Five Below, Inc Third Quarter 2018 Financial Results

CHRISTIANE PELZ:

Good morning everyone, and thanks for joining us today for Five Below's third quarter 2018 financial results conference call. Due to yesterday's market closure, we changed the logistics for our earnings conference call. On today's pre-recorded call are Joel Anderson, President and Chief Executive Officer, and Ken Bull, Chief Financial Officer and Treasurer. We will host a live Q&A session with Joel and Ken today at 8 am Eastern Time.

I need to remind you that certain comments made during this call may constitute forward-looking statements and are made pursuant to and within the meaning of the Safe Harbor Provisions of the Private Securities Litigation Reform Act of 1995, as amended. Such forward-looking statements are subject to both known and unknown risks and uncertainties that could cause actual results to differ materially from such statements. Those risks and uncertainties are described in the press release and Five Below's SEC filings. The forward-looking statements made today are as of the date of this call, and we do not undertake any obligation to update our forward-looking statements.

If you do not have a copy of today's press release, you may obtain one by visiting the Investor Relations page of our website at fivebelow.com. One quick housekeeping note, last year was a 53-week fiscal year, which shifted this fiscal year's quarters by one week. Ken will review this shift in his remarks, and please see our press release for more information.

I will now turn the call over to Joel.

JOEL ANDERSON:

Thank you, Christiane, and thanks, everyone, for joining us for our third quarter earnings call. I will review the highlights of the quarter before handing it over to Ken to discuss our financials and outlook.

We are very pleased with our third quarter performance, which exceeded our guidance. Total sales increased 22% to $313 million, driven by continued strong results from our new stores and a comp of 4.8%. Earnings per share grew 33% to $0.24.

The biggest driver of our growth continues to be our new stores, and the performance of our new stores remains strong. During the third quarter, we opened a record 53 stores in diverse markets across a range of 20 states. Twelve of these stores made it to the Top 25 All-time Summer or Fall Grand Opening list. We believe the growing success of our new stores across geographies and markets is a testament to the universal appeal of Five Below, as well as the benefits of our expanding scale and brand awareness. With only 750 stores today, we have a long runway of growth as we expand nationally to realize our 2,500 plus store potential in the United States.

Including the stores we opened early in the fourth quarter, we have now completed our store openings for the year. The highlight was opening our first Manhattan store - on Fifth Avenue. We are thrilled with this location, and if you have not been there, you need to go! From the street, passersby see our vibrant signage and entry with a colorful, flashing video featuring our eight worlds, and incredible murals on both walls created in-house by one of our talented designers. Our real estate, construction, creative and store opening teams really outdid themselves to see this project to completion. We believe this prime location will attract both New Yorkers and tourists alike, and it will also have the added benefit of increasing our overall brand awareness.

Moving on to comp. You will recall that last year our spinner-driven outperformance in Q2 was followed by equally impressive, broad-based Q3 results, as we delivered a very strong transaction-driven comp of 8.5% in 2017. We believe customers who had discovered us through the spinner craze returned to our stores and continued to shop at Five Below. This quarter, we once again experienced broad-based performance, led by our Tech, Room, Sports, Create and Candy worlds. Our merchandise continues to

resonate with our customers, who shopped for everything from Back To School and Halloween to our core basic programs and trend-right products including Slime, Squishy and Toys. On the last call, we mentioned Toys as an emerging opportunity for us due to the void left by the Toys “R” Us closures and the need for families to find a new toy destination. We set the stores with our Mega Toy island and began advertising toys, games and crafts across our digital marketing channels.

On that front, with respect to marketing in Q4, we are excited to announce our expanded TV advertising to cover about half of our stores, as compared to about 40% last year. We continue to shift our marketing spend and spend to our digital efforts, including TV, YouTube, and other social media. New this year, we are excited to announce we have added influencers to our social media program, with visibility both online and in stores. Rounding out our marketing campaign, our print circulars will also play an important role in Q4. Overall, the marketing team is very focused on increasing brand awareness and driving traffic, engagement and repeat visits. Attracting both new customers and remaining top of mind for current customers is key to delivering a successful holiday season. To that end, the visits to our ecommerce site continue to grow. We believe the site is helping increase Five Below’s brand awareness for those who don’t know us yet, as well as serving as a pre-shopping tool and driving more traffic to our stores, where our customers love exploring our full assortment of products in a treasure hunt experience.

Shifting gears to our systems and infrastructure. As always, we remain focused on ensuring that our foundation can support our significant future growth as we firmly believe having the right people, systems and infrastructure in place will help keep execution at a high and consistent level. To that end, the POS implementation we accelerated into this year is now complete. I want to personally thank that team for their year-long effort to complete this project on time and on budget. This new system is foundational to adding features like a customer loyalty program and eventually Buy Online, Pickup In Store. As for infrastructure, the construction of our Southeast DC is on schedule and the DC is on track to open in Spring 2019. We are also actively scouting the Southwest for our next DC, which we plan to open in 2020.

