Children's Place winning? How have we been able to not only hold on to our market share, but gain share in a shrinking market, which has seen several new players enter the kids space in the past decade combined with an unprecedented digital assault on traditional brick-and-mortar retailers? The answer, offense, through the successful execution of a comprehensive multiyear strategic growth plan focused on proven self-help initiatives that have kept us the #1 pure-play children's specialty apparel retailer in the United States, with the goal to take that title global.

We've been on offense for several years, focused on our 4 strategic growth pillars: product, business transformation through technology, alternate channels of distribution and fleet optimization. And we have consistently delivered strong results for our shareholders.

We have been able to consistently maintain and grow market share through the successful execution of our strategic self-help initiatives, while many of our competitors have seeded market share or missed significant growth opportunities through self-inflicted strategic missteps, resulting in management changes, bankruptcies, significant unplanned store closures and costly midcourse corrections.

Many of our competitors have been forced into playing varying degrees of defense as they come to realize that significant parts of their strategic growth plans are not delivering the intended results. Some had or have serious financial issues, and most have been unable to deliver product that resonates with their target customer from all of their brand portfolios at the same time. None of them have been able to show any level of consistency in their ability to deliver positive comps in their brick-and-mortar channel. Their inability to comp in their stores has forced all of them to revise their overaggressive new store opening plans and resulted in massive unplanned store closures in some cases and a major midcourse strategy pivot in another that significantly reduced new store opening plans and instead now has them focus on closing unproductive stores and downsizing their store footprint. Some have experienced management changes, which have led to inconsistent results and strategy shifts. Some have been caught offguard by unforeseen bankruptcies and unanticipated store closures from long-standing customers, which has further pressured their higher-margin legacy wholesale channels, causing their overall operating margin to fall, leading to potential longer-term structural pressure on their operating margin. Some have made strategic mistakes with respect to international partnerships in key growth markets that are resulting in delayed results and wasted capital. Another is experiencing what appears to be a poorly received brand relaunch, coupled with new pricing and promotional strategies that don't appear to be resonating with their core customers and may result in further loss of market share and potential additional door closures. Others, we believe, are overreaching with size extensions to make up for gaps in their original growth strategies that will, over time, be unsuccessful in taking market share for more established players.

Each competitor has a different set of issues, but the one thing they all have in common is that these missteps were all self-inflicted and have led to on-the-fly strategy shift to try to make up for unanticipated growth gap, forcing them to play defense, which we believe opens up additional market share opportunities for the The Children's Place.

As we referenced, kids wear is not a growing market. There are no new net customers as the birth rates over the past decade have not replaced the number of kids who are aging out of the market. So the only way to gain share is to take it from someone else and acquire new customers to your brand at a faster rate than you are losing them. We don't believe that paying defense results in either meaningful acquisition of new customers or increased retention and engagement rate with respect to current customers. On the contrary, we believe defense results in market share erosion which, in turn, opens up significant opportunity for us.

We worked very hard for many years to be able to play offense, so let's review how each one of the 4 pillars of our growth strategy helps position us to take advantage of market share opportunities from our competition.

First, product. I cannot overstate how important product is to retaining and gaining market share. Product is and has always been our #1 strategic priority, and we're the only major kids retailer who has been able to deliver positive brick-and-mortar comps for several years due to a consistent and compelling product offering that resonates with our target customer. In addition, we have strategically extended our size ranges to appeal to older kids by thoroughly vetting the size extensions with our moms and our kids who have given us the green light prior to full rollout.

Some of our competitors have recently extended their size ranges in what may be a knee jerk reaction to growth gap. Their product does not appear to be designed with older children in mind. It's much more difficult to attract an older child to your brand. You have to ensure that your product resonates with the childs as well as the moms because older kids are very much in charge of what they will or will not wear. It takes extensive testing and an experienced design team. You can't take what works for a toddler and simply make the same styles in bigger sizes.

Another kid's brand has been unsuccessfully trying to resuscitate itself for about a decade, with no luck. Their latest strategy appears to be copy everything The Children's Place does down to our e-mail layout. We know that imitation is the sincerest form of flattery, but from a business standpoint, while copying us might very well produce short-term results, being several steps behind does not usually result in long-term success.

In keeping with product, I know that there has been a lot of discussion regarding how rising cotton prices, rising labor costs and potential China tariffs will impact product costs as we move into the first half of 2019. We've heard some of our competitors say that they're experiencing significant AUC challenges due to higher input costs, and they are passing those higher costs on to their customers.

Let's talk about where we stand with respect to these challenges for the first half of 2019. With respect to our sourcing strategy, we exited agent agreements years ago, resulting in a 100% direct sourcing model. We have been at the forefront with respect to country migration and vendor consolidation for several years. When I first arrived at The Children's Place, over 40% of our product was sourced in China. Today, it's in the mid-teens. We've been laser-focused on this very important effort for almost a decade, and by the end of 2020, our China exposure will be in the single digits. If tariffs are imposed on apparel, we anticipate that we will have much less exposure than many of our competitors. And due to our long-standing strategic sourcing focus, we are projecting that our apparel AUCs for the first half of 2019 will, in fact, be down versus last year.

