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Michaels Cos., Inc. (MIK)

Q4 2017 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning. My name is Phil [ph] and I will be your conference operator today. At this time, we'd like to welcome everyone to The Michaels Companies' Fourth Quarter Earnings Conference Call. All lines have been placed on mute to prevent any background noise. [Operator Instructions] Please note, this event is being recorded.

Thank you. And now I'd like to turn the call over to your host, Kiley Rawlins, Vice President of Investor Relations and Communications. Ms. Rawlins, you may begin the conference.

Kiley F. Rawlins
Vice President - Investor Relations & Communications, The Michaels Cos., Inc.

Thank you, Phil [ph] . Good morning, everyone, and thank you for joining us today. Earlier this morning we released our fourth quarter and fiscal 2017 financial results. A copy of the press release is available in the Investor Relations section of our website at www.michaels.com.

Before we begin our discussion, let me remind you that today's press release and the presentation made by our executives on 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. While these statements address plans or events which we expect will or may occur in the future, a number of factors as set forth in our SEC filings and press releases could cause actual results to differ materially from our expectations.

We refer you to and specifically incorporate the cautionary and risk statements contained in today's press release and in our SEC filings. You are cautioned not to place undue reliance on these forward-looking statements which speak only as of today, March 22, 2018. We have no obligation to update or revise our forward-looking statements except as required by law, and you should not expect us to do so.

On today's call we will reference non-GAAP financial measures, including adjusted EBITDA as defined in our credit agreements, adjusted operating income, adjusted net income and adjusted diluted earnings per share. A reconciliation of these measures to the corresponding GAAP measures are detailed in today's earnings release.

We'll begin this morning with highlights from Chuck Rubin, Chairman and CEO; and then Denise Paulonis, our CFO, will review our financial results and outlook in more detail. Following our prepared remarks, we will open the call for questions. As this is our year-end call, our prepared comments will take longer than usual. To help us accommodate as many questions as possible, please limit yourself to one question and then re-queue for any follow-up questions. Thank you.

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And now I'll turn the call over to Chuck Rubin. Chuck?

[005KTQ-E Carl Rubin]

Thank you, Kiley. Good morning, everyone. I want to start this morning with a review of our fourth quarter results, highlight what we accomplished in 2017 and then discuss our priorities for 2018.

As expected, we continued to build momentum in the fourth quarter. Total sales for the quarter increased 8% to $1.9 billion, inclusive of the extra week. Comp store sales increased 2.5% driven by increases in both average ticket and customer transactions. And adjusted diluted earnings per share increased 24% to $1.19. Denise will discuss the quarter's financials in more detail later in the call.

Our Q4 results were driven by a strong performance in the November- December holiday period offset partially by a softer January. From a category perspective, seasonal, kids and paper crafting tools and technology were our strongest categories this quarter, while ready-made frames, yarn and jewelry were more challenged.

After many quarters of negative trends, custom framing was slightly positive this quarter. The assortment and pricing changes we made in Q3 combined with testing of new management models are having a positive impact on the business.

As expected, sales from michaels.com were strong. While still a very small part of our overall revenues, online sales in Q4 were approximately double the level of online sales in Q4 last year driven by increased traffic, higher conversion rates and a higher order value. Unfortunately, our third-party fulfillment provider struggled to meet planned customer demand.

As a result, many online orders were filled across multiple fulfillment methods, including our ship-from-store, ship from DC and vendor drop-ship nodes. As a consequence, we saw an unexpected increase in split shipments, which drove higher-than-planned fulfillment costs during the quarter. As I will outline in a moment, we had planned on bringing e-commerce fulfillment in-house in the next couple of years, but our experience this holiday season has caused us to accelerate our efforts.

Turning now to the full year, I am generally pleased with what we accomplished in fiscal 2017. From a financial perspective, we delivered 2017 results in line with the outlook we previously provided. Total net sales for the year, which was a 53-week year, increased 3%; and comp store sales increased 0.9%, driven both by increased ticket and transactions.

Leveraging our sourcing efforts, we delivered $46 million of cost savings, which enabled us to overcome $38 million of expense headwind related to incentive compensation. We delivered record operating income of $735 million. Adjusted diluted earnings per share increased 15% to $2.17, compared to adjusted diluted earnings per share of $1.88 in fiscal 2016.

We generated $396 million in free cash flow and purchased 12.7 million shares of our common stock, returning more than $250 million to shareholders. And we reduced our EBITDA leverage defined as total debt divided by adjusted EBITDA to 3.1 times.

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We also made meaningful progress in pursuit of Vision 2020, our long-term strategy to increase market share and deliver shareholder value. In fiscal 2017 we strengthened our omni-channel offering. We refreshed and expanded existing e-commerce sites, including michaels.com and ConsumerCrafts.com, and also introduced new platforms, including the Michaels app and an online framing solution. In total, sales from our consumer-facing online sites doubled from fiscal 2016 to about $100 million in fiscal 2017.

We supported the growth of these e-commerce businesses by diversifying how we deliver product to customers. In 2017, we launched ship from store in hundreds of stores strategically distributed across the United States to help us reduce shipping costs and shorten delivery times. We also tested buy online, pick up in store in a number of markets.

We expanded our offering of free classes and MAKEbreak, continuing to make shopping in a Michaels store more experiential. This past year, more than 1.7 million people made something special with their family or friends in a Michaels store. This was nearly 60% more participation than in fiscal 2016.

We upgraded our POS system in all U.S. stores, providing customers with a faster checkout experience and creating a platform to support new promotional capabilities, which will help us target our discount dollars better. We strengthened our channel-leading assortment with exclusive partnerships, including Martha Stewart, Disney, and Caron Cakes, and we led the industry in trends like slime, Cricut technology and rock painting.