Before I speak about Q4, I want to touch on the handful of store remodels we’ve completed this year, as well as a new test we started. We are pleased with the progress we made in creating efficiencies to our store remodel process and we plan to announce an expanded program on our next earnings call.

As for the new test, we are constantly looking for ways to innovate in our business and we test different ideas frequently. Some of you may have already seen the Ten Below or Just Wow concept we recently launched in six of our stores, where we are offering an extended product assortment of items up to $10. This is an idea we have been working on for quite some time, and we are excited to see it in action. Our goal is to continue to create and offer extreme value, and we believe by expanding our assortment, we are offering even more value to our customers. We are analyzing customer behavior and reaction, and expect to continue to test this concept throughout 2019. However, I will say we are very pleased with the customer response to date.

For Q4, if you’ve been in our stores, you know how amazing they look. Our merchants sourced incredible products like a 4-ft Christmas tree, perfect for a kid’s room, cool tech accessories such as a gaming headset, Star Wars action figures, a Monopoly board game and matching flannel plaids for pets and their parents. We even have a “paint-it-yourself” Squishy toy. For Black Friday, we featured incredible value with wireless earbuds, a drone, a metal string guitar, an etched metal table, craft kits, and branded toys - even a robot. We are pleased with the customer response to our offering and believe our holiday season is off to a solid start.

Before I close, I want to say a few words about tariffs. This is a fluid situation and we have been aggressively exploring all options to mitigate the impact. In particular, our merchants and vendor partners have been working very closely together to lower costs without sacrificing product quality, and I would really like to thank our suppliers for leaning in and supporting Five Below. The recent events regarding tariffs suggest there is the potential for tariffs to remain at 10%. Under this scenario, we expect to fully mitigate the tariff impact. We will continue to closely monitor developments and prepare for all

contingencies. If required, we are also prepared to take selective price increases. We believe, even with slightly higher prices, our products will continue to deliver extreme value with great quality that will appeal to our customers. Finally, we are also exploring sourcing in other countries as a medium to longer term solution.

In summary, we are extremely pleased with our performance thus far in 2018, and we believe we are well positioned to deliver on our goals. We are firmly focused on executing in the all-important fourth quarter. Five Below is a perfect place for holiday gifts and stocking stuffers, with amazing value and fresh, new, trend-right products across our eight worlds.

With that, I'll turn it over to Ken. Ken?

KEN BULL:

Thanks Joel, and good afternoon everyone. I will begin my remarks with a review of our third quarter results and then discuss our outlook for the fourth quarter and full year. Before I review our results, I want to remind everyone of this year's calendar shift due to fiscal 2017's 53rd week. This calendar shift, which is contemplated in our guidance, resulted in additional sales in the first half of the year, and will largely reverse in the second half.

Now I will review our third quarter results in more detail.

Our sales in the third quarter of 2018 were $312.8 million, up 21.6% from $257.2 million reported in the third quarter of 2017. Sales for the quarter were negatively impacted by approximately $3.8 million related to the calendar shift, which was included in our guidance.

We opened 53 new stores during the quarter compared to 41 opened in the third quarter of 2017. We ended the quarter with 745 stores, an increase of 120 stores or 19%, versus 625 stores at the end of the third quarter of 2017. As of mid-November, we opened all of our planned new stores for 2018. As Joel mentioned, our new stores generated another quarter of very strong performance and the Class of 2018 is currently on track to be our highest performing class of all time with Average Unit Volumes projected to be over $2 million.

Comparable sales increased by 4.8% for the third quarter of 2018, which was driven by an increase in both comp average ticket of 2.8% and comp transactions of 2.0%.

As I mentioned on our last earnings call, we expected over 100 basis points of operating margin deleverage in the third quarter due to our planned tax reform reinvestments, all of which were recorded in SG&A. Given our sales outperformance from both comp and new stores, operating margin for Q3 2018 delevered by approximately 80 basis points over Q3 last year, with better than expected results in both gross margin and SG&A rate.

Gross profit for the third quarter increased 22.1% to $102.1 million from $83.6 million reported in the third quarter of 2017. Gross margin increased over last year by approximately 10 basis points to 32.6%. This increase was driven primarily by occupancy cost leverage on the higher sales.

As a percentage of sales, SG&A for the third quarter of 2018 increased approximately 90 basis points to 27.7% from 26.8% in the third quarter of 2017. SG&A expenses as a percent of sales were higher than last year due primarily to the tax reform-related re-investments mentioned earlier.

As a result, operating income increased 5.0% to $15.5 million versus $14.8 million in the third quarter of 2017.