Moving on, we believe we are the best positioned retailer to continue to gain market share from Gymboree following their bankruptcy, the closure of 25% of their stores and their recent brand relaunch. While we were previously focused on harvesting the dollar opportunity in stores where we were co-located with the Gymboree that had closed, we are now moving our focus to the opportunity associated with the 600 co-located stores where Gymboree is still operating.

More on that in a minute, but first, let's discuss our progress in Q2 with respect to locations where Gymboree have closed. For the second quarter, our traffic in locations where Gymboree had closed the store was up high single digits, and our sales in those stores were up low double digits, a significant acceleration from Q1 as they continued to outperform the rest of out fleet.

As you may know, Gymboree have closed over 360 stores since their bankruptcy announcement, and we were co-located with 216 of those stores across 201 centers. Interestingly, 75% of their store closures were in A and B malls. We remain confident in our ability to deliver the 150,000 in incremental volume per store or approximately $30 million in sales over time from their closed locations.

As for the current Gymboree fleet, they have 939 remaining stores. Of the remaining 939 stores, we are co-located with 600 of their stores across 437 of our centers. The breakdown of the 600 co-locations is as follows: 325 Gymborees, 210 Crazy 8s and 65 of their high-end brands. The breakdown by mall type is 132 in A or A-plus malls, 152 in B malls, 17 in C malls, 113 in outlets and the remaining 23 are in strip and lifestyle centers. So 65% of our remaining co-located stores are in A and B malls.

While Gymboree has recently publicly stated that more store closures are a possibility, we have always believed that based on the strong locations of their previous store closures that they would continue to downsize their feet and that we would have the potential to continue to pick up share over time for many additional closures. However, our thinking has evolved. We don't believe that we have to wait for Gymboree to announce more store closures in order for us to gain share. On July 16, Gymboree rebranded their product and made significant changes to their pricing and promotional strategies. We believe that their new strategy could result in an acceleration of their store closure timelines, giving us the potential for additional market share opportunity. Based on this, we have made the decision to aggressively pursue market share from Gymboree in the locations where we are co-located. We believe that we are uniquely positioned to compete very effectively. And with several of our new digital abilities now up and running, we can and are successfully targeting their customers.

Based on their recent rebranding, we also see incremental product opportunities, and Jennifer Groves and her team have already designed incremental toddler product that addresses the void for highly curated, colorful, optimistic toddler mix-and-match head-to-toe outfitting.

With respect to Crazy 8, there are now less than 300 stores left. We assume that their strategy is to target the lower-end consumer. However, we do not believe that their financial profile or their sourcing model will allow them to compete effectively on key commodities for sustained periods of time.

As we discussed earlier, kids wear is not a growing market, and share gains need to come from competitors seeding share. We believe that Gymboree will continue to be a share donor for the foreseeable future and could conservatively represent a $100 million opportunity for The Children's Place over time, inclusive of the stores that they've already closed.

Moving on to alternate channels of distribution. Before I provide you with an update on our upcoming store openings in China, I want to review how our strategic partnership with Semir developed. China, as many of you know, is one of the most difficult regions to be successful in. There are countless barriers to entry. The market and the consumer cannot be compared to any of the other international markets we operate in. We believe that in order for a kids retailer to operate a successful, long-term franchise business in China, it is critical to find the right partner. We believed that the best chance for success was through an established Chinese retailer who was a proven kids expert in this very complex market. We studied the market for a long time before we decided to pursue Semir.

We felt that we only had one chance to get it right and that a partnership with Semir was clearly our best option. The partnership between Children's Place and Semir is a game changer for our international business, as it unites two of the world's largest children's apparel retailers and provides us with an opportunity to enter the China market in a way that would not otherwise be possible with any other partner.

Semir's knowledge of the market in China, their strong retail, digital and operational capabilities provides us with instant access to prime real estate locations, established relationships with a large number of franchise partners, along with significant local product, sourcing and logistics capabilities, making them the ideal partner.

Our competitors, on the other hand, have either not figured out how to enter China or have had to press the pause button on their aggressive China growth plans as their partnership has not produced the intended results. Importantly, we made sure that we had certain exclusivity rights with Semir during our first several years of business in order to afford us the time to establish The Children's Place as the premier U.S. omni-channel kids retailer in China.

Our partnership activities are on track, and we're expecting to open our first store at Global Harbor in Shanghai in September. We're anticipating 4 additional stores to be opened by December in the cities of Beijing, Shanghai and Shenzhen.

From an e-commerce perspective, the transition of our Tmall flagship store to Semir was successfully completed at the end of July. We anticipate that our partnership will result in approximately 300 points of distribution, generating between $125 million and $150 million in retail sales by the fifth year of our partnership.