We reinforced our value position with the expansion of our Everyday Value, or EDV program. Also, the increased use of clear, even-dollar price points for key items, and finally, the introduction of a new price match guarantee program.

We expanded our loyalty program, Michaels Rewards, to more than 24 million customers at the end of 2017, up from 14 million at the end of 2016, and increased our penetration to 57% of sales, compared to 39% at the end of 2016.

We expanded our MAKE [ph] campaign with more marketing, more exclusive digital content, and more media integrations, and we increased our digital engagement, expanding our number-one position in social media platforms like Facebook, Instagram and Pinterest.

We generated approximately $46 million in sourcing savings from our product/cost efforts and supported these efforts with the expansion of our Darice Global Sourcing team in China. Our China offices, comprised of more than 100 team members, enabled us to double our percentage of direct imports as a percentage of total receipts as compared to fiscal 2016, helping us to eliminate middlemen and increase our control over the products we buy. Finally, but importantly, in 2017, we increased team member engagement across the company and reduced employee turnover.

As we begin fiscal 2018, our commitment to our Vision 2020 strategy has not changed. In addition, the benefits from tax reform give us flexibility and opportunity to accelerate previously-planned initiatives to support our long-term profitable growth. This year, we are keenly focused on three key objectives. One, create a more seamless omni-channel experience for customers. Two, continue to differentiate the Michaels brand with exclusives, newness and value. And three, invest to support additional capabilities and drive increased productivity.

Retail continues to evolve and customer expectations for convenience, simplicity and value continue to increase. We are committed to making it easier for customers to shop whenever and however they want.

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Last year we successfully launched ship from store which helped us begin to reduce our dependency on third party fulfillment and enable us to leverage our in-store inventory ownership. This year we will further expand our ship from store distribution points. And for those customers who want their purchases sooner, this spring we will offer buy online, pick up in store in all U.S. stores.

While e-commerce sales are growing quickly, in-store transactions continue to account for the vast majority of our transactions. To deliver a better customer experience in stores, we are making investments to make it easier for customers to get what they need and easier for our team members to help them. To improve consistency across stores for customers and team members, we will continue our efforts to reduce the number of store layouts or snowflakes as we call them and expand the number of stores with our flexible merchandising area often referred to as FMA stores.

As context, in 2016 we introduced this new FMA store layout that created space in the front of the store to showcase newness and seasonal statements. Although this new layout delivered strong sales of seasonal product, our initial results were more disruptive to core basic categories than expected as customers acclimated to the new design and category adjacencies. Additionally, we initially underestimated the inventory sell-through resulting in sporadic seasonal out-of-stocks and missed sales opportunities.

In 2017, we improved how we allocated and flowed seasonal inventory to these stores and also increased how we refreshed the space for the customer. As a result of these changes, the FMA stores outperformed their control group in the second half of 2017.

Building on lessons learned, we have made adjustments to the FMA layout to maintain space for newness and seasonally relevant stories while also reducing the impact on basic categories. This improved approach will enable us to minimize disruption to the customer and reduce complexity for our team members. Therefore, in Q2 we plan to make these layout changes in approximately 235 additional stores, further reducing the number of formats we manage. With these changes added to the approximately 400 stores that already have the FMA layout, about one-half of our chain will be positioned to present stronger, more cohesive seasonal statements to customers.

As I discussed earlier, we have begun to see some stabilization in our custom framing results. In 2018 we will make additional changes to our custom framing business to drive stronger performance. First, reflecting our commitment to investing in growth businesses. Last June we indicated that we would undertake a strategic review of our Aaron Brothers division which is a small specialty retail chain primarily focused on custom framing, ready-made frames, wall art and art supplies. After a comprehensive review, we determined that the cost infrastructure is unsustainable given current comp prospects and the best path forward is to leverage the Aaron Brothers custom framing expertise and name recognition in Michaels stores and online.

At the end of fiscal 2017, we operated 97 Aaron Brothers stores, 94 of which were full size or about 6,500 square feet, and three of which were smaller, custom frame only stores. Over the next few months we will close all 94 full size Aaron Brothers stores and leverage this 70-year-old brand within the Michaels footprint as our store within a store custom framing service. We will maintain the three custom framing only stores as a learning laboratory. The custom framing industry is very fragmented still and these lab stores, which average about 2,000 square feet, will help us learn how we can better compete against independent custom framing shops.

I am grateful for the work our Aaron Brothers team members have done over the last several years and we expect to retain many of these team members as we value their custom framing expertise. Secondly, we will rebrand Framerspointe.com as Aaronbrothers.com, both a standalone site but also with a tab on Michaels.com. We will

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integrate the platform with the in-store custom framing service to make digital custom framing easier. And later this year, customers will be able to leverage a Michaels store to drop off, pick up, or return projects framed online.

Finally, we will invest to strengthen the custom framing sales focus in our Michaels stores. Compared to other categories, custom framing is a high touch, personalized service that requires strong relationship building and selling skills. For the last several months we have tested a new management approach based on earnings from Aaron Brothers which focuses on creating a stronger selling culture within the custom framing team, and the sales results have been very encouraging. In fiscal 2018, we will expand this effort to additional markets and expect to impact about 50% of our custom framing sales with this new approach.

With the abundance of SKUs in a store, we know shopping arts and crafts stores can be confusing. To help make it less overwhelming in 2017, we refreshed and relaunched the Michaels app, making it easier for customers to find product, search projects and determine in-store inventory availability. Since launching the new app in August, more than 5 million customers have downloaded the app and we've seen a nice ramp-up in utilization with more customers using the app to find product and new project ideas. This year we'll continue to enhance the Michaels app to improve the customer shopping experience, adding new functionality like visual search, improving coupon management and developing other enhancements to improve the in-store check-out experience.

