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Q3 2018 Childrens Place Inc Earnings Call

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PRESENTATION

Operator

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

The Children's Place issued its third quarter 2018 earnings press release earlier this morning, and the 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 in the company's SEC filings, including the Risk Factors section of the company's annual report on Form 10-K for its most recent fiscal year. These forward-looking statements involve risks and uncertainties that could cause actual results to differ materially. The company undertakes no obligation to publicly release any revision to 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 our 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, President of Global Product & Director***

Thank you, Lori, and good morning, everybody. After briefly reviewing Q3 highlights, I will focus my remarks on our progress with respect to our accelerated digital transformation initiatives with the goal of gaining additional market share. I will detail the significant upside that we expect customer personalization will deliver over both the short and long term, including an update on the value of acquiring, retaining and engaging customers. I will also discuss the opportunity we have to continue to accelerate market share gains in both the short and long term as we continue to see consolidation in the retail sector. I will then hand it over to Mike, who will discuss progress on our alternate channels of distribution and fleet optimization initiatives as well as share our strategies with respect to some of the current headwinds facing the retail industry. Mike will also cover our Q3 results in detail and provide our forward outlook before passing it back for closing comments. Following our prepared remarks, we will open it up for your questions.

Q3 highlights. EPS was at the high end of our guided range for the quarter. Our top line momentum continued, and we delivered an industry-leading positive 9.5% comp on top of a positive 5.1% comp last year. Our strong results were driven by a 38% increase in our digital sales, which represented 29% of our net sales in the quarter. Margin results were impacted by another quarter of record-setting e-commerce growth and our strategic focus on additional market share gains. As we reiterated in the beginning of the year, there are significant market share opportunities as the competitive landscape continues to shrink, and we intend to stay focused on aggressively pursuing them. Even with our focus on market share gains and our significant investment in our digital transformation strategy, ROIC increased 320 basis points in the quarter to 22.8%, which we believe places us firmly at or near the top of our retail peer group.

Product. Product is and has always been our #1 strategic priority, and our product is clearly resonating with our customer. Our back-to-school sales were outstanding, and we delivered one of our strongest tax-free holiday results ever, driven by our strong product and strategic inventory positioning in key back-to-school categories. We saw strength in wear now product across categories in Q3, and we comped positive every month of the quarter. Our strategic focus on extended sizes paid off, with strength across both apparels and accessories.

Market share opportunities. Gymboree. We continue to believe we are the best positioned retailer to gain market share from Gymboree. Based on recent news, we are anticipating a near-term sales and margin impact. We have targeted $100 million market share opportunity from Gymboree, inclusive of the $30 million opportunity we have detailed from the stores they have already closed. We continue to monitor the situation and look forward to providing investors with any update news.

Moving on to Sears and Kmart. Recent reports suggest that Sears plans to reorganize as it negotiates with major stakeholders and liquidations and assets sales are planned. We are co-located with over 1/3 of the 687 Sear stores that were opened as of the news of the bankruptcy filing. Sears and Kmart combined still generate meaningful sales in the children's apparel category. We internally estimate that Sears, Kmart and Bon-Ton will also close its remaining 260 locations may have generated between $425 million and $475 million in children's apparel volume over the last 12 months.

Looking at longer-term market share. As we strategically outlined the market share opportunities we are targeting from select competitors, we'd like to point out that these select competitors are a smaller slice of a much larger pie of share-donating retailers. We estimate the market share opportunity from this collective group is large, possibly 5 to 10x as large as a single player, like Gymboree or Sears. Collectively, we anticipate this group of capital-constrained and/or poorly positioned retailers will continue to consolidate, and if we continue to successfully execute on our strategy and take a long-term view, the current market presents us with significant and ongoing market share opportunities. We don't think of the recent bankruptcies as isolated events that will shift to the rearview mirror. Rather, we consider these events to be part of a longer term and significant shift in the competitive kids wear landscape. We see market share gains as an annuity that is anticipated to live long beyond any single troubled competitor.

Moving on to digital transformation. Let's review our progress on our digital transformation initiatives in Q3 and share with you what we're working on for Q4 and beyond. Our digital business was outstanding in Q3. We delivered a 38% growth in the quarter and continue to provide our millennial mom with a stronger omnichannel offering. E-comm penetration increased 650 basis points to 29% of net sales in Q3 versus a year ago. We delivered a 40% sales increase in our U.S. digital channel for the quarter, and our outsized digital growth is fueling our loyalty and private-label credit card programs, which are key to our digital transformation. The significant momentum we're seeing in our digital business gives us continued confidence in achieving a mid-30s digital penetration rate by 2020. Following a successful rollout of BOPIS in U.S. in Q3 2017, we rolled out BOPIS in Canada in Q3. Our mobile POS penetration in stores continues to increase with 30% of eligible transactions performed on a mobile device in Q3. Mobile POS has a 14% higher UPT and a 19% higher ADS than wired POS. So we're excited about the increased utilization we're experiencing so far.