Overall, our international business added 10 points of distribution in the quarter, primarily in India and Israel, and is on track to add over 40 points of distribution in 2018.

Moving on to fleet optimization. As I covered earlier, we believe that every one of our competitors have, to varying degrees, mismanaged their real estate portfolios, and these self-inflicted wounds have resulted in wasted capital, subpar performance and costly strategy shift. Conversely, we've been working on our self-help fleet optimization strategy for over 6 years, putting us in a differently league from our competition. Up until very recently, our competitors were opening stores at an untenable pace, which contributed to a bankruptcy filing for one, significant store closures for several and a major mid-course strategy reversal for another, who went from a stated strategy of opening several hundred new stores over a short period of time to dramatically slowing down store openings to focus on store closings and smaller, more productive formats.

Due to our strategic foresight, we're now at a point where we have over 1,000 lease events occurring over the next 3 years, which provides us maximum flexibility to continue to optimize our fleet.

In keeping with fleet optimizations, I said in my opening remarks that I would revisit our traffic numbers for Q2, as they were nothing short of spectacular. One of the most important results of our self-help fleet optimization strategy has been how far we have separated ourselves from the pack with respect to brick-and-mortar traffic and our ability to positive comp in our brick-and-mortar stores.

Up through Q4 of 2017, where our traffic was almost flat, we had seen sequential traffic improvement for 8 consecutive quarters, then our traffic took a hit from the severe weather in Q1. However, for Q2, our total brick-and-mortar traffic was up positive mid-single digits, and our mall traffic was up high single digits. In addition, our traffic was positive in our brick-and-mortar channel every month in the second quarter. These traffic results make us a rare positive outlier in the retail space. We are, by far, the strongest children's retailer in traditional malls, as many of our competitors are in the process of significantly reducing their mall store counts or, in another case, they are not in traditional malls, with almost their entire fleet located in outlets and off-mall locations.

We have an overwhelming head-start versus our competition, both in malls and off-mall with respect to our fleet optimization initiatives. Our track record of consistent improvement in comp traffic positions us to continue to take share from our competitive set over the next few years as they have been unable to show any consistency in comping positives, and they certainly have not delivered positive comp traffic in their brick-and-mortar channels.

Our fleet optimization program will contribute 200 basis points of operating margin in total when completed, with approximately half of that amount already realized. And importantly, our ability to comp positive in our brick-and-mortar channel is a significant tailwind towards our 12% operating margin target, since our operating margin target assumes slightly negative brick-and-mortar comp.

Moving on to digital transformation. I've been asked many times, can you explain how the customer experience will be different at the end of 2020 versus the customer experience at the end of 2017? I'd given a lot of thought as to how to best answer that question in a way that it's easy to understand while, at the same time, speaks to the tremendous complexity associated with the digital transformation of this magnitude.

One way to answer, at this point, would be, at the end of 2017, many of our moms would have said that they love The Children's Place, they love the product, the quality and the price, but that they wished the omni-channel experience was more developed. At the end of 2020, with sophisticated personalization strategies and predictive analytics capabilities in place, we believe our moms will be more likely to say, "I love The Children's Place, and I can't live without them. I don't know how they do it, but they seem to know just what I need even before I do. They make shopping fast and easy. They save me time, and they save me money. I won't shop anywhere else."

We shared with you earlier this year that we would be investing an incremental $50 million in SG&A over the next 3 years in support of our digital transformation. We are making these digital investments to gain market share by improving customer retention and engagement and, importantly, driving customer acquisition to our brand.

Based on the market we compete in, which, as we discussed, is not growing and the fact that one 100% of our customers eventually grow out of our product, a robust acquisition strategy is imperative for sustained market share growth. Our digital initiatives are starting to produce measurable results, and without going into too much competitive detail, we are thrilled to be able to share with you that over the past 12 months, our customer file has grown 5% through both an increase in acquisition and reactivation, along with a decrease in customer churn, all driven by our recently launched digital initiatives.

Importantly, over the past 12 months, our omni-channel and online customers now represent 22% of our customer file versus 17% last year. Our omni-channel and online customers spend 2.5x more than our retail-only customers and now represent 39% of our sales. We're in the beginning stages, but I thought it was important to share with you how much progress we have made in a very short time now that we have the right team, the vision, the process and the tools to enable us to implement state-of-the-art acquisition, retention and engagement strategies.

As we said in the last call, we would update you on our digital transformation progress each quarter and share with you our goals for future quarters. We made significant progress in Q2. We implemented a new state-of-the-art on-site search tool, we enhanced our e-mail trigger capabilities, we introduced dynamic display retargeting and in addition to these 3 important capabilities, we also delivered a complete replacement of all of our register hardware to support our upcoming pricing, promotional and loyalty system.