We will continue to invest in technology in our stores to make it easier for our customers and to empower our team members. Last year we refreshed our POS system in all U.S. stores and rolled out a new task management tool in all stores. This year we will refresh our POS system in our Canadian stores and we will provide new tablets to all stores. Customers can use these tablets to place online orders while in a Michaels stores and team members can use the tablets to leverage the Michaels app or michaels.com and work side by side with customers to help look for projects, search our expanded online assortment, or place an online order.

Since launching e-commerce in 2014, we have learned much about how customers use online platforms to support their personalization and making needs. The tactile nature of the product, the general lack of national brands and a low average item price make it unlikely that e-commerce will grow to be the double-digit penetration of sales in arts and crafts as it is for many other retail formats. However, we do believe online is an attractive complement to the brick-and-mortar experience. Given our low sales penetration today, this is an attractive sales growth opportunity for us over the next couple of years.

In 2017 we expanded our SKU assortment on michaels.com by nearly 30% to include more of the seasonal and core basic products that are available in our brick-and-mortar stores as well as more online-only SKU as part of our endless aisle efforts. We also made improvements in our online search capabilities and provided visibility to in-store product availability.

A few weeks ago, we refreshed michaels.com to deliver a more current, cleaner look that is more reflective of our Michaels brand. We simplified the look and feel and added a new preferred store functionality so customers automatically see in-store product availability and local coupon offers for their preferred store. And we made it easier for customers to find what they want. We know that browsing through thousands of items can be overwhelming so we redesigned our product manufacturing and menu functionality to improve discoverability by providing better visibility to more categories and subcategories. We also redesigned our coupon page to make it easier for customers to access their coupons by reducing the number of clicks to retrieve and redeem coupons, an enhancement that is especially helpful on mobile and should make the in-store check-out process faster.

As we look to the rest of the year, we intend to offer new ways to provide more personalized experiences and product recommendations and will leverage the flexibility of the digital space to create solutions for unique

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shopping missions. For example, weddings are multifaceted events. In our brick-and-mortar stores, we showcase product by category, not necessarily through the customer's lens of what she's trying to accomplish. A customer planning a wedding might need to shop floral, paper, party and frames, which are all separate categories within a Michaels store.

We are limited by space constraints in a physical store by online we can bring multiple categories together in a more intuitive way. This spring, customers will be able to shop a Michaels Weddings, a new micro site on michaels.com. This microsite will be a new cross-category platform with new trend-right merchandise and partners, more value and more assortment breadth to help customers bring the unique vision to life. We will also connect Michaels Weddings in our stores experience.

Finally, we know leveraging our scale to facilitate customer communities particularly in the digital arena can drive customer engagement in a brand differentiation. To this end, we are focused on two exciting platforms for 2018.

First, a few weeks ago, we launched a new social tool on michaels.com to give new Makers the opportunity to ask more experienced Makers questions about products and projects. We've only been live for about two months, but we've already seen more than 21,000 questions posted. This community is Maker talking to Maker and is hosted on the michaels.com site.

Our second focus this year will come to life later in the year when we launch Michaels Marketplace [ph] , a selling platform that will connect Makers with customers who want to purchase completed handmade items.

Building on progress made in 2017, this year we will continue to leverage our size and scale to offer customers more merchandising exclusives, product and category newness and a strong commitment to value. Exclusive brands and products help us differentiate Michaels from other arts and crafts players.

Last year, through the successful efforts of our Darice team, we secured the exclusive development and distribution rights from Martha Stewart Crafts and launched Martha Stewart Paint. Building on this success, we have just launched Martha Stewart Party, a fully coordinated party program designed by Martha and her team and only available in Michaels stores and on michaels.com.

In addition, we've recently partnered with Drew and Jonathan Scott, HGTV personalities and Design Gurus more commonly known as the Scott Brothers, to create a new custom framing collection, again, exclusive to Michaels.

Last year, we began testing fabric and notions in Pat Catan's brick-and-mortar stores and also introduced an assortment of fabric on michaels.com. Building on these efforts, this quarter, we will refresh and rebrand our fabric program as the Hancock Fabric Shop on michaels.com. Through this new program, we will offer customers thousands of fabric choices cut-to-order by our Pat Catan team and shipped directly to the customer, and all available at great everyday values. We view this entry into fabric as an attractive added sale for Michaels.

In total, we expect to have around 100,000 SKUs available on michaels.com by the end of fiscal 2018, about twice the average number of SKUs in a Michaels store, furthering our merchandise leadership.

Finally, we will accelerate our investments to support future sales and profit growth. We will accelerate our efforts to bring e-commerce fulfillment in-house earlier than initially planned. Our e-commerce business continues to grow in line with the original plan we laid out three years ago, and as we experienced in the most recent quarter, our dependence on a third-party for order fulfillment is a constraint creating operational volatility and resulting in higher fulfillment costs.

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In 2018, we will invest in technology and in our supply chain to build the foundation to enable us to fully in-source e-commerce fulfillment in 2019. We will accelerate our investment in data analytics to drive additional actionable insights.

Today, we can link about 70% of our transactions to a specific customer. In between the Michaels app, michaels.com and in-store transactions, we collect billions of customer interactions. This year, we will invest in new data analytical capabilities to help us harvest this customer data to identify actionable insights and create more effective customer communications.

We will also invest in new promotional capabilities facilitated by our recent POS refresh to manage discounts more effectively through the use of targeted offers and serialized coupons.

In summary, in 2017 we delivered against our financial goals and made progress in every facet of our Vision 2020 strategy, and I want to thank each of our nearly 50,000 team members across the company for their hard work and dedication to serving customers.