Our effective tax rate for the third quarter of 2018 was 18.6% compared to 34.8% in the third quarter of 2017. Our tax rate was favorably impacted by lower rates from tax reform, which was included in our

guidance, and the accounting for stock based compensation, which, as is our practice, was not included in our guidance. The impact of stock based compensation accounting was a benefit to third quarter diluted EPS of approximately $0.02.

Net income increased 36.8% to $13.5 million, or an increase per diluted share of 33% to $0.24, versus $9.9 million or $0.18 per diluted share last year.

We ended the third quarter with $188 million in cash, cash equivalents, and investments, and no debt.

Inventory at the end of the third quarter was $339.9 million, as compared to $271.7 million at the end of the third quarter of last year. Average inventory on a per store basis at the end of the third quarter of 2018 was approximately 5% higher versus the third quarter last year, due primarily to accelerated import receipts in anticipation of the previously announced January 1st increase in tariffs. As a reminder, we take ownership of direct imported goods earlier as we record in-transit inventory on our balance sheet when goods leave the overseas ports.

Now I would like to turn to our guidance. As a reminder, our guidance does not include any future impact from stock-based compensation accounting or share repurchases. We will report the impact, if any, with our actual quarterly results, which are incorporated in our guidance. In addition, the fourth quarter and full year of fiscal 2017 included an extra week, “the 53rd week,” versus the 52 weeks in fiscal 2018. This week added approximately $15.7 million to net sales, $3 million to operating income and $0.03 to diluted earnings per share. For our guidance, the year over year comparisons I will reference will be on a 13-week quarter and 52-week fiscal year basis. I’d also like to remind everyone that the tariffs already implemented are not expected to have a material impact to our business or our results in Q4.

For the fourth quarter ending February 2, 2019, net sales are expected to be between $593 million and $600 million, an increase of 21% to 23% over Q4 2017. We are assuming a comp sales increase for Q4 2018 of approximately 3 to 4%, versus the 5.9% comp in Q4 2017, which was our highest Q4 comp since 2011.

With regards to operating margin for Q4 2018, as previously announced, we still expect over 100 bps of deleverage, driven by tax reform-related investments.

Net income for Q4 2018 is expected to be in the range of $86.5 million to $88.5 million, a 32% to 35% increase over Q4 2017. Earnings per diluted share for Q4 2018 are expected to be $1.53 to $1.57, a 30% to 33% increase over Q4 2017.

For the full year 2018, we are raising our sales guidance, which we expect to be in the range of $1 billion 550 million to $1 billion 557 million, an increase of approximately 23% over 2017. Comp guidance for the full year increases to a range of 3.3% to 3.7%. We expect to open 125 net new stores and end fiscal 2018 with 750 stores, an increase of 20% as compared to our 2017 ending store count of 625.

We expect an effective tax rate of approximately 22.5% for the full year, which includes a normalized quarterly tax rate of 24.5% for Q4, excluding any impact of stock-based compensation accounting in Q4.

Our net income outlook has increased and is expected to be in the range of $146.9 million to $148.9 million, or growth of 46% to 48% over 2017.

Diluted EPS is now expected to be in the range of $2.60 to $2.64, or growth of approximately 44% to 46% over 2017, compared to our previous EPS outlook of $2.51 to $2.57.

With respect to CapEx, we plan to spend, in total, approximately $130 million in gross expenditures in 2018, reflecting 125 net new stores, with the remainder projected to be spent on our new Southeast distribution center, our existing store base and corporate infrastructure.

For all other details related to our results and guidance, please refer to our earnings press release. And with that, I would like to turn the call back over to Joel to provide some closing comments. Joel?

JOEL:

Thanks Ken.

We've had an amazing year so far with broad-based strength across our business. The teams are continuing to execute at a high level, as you can see from our new store performance, comp results and profitability metrics. I want to thank everyone at Five Below for delivering these results. Our store associates are delighting our customers, our distribution teams are optimizing getting product to the stores, and the home office WowTown team is providing amazing merchandise and excellent support for our operations and growth.

We remain focused on executing our growth strategy and are confident in our 20/20 through 2020 plans as well as our 2,500 plus store potential in the United States. We will continue to leverage our growing scale and deep vendor relationships to innovate and reinvest in product to offer even more value, newness and wow. We strongly believe that trend identification, innovation and reinvention are key to remaining relevant with our growing customer base. We will continue to utilize our core skill sets, gained over many years of experience, to capitalize on and manage through trends, whether big or small. We also believe our edited assortment of exceptional value products, combined with our amazing store experience, is what differentiates Five Below and keeps our customers excited to come back.

Five Below is a unique retailer and brand that is on a mission to help make life better for our customers so they can Let Go and Have Fun!, and there is no better time to do that than during the holidays.

We look forward to speaking with you on our Q&A session at 8 am ET.