For the back half of 2018, our plan is to develop a new state-of-the-art pricing and promotional system that will enable us to deliver personalized offers to mom in whichever channel she prefers to shop; a new state-of-the-art loyalty system that will deliver real-time personalized communication and promotions; foundational improvements to our e-commerce platform that will allow us to scale our digital business in line with our strategy; improve site responsiveness and provide a more seamless checkout; personalized SMS delivery; BOSS, or Buy Online, Ship to Store; and enhance predictive modeling capabilities that will allow for sophisticated personalization capabilities.

And we will also begin to assess the feasibility of technology upgrades in the following areas: first, an ERP upgrade; and second, an upgrade of our order management system.

And looking ahead to 2019, we plan to implement several key capabilities, including a new point-of-sale system in conjunction with the rollout of Save the Sale functionality to all stores, along with the implementation of a single pool of inventory. These digital initiatives and the balance of our digital road map will further separate us from our competition. Our digital transformation is critical to our continuing to drive sales, gain market share and expand operating margins through improved acquisition, retention and engagement strategies as we work towards our 12% operating margin target for 2020.

Now let me provide you an update on our private label credit card performance. For Q2, we continue to make excellent progress on this key strategic initiative. Our private label credit card strategy is another example of a self-help initiative that is foundational to our digital transformation. We went through a very detailed analysis of our private label credit card on our last call. We mentioned that the lifetime value of a private label credit card member is over 15x more than that of a non-loyalty member. For Q2, our private label credit card penetration increased to 23% of sales from 21% last year, and our private label credit card file increased 25% versus last year. Together, with our provider, we believe that based on our unique business model, we can achieve a 30% private label credit card penetration by 2020.

In the interest of time, I'll end here, but there are many more examples of how our strategic focus and our vision have kept us on offense in a very complex retail environment. We believe we have significant runway ahead of us by continuing to execute on our self-help growth initiatives, and we also believe we are well positioned to gain market share from our competitors.

We are looking forward to continuing to deliver for our shareholders as we move through the back half of this year and beyond. And now, I'll turn it over to Anurup.

Anurup Pruthi - *The Children's Place, Inc. - CFO & Senior VP*

Thank you Jane, and good morning, everyone. In the second quarter, we generated adjusted EPS of $0.70 compared to $0.86 last year. This compares to our guidance of $0.51 to $0.61 per share.

Details for the second quarter are as follows: net sales increased by $75.1 million, or 20.1%, to $448.7 million during the second quarter 2018 from $373.6 million during the second quarter 2017. This increase was primarily driven by a positive comparable retail sales increase of 13.2%, approximately $22 million resulting from the calendar shift related to the 53rd week in fiscal 2017 and approximately $5 million due to the new revenue recognition rules.

U.S. comp sales increased 14.2%. Canada comp sales increased 4.2%. Our key metrics were all positive, total ADS, UPT, transactions, conversion and, most importantly, store traffic. AUR was down slightly in the quarter.

Adjusted gross margin leveraged 10 basis points to 34.5% of sales as a result of the fixed cost leverage based on the strong comp, the reclassification of certain items due to the new revenue recognition rules offset by lower merchandise margins, with continued increase in e-commerce penetration.

E-commerce had very strong revenue growth of 41% in the quarter and continued its upward trajectory to represent a higher percent of our total net sales. For the quarter, e-commerce represented 26% of total net sales versus 22% last year. As you know, while e-commerce operates at a lower gross margin rate due to higher fulfillment costs, it is accretive to operating margin, and a significant increase in digital penetration is a key component of our 12% operating margin target by 2020.

Adjusted SG&A leveraged 150 basis points to 27.3% due to the strong comp. SG&A was $122.5 million in the quarter compared to $107.6 million last year, including approximately $12 million incremental dollars of investments in our transformation initiatives and approximately $5 million increase driven by the reclassification of certain items due to the new revenue recognition rules, partially offset by lower incentive compensation expenses.

Depreciation was $16.6 million for the quarter. Adjusted operating income was $15.7 million compared to $5.1 million last year or 3.5% of sales versus 1.4% of sales last year.

Our adjusted tax rate was 21% versus negative 226% last year. The impact of the accounting rules related to the income tax impact on share-based compensation was $0.03 in the second quarter compared to $0.68 last year, as the majority of share vesting occurred in Q1 this year versus Q2 last year.

For the first half, the income tax impact on share-based compensation was $0.85 versus $0.86 last year.

Let me discuss the key components of our second quarter EPS. The operating results associated with our 13.2% comp, excluding the impact of our accelerated investments, generated $0.90 in incremental EPS. The EPS benefit from the shares we repurchased, including the accelerated share repurchase program, was $0.06. A lower tax rate generated an incremental $0.05 in EPS due to the new tax legislation and ongoing tax planning. This adds up to $1.01 in incremental EPS over last year. This is offset by -- the EPS impact of the income tax on share-based compensation was $0.65 lower compared to fiscal 2017, and the impact of acceleration of our investments and higher depreciation was $0.52. This resulted in EPS of $0.70 in the second quarter.