In 2018, we will build on these efforts and proactively invest some of the benefits from tax reform to accelerate investment for our long-term growth. While this choice will result in temporarily elevated operating expense in 2018, we are confident that our investments to create a more seamless omnichannel experience for customers, to expand our FMA [ph] stores, to bring e-commerce fulfillment in-house and to strengthen our data analytics will result in increasing our sales, earnings and free cash flow over the longer-term.

Now let me turn the call over to Denise for a more detailed discussion of our financial performance. Denise?

[0FH8Y5-E Denise Paulonis]

Thanks, Chuck, and good morning, everyone. Before I discuss our results, I want to provide additional context on our GAAP versus non-GAAP metrics. Adjusted net income and adjusted diluted EPS for Q4 and fiscal 2017 excludes two onetime charges related to tax reform. First, approximately $11 million related to a onetime repatriation tax on the accumulated earnings of foreign subsidiaries, and second, approximately $4 million resulting from the revaluation of our net deferred tax assets at the lower corporate statutory rate. Adjusted net income and adjusted diluted EPS for Q4 and fiscal 2016 excludes losses on early extinguishment of debt and nonrecurring adjustments associated with the February 2016 acquisition of Lamrite West.

My discussion this morning will focus on adjusted results for both years. A full reconciliation of the GAAP to adjusted metrics is included in our Earnings Release. As a reminder, fiscal 2017 was a 53-week year. For the full year, the extra week contributed approximately $79 million in sales, approximately $27 million in operating income and approximately $0.09 in adjusted diluted earns per common share.

Now let's talk about our fourth quarter results versus last year. Fourth quarter net sales increased 8% to $1.89 billion. The increase in net sales was primarily due to sales from the extra week, a 2.5% increase in comparable store sales, which was at the high end of the guidance we provided last quarter, and the operation of 15 net additional Michaels stores opened since the fourth quarter of fiscal 2016. Our customer messaging to support holiday decor and creative gifting combined with our ongoing efforts to strengthen our value message with simple, clear, even dollar price points resonated with customers and delivered results.

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In addition, the changes we made to better flow seasonal inventory to stores with a flexible merchandise area, which we sometimes call our FMA stores, helped drive stronger seasonal sales. Finally, custom framing, which was slightly positive for the quarter, was less of a headwind on our overall results.

Gross profit dollars for the quarter increased 9.7% to $775 million. As a percentage of sales, our gross profit rate for the quarter was 41% versus 40.3% last year, an increase of about 70 basis points. The increase in the Q4 gross profit rate was primarily a result of the increase in our product margin driven by benefits from our ongoing sourcing efforts.

Additionally, we saw benefit from occupancy cost leverage resulting from the extra week of sales, less discounting activity during the quarter, as we made progress in better targeting discount dollars, and the anniversary-ing of $1.1 million of net nonrecurring purchase accounting adjustments related to the acquisition of Lamrite West. These benefits were partially offset by higher supply chain costs and higher inventory shrink.

In regards to supply chain costs, we had two headwinds in the quarter. First, as we discussed in our last call, we've experienced higher than expected supply chain costs as domestic trucking capacity has tightened. In addition, we are experiencing higher international freight rates. We expect these headwinds will continue in 2018. Second, we incurred higher than expected e-commerce fulfillment costs due to challenges with our third-party fulfillment provider which, as Chuck discussed, led to more split shipments as many of our customer orders were filled across other fulfillment methods including ship from store, ship from DC and vendor drop-ship. While we are accelerating plan in 2018 to bring e-commerce fulfillment in-house in 2019, we do expect e-commerce fulfillment costs to increase in 2018, reflecting planned e-commerce growth.

Total store rent expense for the quarter was $101 million versus $98 million last year with the increase primarily due to a net 15 additional Michaels stores. SG&A expense including store preopening costs increased 14% to $420 million or 22.2% of sales from $369 million or 21.1% of sales last year. The increase in SG&A expense was primarily due to a $23 million increase in incentive-based compensation. Recall, that in the fourth quarter last year was a $28 million decrease in incentive-based compensation compared to the fourth quarter of fiscal 2015.

Additionally, this year we had higher expenses during the quarter due to the extra week. As a result, operating income increased 5% to $354 million or 18.7% of sales. While our fourth quarter operating income result was solid, it was the low end of our expectations, largely due to higher than expected supply chain related costs including e-commerce fulfillment costs.

For the quarter, interest expense was $35 million, about $4 million higher than the fourth quarter of last year. This increase was primarily due to interest related to the extra week and higher interest rates during the quarter.

Excluding the onetime charges I discussed in my opening comments, the effective tax rate for Q4 was approximately 32% compared to 36.2% last year. The lower effective tax rate was a result of the benefits of our global sourcing initiative, which has lowered our consolidated effective tax rate. As we've previously discussed, our global sourcing operations give us more control over the manufacturing process and an opportunity to negotiate lower costs and deliver more value to our customers.

In addition, we realized benefit from a lower corporate tax rate for the month of January due to tax reform changes which resulted in a benefit of $6 million and we recognized $2 million of excess tax benefits associated with the adoption of the new accounting requirement related to the tax impact of share-based compensation.

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For the quarter, adjusted net income increased 11% to $218 million from adjusted net income of $196 million last year. Adjusted diluted earnings per share increased 24% to $1.19 compared to adjusted earnings diluted per share of $0.96 last year.

Now turning to the full year. Net sales increased 3% to $5.4 billion and comp sales increased 0.9% or 0.7% on a constant currency basis. For the full year, operating income increased 1% to $735 million or 13.7% of sales compared to adjusted operating income of $727 million or 14% of sales last year. As Chuck mentioned earlier, this year we generated approximately $46 million in sourcing savings from our first cost efforts, which helped to offset $38 million increase in incentive-based compensation and higher inventory shrink. Of note as we look to 2018, we expect to generate approximately $40 million in additional sourcing benefits.