Moving on to the balance sheet. Our cash and short-term investments at the end of the quarter were $106 million compared to $258 million last year, reflecting the impact of $190 million in cash repatriated in the first half of this year, which was utilized to fund accelerated share repurchase program and working capital. We ended the quarter with $89.3 million outstanding on our revolver compared to $54.5 million last year.

Inventory was up 18% at the end of the quarter, in line with our guidance. Cash flow from operating activities was $11 million in the first half compared to $71 million in 2017, driven by the timing of inventory purchases and lower operating income.

We repurchased $25.4 million of stock in the second quarter, inclusive of the repurchase of shares surrendered to cover tax withholdings associated with the vesting of equity awards. A total of 440,000 shares were repurchased or retired in the quarter. This includes 237,000 shares that were retired as a final settlement of the accelerated share repurchase program.

For the first half of the year, we have repurchased approximately $188 million of stock. This equates to approximately 1.5 million shares repurchased in the first half, of which approximately 1 million shares was due to the accelerated share repurchase program.

We made dividend payments of approximately $8 million, or $0.50 per share, in the second quarter versus $7.1 million last year, or $0.40 per share.

Before we move on to guidance, we want to reaffirm our fiscal 2020 financial target of a 12% adjusted operating margin and $12 in adjusted EPS. We are targeting adjusted operating margin in the range of 8.5% to 8.7% in 2018, a range of 10% to 10.5% in 2019 and 12% in fiscal 2020.

We expect total net sales to be approximately $2.1 billion by 2020 based on a mid-single-digit comp growth in 2018, '19 and '20, in addition to growth in our international and wholesale businesses. This growth will be primarily driven by our digital business, which we expect to grow at a compound annual growth rate in the low 20% range, increasing our digital penetration to approximately 35% of total net sales by 2020.

Based on the expected growth in our digital penetration, a long-range plan incorporates slightly negative comps in our brick-and-mortar channel. However, we have seen positive -- we have been positive in this channel for the last 2-plus years. In addition, the remaining 109 stores that we plan to close by the end of 2020 as part of our fleet optimization program have been running low negative single-digit comps. This gives us further confidence in our ability to continue to generate positive low single-digit brick-and-mortar comps. Also with our average lease life of 2.5 years and more than 1,000 lease events through 2020, we have the flexibility to close additional doors as business dictates in order to further drive productivity and comp performance.

As we have previously discussed during the 2018 to 2020 period, we expect to invest approximately $50 million in incremental SG&A or nonrecurring SG&A or less than 1% of our total sales over this 3-year period versus our 2017 baseline, consisting of $30 million in 2018, $15 million in 2019 and the remaining $5 million in 2020.

We expect CapEx to be approximately $250 million over this 3-year period, with the majority attributed to our transformation initiatives. And based on our continued strong cash flow generation and consistent shareholder return program, further aided by the ability to repatriate excess cash with the new tax legislation, our projections include $0.5 billion in share repurchase during the period of 2018 to 2020, which does not contemplate us incurring any debt to do so.

Now let me take you through detailed full year 2018 and Q3 guidance.

Full year 2018 guidance. Based upon our strong results in the second quarter, we are increasing our full year guidance for fiscal 2018 for adjusted EPS to a range of $8.09 to $8.29 from a range of $7.95 to $8.20. We expect that this will result in operating margins in the range of 8.5% to 8.7% for the full year.

As a result of the strong sales results in Q2, we now expect total net sales for the year to be approximately $1.945 billion to $1.955 billion, with comp sales growth of mid-single digits compared to fiscal 2017. We project digital penetration to grow from approximately 23% to 26% of net sales.

The total revenue guidance includes the impact of the new revenue recognition rules. Due to these new accounting standards, total revenues, gross margin and SG&A will all increase by approximately $19 million in fiscal 2018. The reclassification of certain items due to the new revenue recognition rules has no impact on adjusted EPS and comp sales.

We now expect our adjusted tax rate to be approximately 15% for the year as compared to 20% in 2017 as a result of the positive impact of the new tax legislation and ongoing tax planning initiatives. This tax rate for 2018 represents our current best estimate and will be subject to change as we evaluate the many aspects of the new tax law in future regulatory updates. We expect weighted average shares for 2018 to be approximately 17 million shares.

Let me discuss the key components of our EPS guidance for 2018. The operating results associated with our planned mid-single-digit comp, excluding the impact of our accelerated investments, are now expected to generate $0.95 to $1.15 in incremental EPS. We now expect $0.47 EPS benefit from the shares we expect to repurchase, associated with the accelerated share repurchase program and other share repurchases. We expect that a lower tax rate will now generate an incremental $0.46 in EPS due to the new tax legislation and ongoing tax planning. And we now expect EPS resulting from the income tax impact on share-based compensation to be $0.03 lower compared to fiscal 2017. This adds up to a range of $9.76 to $9.96 in EPS in fiscal 2018, an incremental $1.85 to $2.05 over last year. This will be partially offset by the negative $1.67 impact of the acceleration of our investments and higher depreciation, resulting in EPS guidance of $8.09 to $8.29 for fiscal 2018.

Let me now discuss some additional key metrics. Our CapEx is expected to be approximately $75 million to $85 million for the year. We expect to close 40 to 45 stores in 2018. By the end of fiscal 2018, we expect to have 210 to 215 store closures completed of our target of 300 store closures by 2020. As our digital penetration grows, the flexibility provided by average lease term of less than 3 years enables us to continue to evaluate the opportunity for additional store closures.

Third quarter guidance. For Q3, we are guiding to EPS in the range of $2.97 to $3.07 compared to adjusted EPS of $2.58 in Q3 2017. Total sales for the quarter are projected to be $504 million to $509 million, inclusive of an expected $13 million negative impact resulting from the calender shift. We project operating margin to be in the range of 13.3% to 13.6% in the third quarter compared to 14% in 2017.

Let me discuss the key components of our EPS guidance for Q3 2018. The operating result associated with our planned mid-single digit comp, excluding the impact of our accelerated investments and higher depreciation, are expected to generate $0.29 to $0.39 in incremental EPS. We expect a $0.32 benefit from a lower tax rate associated with the new tax legislation. We expect a $0.20 EPS benefit from the shares we expect to repurchase associated with the accelerated share repurchase program and other share repurchases. We expect EPS resulting from the income tax impact on share-based compensation to be $0.03 lower compared to Q3 fiscal 2017. This adds up to a range of $3.36 to $3.46 in EPS in Q3 2018, an incremental $0.78 to $0.88 over last year. This will be partially offset by the negative $0.39 impact in Q3, resulting from the $8 million investment in incremental SG&A in our transformation initiatives and $2 million in higher depreciation compared to last year, resulting in EPS guidance of $2.97 to $3.07 for Q3 2018. We expect inventory at the end of the third quarter to be up mid-single digits compared to last year in line with sales.

At this point, we will open the call to your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And your first question is from Susan Anderson of B. Riley FBR.

Susan Kay Anderson - *B. Riley FBR, Inc., Research Division - Analyst*

I was wondering if you could maybe give a little bit more color on the gross margin in the quarter, the puts and takes there. How much of the e-comm shift continued to impact gross margin? And it sounds like there's a little bit lower e-comm margins, but then also I wanted to ask if e-comm operating margins are still better than the stores. And then after you've got past kind of that first quarter clearing from the bad weather, did you see merch margins go back to more normalized levels?

Anurup Pruthi - *The Children's Place, Inc. - CFO & Senior VP*

Yes, Susan, its Anurup. Adjusted gross margins leveraged 10 basis points in the quarter. This is, obviously, a result of fixed cost leverage base on a very strong comp, reclassification of certain items due to the new revenue recognition rules. This was offset by lower merchandise margins and continued increase in e-comm penetration, which was very strong in the quarter, as you would note. Especially in July, we achieved a mid-30s penetration driven by our back-to-school promotional strategy in e-comm, including our ownership in key categories. Now as you know, we don't guide to gross margin, Susan, but that being said, we would expect margins in the back half of the year to improve versus the levels we have achieved in the first half of the year and have a greater flow-through of fixed expense. Also, I would step back from gross margins for a second and talk about, in the quarter, we generated over $1.01 (corrected by company after the call) of incremental EPS between our operations, our share buyback and our tax planning and, obviously, this was offset by the accelerated investments of $0.52 and the impact of the income tax rules and excess stock comp of $0.65, but the $1.01 EPS accretive result was very, very strong in the quarter.

Operator

Your next question is from Adrienne Yih of Wolfe Research.

Adrienne Eugenia Yih-Tennant - *Wolfe Research, LLC - MD and Senior Analyst Retailing, Department Stores & Specialty Softlines*

Jane, I'm going to start with a couple of sort of competition questions. So as you are seeing some of the evidence of the relaunch of product from Gymboree, are there any categories that you see in their stores that you think you can take advantage of and maybe add to the stores go forward? When do you think you will see sort of the impact of whether their initiatives launched in July work or don't work? And then if you can talk about some of the initiatives that you're doing at both Amazon and in the third-party channel, that would be great.