Finally, adjusted net income for the year increased 4% to $405 million, compared to $390 million in fiscal 2016 and adjusted diluted EPS increased 15% to $2.17 per diluted common share, up from $1.88 per diluted common share in fiscal 2016.

Turning to the balance sheet. Total merchandise inventory was $1.1 billion, down $4 million from the end of 2016. Average inventory per Michaels store including e-commerce and distribution centers at the end of 2017 was 2% lower than at year-end last year.

At the end of the year, cash on the balance sheet was $426 million, total debt was $2.7 billion and revolver availability was $717 million. Total debt to adjusted EBITDA decreased to 3.1 times.

As it relates to capital allocation, our approach has not changed from what we outlined at our Analyst Day in June. Our strategy is to fund operations and investments including potential acquisitions and then to return excess free cash flow over time to shareholders through share repurchases, while targeting total debt of 2.5 to 3 times adjusted EBITDA.

In fiscal 2017, we generated free cash flow defined as cash flow from operations less capital expenditures of $396 million. Cash capital expenditures for the year were $128 million. For the full year, we purchased 13 million shares of our common stock or approximately $249 million. At the end of the year, we had approximately $350 million left under our current repurchase authorization.

Reflecting our commitment to investing in businesses with sales and profit growth potential, we plan to close 94 free-standing Aaron Brothers stores and reposition Aaron Brothers as a store within a store within all Michaels stores providing custom framing services. Aaron Brothers is a respected brand. The comp sales have been challenging for multiple years. For reference, net sales for Aaron Brothers is approximately $110 million and operating income was approximately breakeven in 2017. The business was on track to be unprofitable in 2018 and continuing to operate the stores would require significant infrastructure investment.

We expect the after-tax cost of implementing these changes will be in the range of $37 million to $42 million, driven primarily by expense associated with the remaining lease obligations. We expect the vast majority of the costs will be recognized in the first quarter of fiscal 2018. We expect the after-tax cash impact of the changes to be minimal.

The benefits of tax reform provide a unique opportunity to accelerate key initiatives to support our long-term profitable growth. The reduction in corporate tax rate equates to a total of 2018 net income benefit of between $50 million and $55 million, of which we expect to flow through about two-thirds to net income.

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We have decided to proactively reinvest the remainder into the business to drive longer-term benefits, which in the near term will pressure 2018 operating margins by 40 basis point to 50 basis points. We expect the timing of the spend will be weighted more towards the first half of the year, so that we are well-positioned for the holiday season.

As Chuck mentioned earlier, our investments include converting approximately 235 additional stores to our FMA [ph] layout, bringing e-commerce fulfillment in-house, strengthening our data analytics and enhancing the customer experience in-store and online. With that as context, let me walk you through our fiscal 2018 guidance.

As a reminder, fiscal 2018 will have 52 weeks versus 53 weeks in fiscal 2017. Also, our 2018 guidance assumes the Aaron Brothers stores were closed as of the start of the fiscal year and excludes any restructuring charges. For fiscal 2018, we expect total sales will be between $5.2 billion and $5.3 billion and comp-store sales will be flat to up 1.5%. This guidance includes our plans to open 19 new Michaels stores and relocate 17 Michaels stores.

Operating income for the year is expected to be between $677 million and $710 million. This guidance includes a temporary headwind of $23 million of investment facilitated by the tax reform benefits I just discussed and $10 million to $15 million of increased transportation costs. Excluding these two items, on a 52-week basis, the implied operating income growth at the upper end of our guidance range would be about 5%, in line with the longer-term operating income growth guidance we provided at our Investor Day last June.

We expect interest expense will be approximately $144 million, reflecting the expectation of three additional rate increases as implied by the current LIBOR curve. Today, most of our debt is impacted by rising interest rates. Given the current rate environment and expectations for rate increases, we'll be looking at how we can create a more balanced mix of fixed and floating debt. We'll share more information with you on our progress as appropriate.

Our earnings outlook assumes an effective tax rate of approximately 24% for the year, reflecting the full benefit of a lower corporate tax rate. I would note that the cash benefit from the lower corporate tax rate will be realized in 2019 as we defer a majority of our cash tax payments from the current year to May of the following year, a practice commonly known as the annualized income installment method.

These assumptions translate to an adjusted diluted EPS range of $2.19 to $2.32 for fiscal 2018 on approximately 185 million diluted weighted average common shares for the full year. This range represents an increase of 5% to 12% when adjusted for Aaron Brothers store closings and compared to adjusted earnings per share of $2.08 [ph] for fiscal 2018 on a 52-week basis. As a reminder, this guidance does not include any potential stock repurchases or debt paydowns.

Our fiscal 2018 capital expenditure plan is to invest $160 million to $170 million, which is at the higher end of our longer-term guidance for CapEx of around 2% to 3% of sales. Turning to Q1, we expect total sales will be between $1.14 billion and $1.15 billion, and comp store sales will be flat to up 1%.

As a reminder, Easter is earlier in 2018 than in 2017, which results in a shorter selling season and is a sales headwind for us. We plan to open eight net new Michaels stores and relocate nine stores in the quarter. For comparison purposes, in Q1 last year, we opened three new Michaels stores and relocated seven stores.

We expect operating income for the first quarter will be between $121 million and $127 million. This guidance includes the expectation of a higher supply chain cost, higher occupancy costs reflecting the timing of new stores and modest expense de-leverage resulting from our investment agenda, partially offset by sourcing benefits.

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Our Q1 guidance for adjusted diluted earnings per common share is $0.36 to $0.38, assuming a diluted weighted average common share count of 184 million shares.