Jane T. Elfers - *The Children's Place, Inc. - CEO, President & Director*

Sure. I'll take the first part, and then I'll put -- give Mike the Amazon part of it. As far as Gymboree is concerned, as we said in the opening remarks, we were really focused on taking the share from the closed stores, but our thinking has evolved. So we're really looking at those 600 stores that are co-located with Children's Place. A portion of them are Gymboree, and as far as taking advantage of opportunities there, they seem to have dramatically changed the product from what they are known for. And if you look at any of their social media channels, I think there is also an article in The Wall Street Journal about it the week they launched. It seems to be certainly some level of their customer not happy with what they've done. So Jennifer Groves, our Head of Design, has already designed into product that is more in keeping with what that core Gymboree customer is looking for, which is really that highly curated, optimistic, bright, colorful kind of mix and match toddler product, and we'll be putting that in the stores, the mall stores, not the outlet stores, but the mall stores where we compete directly with Gymboree starting next spring. So I think there's an opportunity for us to add a different level of toddler products that we would normally do to see if we can take some of that market share from the open stores. As far as Crazy 8 is concerned, I think that has been not the greatest success story for Gymboree. Certainly, they opened it probably with the assumption that they would cannibalize Children's Place sales, but I think really what they've ended up doing is cannibalizing themselves. And as we said, I think there's only about 275 of them left. I don't think that their financial profile or their sourcing strategy allows them to compete on key items as our strategy does, which we covered in depth on the opening remarks. So I anticipate not to be surprised to see more store closings from Crazy 8. They seem to try to keep competing on key items, and I don't think that over time that will be a winning strategy, and I don't think to date it has been either.

Michael Scarpa - *The Children's Place, Inc. - COO & Executive VP*

As far as the name Amazon goes, our business with Amazon continues to perform very well. Replenishment has been the big driver of sales, and we currently have over 6,000 SKUs in the program. We think that replenishment will be a significant growth vehicle for the business over the next couple of years, as we've recently launched our seasonal basics in fashion product as part of this replenishment program during the back-to-school season. It's been early stages so far in terms of the back-to-season (sic) [back-to-school season] response, but it's been very positive on seasonal basics in fashion and has exceeded our expectations, and we've also seen a very significant increase in the demand for basics during this back-to-school period versus a year ago. In addition, from a marketing perspective, we're controlling our brand image on the site by launching a brand store, and we are participating in their launch of Prime Wardrobe. So all very positive Amazon at this point.

Operator

Your next question is from Janet Kloppenburg of JJK.

Janet Kloppenburg

Jane and Anurup, maybe you could talk a little bit about any other pressures on selling margin in the second quarter. I know that the digital mix was the primary driver of the gross margin. But I'm just wondering, Jane, how you're thinking about market share pursuits? And then I'm very encouraged on the AUC outlook for the first half of next year. And given the cotton price increasing, I'm just -- increases that we're seeing, I'm wondering if you have just been able to negotiate better deals or if there were other factors influencing that outlook.

Jane T. Elfers - *The Children's Place, Inc. - CEO, President & Director*

Sure. I'll take the AUC part of it. I think as we discussed, Janet, in the opening remarks, I think that we're just better at what we do than a lot of our competition. We've been focused on strategic sourcing for close to a decade now. And I think when you look at how we have been able to handle, I give a lot of credit to Greg Poole, who has been with us for a long time, and he and his team who run our strategic sourcing area. We've been at the forefront of vendor consolidation and country migration and that has really served us well over time and continues to serve us well as we move into the front half of 2019. We talked a little bit about China and how we've been reducing our reliance on China for several years and then certainly advantageous wise and really being ahead and having the vision as to how to place categories -- key categories by country, all that really works together to give us an AUC that is down in the front half of 2019, which I think makes us an outlier versus any of the other competition that I've heard.

Anurup Pruthi - *The Children's Place, Inc. - CFO & Senior VP*

Janet, as you've talked about on gross margins, obviously, e-comm's strong performance certainly had an impact on our gross margin mix, but when you step away from gross margins for a minute, I would reiterate, in our operations, we generated over $1 of incremental EPS versus last year between operating performance, the shares and tax planning. This is, obviously, offset by the accelerated investments in our transformation work and the impact of -- the income tax impact on excess share-based compensation. But I think, overall, when we look at the quarter, we deployed promotional strategies that were appropriate to win. And in the back half of the year, as I mentioned in the earlier question, we would expect gross margin levels to improve vis-à-vis the flow-through on fixed cost base that we saw in the first half.

Operator

Your next question is from Kate McShane with Citi.

Kate McShane - *Citigroup Inc, Research Division - MD, Head of the U.S. Discretionary and U.S. Apparel and Retail Analyst*

Jane, with all of your comments focused on market share gains, it sounds like you have a lot of opportunity. I just wondered how pricing and promotions come into play within the strategy. Can we anticipate you offensively discounting more? Or if the other competitors continue to struggle, does this mean we can see prolonged discounting in the space?

Jane T. Elfers - *The Children's Place, Inc. - CEO, President & Director*

Yes, I think that's a little bit of a complex question, but let me try to take pieces of it. I think when you look at what happened in the second quarter, we had very strong comps every month of the second quarter. May was absolutely spectacular, and margins were very strong. June was much more of a promotional month, as everyone was struggling to get rid of the hangover from a tough Q1 and also particularly in the kids market to set themselves up for the back-to-school deliveries in July. So we were not surprised by the strong business in May and June, as we had said on our Q1 call. We were pretty confident that we would see that pent-up demand realize itself in the second quarter, which we did. Really, I think, when you look at what happened in July, I think we had a lot of confidence in the preparation. We spent a lot of time getting ready for back-to-school, and we had a lot of confidence in our preparation. But I think we were even surprised at how spectacularly we did in the month of July with respect to back-to-school and, certainly, in the first 2 weeks of August. When you think about a mid-30s penetration in digital, that is a new record for us. And certainly, that business is extremely promotional in those last 2 weeks of July and the first 2 weeks of August, as we're going after big key categories like short-sleeve graphics, like uniform, like denim, like backpack. That's really what makes up the bulk of that business. So to see such an outsized performance in the month of July on digital as well as in the stores, I think that, that probably -- not probably, but that had an influence on the margins in Q2. I think as you look forward into the balance of the year, as Anurup alluded to, I think you're going to see that merchandise margin stabilize, particularly as we get out of these highly promotional categories. I do think, on the other hand, to answer the question, I think there's a lot of market share opportunity out there from our competitive set. Not only have we been focused on these self-help initiatives for several years, which have really put us in a great position and allowed us to positive comp for the last couple of years, but now we can keep going with our self-help initiatives, but I think we can take advantage of the self-inflicted opportunities from our competitors. So if you'd break it down, I think Gymboree is our #1 opportunity. We discussed it in in depth in the opening remarks, but we're still co-located with a lot of their stores. And I think with the digital tools we have coming on and some of the abilities we have in our sourcing models as evidenced by our lower AUCs, I think where we need to compete with them or where we feel like competing with them will help us realize those market share opportunities. We will, certainly, take advantage of those in the back half of the year. I think overall, when you look at what happened to us and when you look at where we're projecting the back of the year and where we're giving guidance on the full year, I think that those promotional opportunities are assumed within that guidance and that we're confident, based on our strong sourcing arm in our company and our preplanned promotions, that we will be able to deliver that guidance that we spoke about this morning and take advantage of those competitive opportunities.

Operator

We do have time for one more question. Your final question will come from Marni Shapiro of Retail Tracker.

Marni Shapiro - *The Retail Tracker - Co-Founder*

Back-to-school was fantastic. Can you just talk, Jane, a little bit about back-to-school for a minute? You guys had an outsized direct business, obviously. And could you just talk a little bit more in detail? Did you see a good split between pure buying online, shipping to home versus things like, I think, you call it ROPIS and BOPIS and all those kind of iterative elements of the direct business?

Jane T. Elfers - *The Children's Place, Inc. - CEO, President & Director*

No, we really haven't seen any of those elements significantly impact our business. We have a very small BOPIS business right now. The business we do have has a nice attachment rate. But as far as omni-channel initiatives, BOPIS is small because we offered free shipping every day. And I think a lot of people use BOPIS as their free shipping tool because our competitors don't offer free shipping every day. So I think they're more reliant on that, and they use the hook of calling that free shipping. What is coming up for us in January is Buy Online, Ship to Store. I think that's when we'll have more opportunity there. When you look at our digital business, I think there's still a lot of runway as far as digital is concerned. And when you answer your question about back-to-school, where it came from, we had a mid-30s penetration in the month of July, highly driven by back-to-school, but our brick-and-mortar comps and our brick-and-mortar traffic in that period was also outstanding. So when you look at the 2 pieces of back-to-school, there is a basics piece and then there is fashion piece. The fashion part of back-to-school, particularly in the growth side of the business, has been absolutely outstanding. So to have those 2 pieces, basics and fashion, firing on all cylinders at the same time is really what is driving this outsized comp and really has given us spectacular results. Toddler is meaningless for us during this period, and we spend a tremendous amount of time and effort, making sure that our floors sets and our penetrations are really highly geared into big kids. And we have been -- as kind of getting back to a little bit what I mentioned in my opening remarks, we have been laser-focused on making sure that our big kids assortment resonate with the kid as well as the mom, and we've been very, very successful in size extension. So you can really see right now in the business everything we've been working on coming together beautifully, whether it's the digital transformation, whether it's the increase in the customer file, whether it's the basic product we bought into, whether it's the big kids fashion, how we setup the floors, and then I would be remiss if I didn't mention Kevin Low and his field team what they were able to accomplish during tax free. They were in every single market for the past 6 weeks making sure that we were completely and fully set, and we had an absolutely spectacular tax-free result, by far the best we've had since we've been here. So it's really a combination of everything coming together.

Operator

And this does conclude today's Q&A session. Thank you for joining us today. If you have further questions, please call Investor Relations at (201) 453-6693. You may disconnect your lines at this time, and have a wonderful day.