In closing, in 2017, we made meaningful progress against all of our objectives and delivered another year of solid performance. In 2018, we intend to build on this foundation and accelerate key initiatives which we are confident will position us to drive profitable growth over the longer-term.

Now I would like to open up the call to take your questions. Operator?

QUESTION AND ANSWER SECTION

Operator: We will now begin the question-and-answer session. [Operator Instructions] Please limit yourself to one question. If you have additional questions, you may re-enter the question queue. At this time, we will pause momentarily to assemble our roster. The first question comes from Steven Forbes with Guggenheim Securities. Please go ahead.

Steve Forbes

Q

Good morning.

Carl S. Rubin

Chairman & Chief Executive Officer, Michaels Cos., Inc.

A

Good morning, Steve.

Steve Forbes

Q

Maybe to start here, can you provide some additional color around the comp guidance? I guess as I think about it, a couple things come to mind, right? You think about the FMA [ph] format conversions, is that a potential headwind to the comp profile, given any disruption? Are you assuming that you capture a transfer of revenue from the Aaron Brother store closures, right? I mean, the e-commerce channel is still performing really well. I mean, all these things could be potential drivers. I guess just curious about your thoughts about the underlying performance of the business given the implied comp guide and these likely tailwinds that you have in 2018.

Carl S. Rubin

Chairman & Chief Executive Officer, Michaels Cos., Inc.

A

Steve, I think there's some headwinds and tailwinds. So you talked about the FMA [ph] . We don't see that as an overall headwind for the year, and in fact, in the back-half of the year, it should be a tailwind.

The Aaron Brothers component of it, on the one hand, we expect that we're going to be able to capture some of the business from Aaron Brothers in Michaels stores. We're certainly going to target those Aaron Brothers customers. At the same time, we have to liquidate inventory. That's starting today in those Aaron Brothers stores, so there's a tailwind and then there's a headwind as well.

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You've got other situations. You've got the Toys 'R' Us liquidation. We're not heavily in the toy business necessarily, but we have a good-sized kids business that does have some degree of overlap.

Underlying all of it though is when you break out our business, we continue to do very well with our seasonal product. It's a much wider playing field. Everybody from home improvement to discount to Michaels plays in that arena, and we're doing very, very well with that.

When it comes to the core arts and crafts business though, as we've talked before, there's no great third-party data to track this, but all the data that we can put together, and there are pieces that we have to compile together, would suggest that the industry as a whole right now is flattish.

So when you throw all that together – and then as many of you on the call today coming from the Northeast, clearly the Northeast has had more than its fair share of weather problems in this first quarter – when you throw it all together, we believe that it was wise to take this kind of view on comp. We planned our expense structure to this conservative view, and we're working to make it better than this. But at this early stage, given all those dynamics, we thought it was wiser to be conservative.

Steve Forbes

Q

Thank you for the color. I'll get back in the queue.

Carl S. Rubin
Chairman & Chief Executive Officer, Michaels Cos., Inc.

A

Thank you.

Operator: The next question comes from Christopher Horvers with JPMorgan. Please go ahead.

Chris Horvers

Q

Thanks. Good morning.

Carl S. Rubin
Chairman & Chief Executive Officer, Michaels Cos., Inc.

A

Good morning, Chris.

Chris Horvers

Q

Can you talk about cash? At this morning's stock price, $426 million on that stock price is in teens, low-teens relative to the market cap. You didn't buy back any shares, or no material shares in the fourth quarter. Why? Does any of that have to do with a potential debt refinancing as you look to lock in some fixed rates? And any thoughts about how you plan to deploy the cash going forward, more than just the normal sort of here's our capital allocation priorities, if I can front-run your answer?

Carl S. Rubin
Chairman & Chief Executive Officer, Michaels Cos., Inc.

A

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You may be disappointed, Chris, but.

Denise Paulonis

A

Yes, Chris, I don't think that our – our strategy really has not changed since what we discussed at Analyst Day in June. We view being disciplined with our cash as a high priority for us, and we have a focus on returning capital to shareholders while we prudently manage the balance sheet. So when we think about what we do, we focus on investing in the business and strategic acquisitions that might drive growth, and then think about how to return capital through either share repurchases or debt paydowns. We haven't changed that. When we think about buyback activity in a given quarter, it's impacted by both our ability and willingness to execute the buybacks at a given time, and a lot of factors can influence that. We want to maintain flexibility right now, and our overall approach to capital allocation hasn't changed.

Chris Horvers

Q

So was there 10b5-1 in place to where the stock ran above that and that limited the a ability to buy?

[0FH8Y5-E Denise Paulonis]

A

I don't think we can comment on that now. I'd just say our overall approach hasn't changed.

Chris Horvers

Q

Understood. Thanks very much.

A

Thank you, Chris.

Operator: The next question comes from Simeon Gutman with Morgan Stanley. Please go ahead.

Joshua Siber

Q

Good morning. It's Joshua Siber on for Simeon. I'm curious. the investments that you outlined, they tend to be longer tailed for most retailers. Can you talk about the timeframe for some these initiatives and when they roll and whether or not they roll off in 2019?

A

Well, the FMA ph pads will be put in place in the latter part of Q2. So there's work going on now for those, but the significant impact is in Q2. The supply-chain work to bring e-commerce fulfillment in-house from our third-party provider, a lot of that work runs through you the year but, as Denise said, most of the spending that we're going to be doing is in the front half of the year. Like most retailers we try to limit a lot of extraneous activity in the back half

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of the year as we focus on sales. The work on the supply chain to bring e-commerce fulfillment in-house, while that work is taking place this year, the actual in-sourcing won't fully take effect until next year. As far as the analytical investments that we're making, here again, that's happening. That's mostly front loaded in the front half of the year, although there will be some trickle to that in the back half.

Joshua Siber

Q

Okay. Thank you.

Operator: The next question comes from Seth Sigman with Credit Suisse. Please go ahead.

Seth Sigman

Q

Thanks a lot. Good morning. I want to talk a little about the Custom Framing business. So it was obviously nice to see that improvement this quarter. Can you elaborate a little bit more on what do you think is driving that improvement? And also, remind us, how has that category performed, I guess, on a full year basis? Obviously, it was better in the fourth quarter, but it was a drag, I think, prior to that. Just as we're trying to assess the opportunity in 2018. Thank you.

A

Well, as you said, it was better in the fourth quarter. It was, overall for the company, a drag in 2017. This is a radically different operating model than the rest of the store. So remember, in the rest of a Michaels store, just to make the math somewhat simplified, we do about $4 million per store. The average item we sell sells for about $4. So there's a million units of product that have got to be moved through a store. There's a lot of operational work that goes into running a Michaels store. The custom frame counter, though, is a true selling environment. And it's a different approach. It's a different time span that you spend with a customer.

So the progress that we made – we've done a lot of things but one of the most exciting things that we've seen is the Aaron Brothers selling model was a bit different than what we had in the Michaels store, and we leveraged that, and we've put in a different management model. So again, to simplify this a bit, we've got kind of a district management staff focused only on the custom frame counter. There's a lot of role-playing that goes on between that new management staff and the teams within the individual Michaels store. There's a lot of additional training that's provided to them.

So we think the progress that we're seeing is through – while a result of many things, it's largely driven by just an improved experience between our own certified custom framer and the customer through this changed selling model that we put in place and we've expanded that management model into the Michaels stores such that about 50% of our sales volume in Custom Frame this year will be working under this new selling model.

Seth Sigman

Q

Okay. Thank you.

Operator: The next question comes from Matt Fassler with Goldman Sachs. Please go ahead.

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Matt Fassler

Q

Thanks a lot. Good morning.

A

Hi, Matt.

Matt Fassler

Q

Good morning. Can you talk about the consequences of the growing loyalty program and the data capture, both what you've been able to achieve so far commercially and with the additional investment that you said you're going to make in 2018, what kind of outcomes you're hoping for?

A

Well, all along we've talked about that this is a really long process. There's a tremendous amount of data, and we've made good progress on leveraging that data. So we saw in 2017 really good scan margin, or what we call our product margin improvements and a lot of that was driven through our sourcing effort but we've made continued progress on managing our discounts better, such that we're able to send different discount levels to different customers based on the historical profile. And our prepared comments, we talked about one enhancement to our new POS system where we can put out a serialized coupon. Up to this point when we put a coupon out there, it's the same coupon. If somebody wanted to share it with their friend, then they could. Serialized coupons are onetime use coupons. So we've made good progress on targeting different discount levels to individual customers.

But we have a lot of data in analyzing that data like other companies, it becomes an ocean of data to work through. So leveraging additional technology, leveraging additional resources, the ability to target discounts, the ability to target marketing communications, the ability to glean additional merchandise insights out of what people are buying already, whether that's things around color or size of an item, those are all things that we get really excited about. But we've talked to you and we talked to others about this. This is running on the trajectory that we believed it would.

When previously asked about where we were in this game of analytics, I said we were in the very early innings. We're still in the second innings, in the second inning but we've made progress. I'm pleased with the progress we've made but we've got to become more sophisticated. And 2018 is one step along the way. I promise you that in years to come there'll be additional enhancements to be made on these analytics.

Matt Fassler

Q

Is there a third-party module that you're importing in 2018 or is it more of an incremental iterative change over time?

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Carl S. Rubin
Chairman & Chief Executive Officer, Michaels Cos., Inc.

A

We're using third parties to help us as well as internal resources, combination.

Matt Fassler

Q

Thank you so much, guys.

Operator: The next question comes from Curtis Nagle with Bank of America. Please the go ahead.

Q

Hi. Actually this is Liz Sue [ph] from BofA. So the expansion of your fabric offerings online is actually a pretty interesting development especially since traditionally I think this is a category that many have considered to be pretty difficult to do online. It's tactile. The weight and feel is very important. So what have you found in your analysis of this category that led you to the decision to expand your fabric program online?

Carl S. Rubin
Chairman & Chief Executive Officer, Michaels Cos., Inc.

A

Well, it's a low risk, low investment offering that we can put out there. We put – so remember, we have a division of stores in the upper Midwest called Pat Catan, a small division, about 35, 36 stores. They're larger footprint stores and last year we put fabric into those stores. And what we've discovered is that the selling on the fabric and the notions that go with fabric in the Pat Catan stores is pretty good. Now it's lower productivity than a Michaels store is, so that it's unlikely that you're going to see a big fabric presentation in Michaels stores, although we are testing a couple of interesting models. That's very much in a test mode.

But we viewed being able to sell fabric online and leveraging that Pat Catan backend and leveraging the Hancock fabric name that we purchased, I don't know, about 24 months ago I guess, we viewed this as an interesting combination to play in an area that we are not a player in today. We have very realistic expectations on the financial results. I don't see this as being at least initially not a huge sales mover, but we know our customer has looked to us to provide fabric in this arena. So we're going to test this and see what we can do. As I say, it's low risk, low investment on our side.

Q

Sounds good. Thanks.

Operator: The next question comes from Cham Pon [ph] with Loop Capital. Please go ahead.

Laura Champine

Q

Good morning. It's Laura Champine. Thanks for taking my call. Could you quantify the headwind from the earlier Easter because your Q1 comp guidance just looks very conservative, given the momentum you had coming out of

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Q4. So is there anything we might not understand happening in your sales trend quarter to date? And if you can quantify that Easter head headwind, that would be great. Thanks.

Carl S. Rubin
Chairman & Chief Executive Officer, Michaels Cos., Inc.

A

Yes. We're not going to quantify the Easter headwind, but Easter is two weeks earlier. An earlier Easter is not good for us. The guidance that we gave reflects the things that I commented on before. It's a recognition that the Northeast is on its fourth nor'easter. And like many retailers, our northeastern stores tend to be higher volume, so we've had that impact. You've got a lot of things in the marketplace. You've got Toys R Us liquidation. But most importantly, when you look at our seasonal business which has been so good for us, the first quarter seasonal is a smaller percent of our overall revenue and, with Easter being earlier, it's an even smaller percent of our overall revenue. Then when you look at the balance of our Craft business, we think the industry, right now, is in a flattish kind of environment. So put all that together, and that's provided the – that's led to the guidance we provided. Denise?

[0FH8Y5-E Denise Paulonis]

A

And I'd add one more item. One choice we did make this year is every year we do a certain amount of product resets or changes in our stores. We, last year, did more of that in Q1 and, this year, we are doing a bit more of that in Q2. It was really an effort to balance more of the workload for our team members in our stores and be able to be a bit more efficient in our stores, but that delay in a bit of the newness coming in for the customer is also reflected in how we thought about Q1.

Laura Champine

Q

Got it. Thank you.

Operator: The next question comes from Cristina Fernandez with Telsey Advisory Group. Please go ahead.

Cristina Fernandez

Q

Hi. Good morning. I wanted to ask about the promotional landscape. I know you talked that you were able to be more efficient in lower promotions. So what are you seeing from your peers? And what is your expectations over the course of 2018?

A

As we've talked before, Christina, this industry is a portfolio of businesses, and we compete with everybody. So people sometimes look at us in the pure-play perspective of us and Joanne's and A.C. Moore and Hobby Lobby. We compete with Walmart and Amazon and Target and the dollar stores, and now you've got home improvement expanding into pieces of what we do as well. It's a very promotional environment. There's no doubt about it. It's high- margin, low-price-point kinds of stuff, and the promotional environment continues to be intense. We don't see it changing, and the number of distribution points, if anything, will increase in 2018 compared to 2017. So we're pleased that we're getting smarter in how we use our discount dollars, but we're continuing to be aggressive in the promotion, and we planned for that this year as well.

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[0FH8Y5-E Denise Paulonis]

A

Phil [ph] , I think we have time for one more question.

Operator: Okay. Yes. The next question comes from Mike Baker with Deutsche Bank. Please go ahead.

Mike Baker

Q

Hi. Thanks. A question on some of the reinvestment math, and maybe it's one question in three parts. But so you said a third of the $50 million to $55 million in tax savings will be reinvested, so that's $17 million or $18 million at the midpoint, which is 30, 33 basis points. You said 40 to 50 basis points. I presume that that includes the transportation-cost part of it, that 40 to 50 basis points.

[0FH8Y5-E Denise Paulonis]

A

No, Mike, I think it's a difference of if you're using 52- versus 53-week in the prior year and what the operating income rate would be. I think the key for you to think about is it's $23 million of incremental expense dollars that we're investing pre-tax.

A

Okay. That makes sense. And then CapEx is also up about the midpoint $30 million, $35 million. Is that step up, I presume a lot after that is going to some of these initiatives you're talking about accelerating because of the tax wind fall, is that fair?

Mike Baker

Q

Okay. Yes. That extra week, that's probably it. That makes sense. And then CapEx is also up about the midpoint $30 million, $35 million. Is that step up, I mean I presume that a lot of that is going to some of these initiatives that you're talking about accelerating because of the tax windfall? Is that fair?

[0FH8Y5-E Denise Paulonis]

A

Some of it is certainly helping to support that. When you think about us bringing e-commerce fulfillment in-house, there will be capital costs associated with doing that that are both physical costs as well as IT costs. There was also some natural cadence in how we were just planning some regular investment coming through as we continue to evolve our digital capabilities and those types of activities. We are a little bit more elevated this year as well.

Mike Baker

Q

Okay.

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[0FH8Y5-E Denise Paulonis]

A

The other part to remember is that in Canada we are rolling out POS this year and investing in our stores behind that.

Mike Baker

Q

That makes sense. Third part of the same question. In the reinvestments, you didn't really mention anything about labor or wages. I presume you think your labor and wage rates are consistent with industry standards, but a lot of retailers have talked about increases there. Do you feel like there will be any pressure on margins by needing to do that as well?

A

I think in the near term, Mike, we feel good. So we've made investments in our team. We continue to make investments in our team. They're reflected in the numbers that we guided on this morning, and we're generally pleased with where we are. I mention we had incredibly high engagement. We do a company-wide engagement survey every year. We had the highest engagement maybe ever, but certainly that I recall. We've got low turnover amongst our team members. So we continue to invest to present both a good work environment and a good compensation scenario for our team, and we'll continue to do that.

Mike Baker

Q

Okay. That's helpful. Thank you for the color.

A

Thank you.

Operator: Okay. This concludes the question-and-answer session. I would like to turn the conference back over to Kiley Rawlins for any closing remarks.

Kiley F. Rawlins

Vice President - Investor Relations & Communications, The Michaels Cos., Inc.

Thank, Phil [ph] . Thank you, everyone, for joining us today. I know we didn't get to every question in the queue. As always, I will be available this week and the next couple of weeks for any follow-up questions. Again, thank you for your continued interest in The Michaels Companies.

Operator: The conference has now concluded. Thank you for attending today's presentation. You may now disconnect.

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