For the fourth quarter, our plan is to continue to work on our new state-of-the-art pricing and promotional systems that will enable us to deliver personalized offers to mom in whichever channel she prefers to shop. We will also continue to work on our new state-of-the-art royalty system that will deliver real-time personalized communication and promotion. Foundational improvements to our e-commerce platform that will allow us to scale our digital business in line with our strategy and improved site responsiveness and provide a more frictionless experience, personalized SMS delivery and BOSS or Buy Online, Ship to Store, lifetime value of the customer today and lifetime value of the discount today. We've been asked how our near-term capital and margin investments provide long-term value to TCP and its shareholders. Our seasoned management team appreciates that there are near-term margin pressures that come along with competing to win the customer today. However, we have a deep analytical understanding of the likely long-term benefits associated with acquiring and retaining customers into our omnichannel ecosystem. So let me share with you why we are so strategically focused on customer acquisition and retention.

100% of our customers eventually grow out of our product, so it's imperative that we acquire new customers into our brand, while at the same time, increasing engagement and retention with our current customer base. We have an experienced data analytics team, which provides us with the information that allows us to make strategic, data-driven decisions to increase our acquisition and retention rates. Last quarter, I shared with you that 22% of our customer file was comprised of online and omnichannel customers, and this group represented 39% of our sales, which underscored the value of securing and matriculating customers into our omnichannel ecosystem. As of Q3, 24% of our customer file is now comprised of online and omnichannel customers and this group now represents 42% of our sales. We are making significant progress driving more of our customers to join our omnichannel ranks and spend more year-on-year as they make this transition. Our digital transformation efforts are paying off with respect to our customer file as well. Our customer file is up 5% to over 12 million, and our online customer file was up an impressive 22% in Q3, which provides us with increased visibility into future sales.

So let's walk through how these new customers add value over time. Even at an initial discount, adding a new customer and then moving them up the funnel into higher-spending tiers is anticipated to have a significant impact on our future sales and margin. We now have a data infused understanding of spend and lifetime value for our customers at different spending tiers. And although we are very early in our process, our customers are moving into higher-spending tiers at a rate above our initial expectations. Our highest value customers continue to generate 15x more value than that of new or infrequent customers. Importantly, we now know that an incremental discount provided to a new or infrequent customer today has the potential to yield nearly 50x the value of that discount in sales over the next 2 years.

Further, omnichannel customers and customers moving into higher spending tiers are much less likely to churn compared to single channel or infrequent customers, which suggests a built-in loyalty versus simply a transactional relationship based on price. We anticipate that our data-driven personalization initiatives and lower cost fulfillment options, such as BOPIS and BOSS, will work together over time to enhance the profitability of our omnichannel customers. We have the team and the tools in place, and we have now segmented our customers at very low levels. And based on these subsegments, we are now using predictive modeling to test personalized offers and strategies to drive retention and engagement. Curated offers personalized to the needs of mom is anticipated to have a significant impact on our digital conversion rate or the measure of how much of our digital traffic converts to sales. Further, it will reduce the expense inherent in sending nonrelevant marketing to customers and help us to further optimize our total marketing spend. We anticipate this conversion benefit will be significant as 1 point of incremental conversion today yields approximately $75 million in incremental digital revenue annually. Further, personalization will offer a significant benefit to conversions in our brick-and-mortar channel. As we have shared many times before, our digital transformation is the last piece of our strategic transformation, and the early results are very compelling. They are the reason we're so urgently focused on customer acquisition, personalization and market share gains, particularly in the current environment where significant market share opportunities are presenting themselves more frequently.

And finally, an update on our private-label credit card performance. As you all know, our private-label credit card strategy is foundational to our digital transformation strategy. In Q3, our private label credit card penetration continued to increase with penetration up 200 basis points to 25% of sales from 23% last year, and our private-label credit card file increased 20% versus last year. New credit applications in Q3 increased 15%, with e-com applications up a staggering 41%. And approximately half of our new private-label credit card applicants are new customers to our brands. Together with our providers, we continue to believe that based on our unique business model and our laser-like focus on this initiative, we will achieve 30% private-label credit card penetration by 2020.

Now I'll turn it over to Mike.

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

Thank you, Jane, and good morning, everyone. Today, I will provide an update on our China and Amazon growth initiatives, update you on our fleet optimization strategy and provide our insight into how the news on tariffs and labor impacts The Children's Place before moving on to our financial results.

China. Our China growth strategy through our strategic partnership with Semir is progressing well, and we remain excited about the open runway for growth in this key strategic market. We opened 2 stores in Shanghai in the third quarter and have 3 additional openings planned for the remainder of 2018. On Tmall, we transitioned our Tmall flagship to Semir at the end of July and Semir has expanded these assortment of product available on the site over the past few months. We are also working closely with Semir on localizing the product assortment, which is critical to success in China. Several of the styles our designed teams have collaborated on are already top sellers in the market. We continue to anticipate that our partnership will result in approximately 300 points of distribution and generate between $125 million and $150 million in retail sales by year 5.

Amazon. We continue to see nice increases in our Amazon business with third quarter sales up nearly 40% versus last year's comparable period. This growth is of a low base, but we thought we'd offer a window into the trend in the business for those trying to understand the health of the relationship. As discussed before, replenishment has been a big driver of sales growth on Amazon as we continue to increase our product offerings on the platform. So all is positive on the Amazon front.

Fleet optimization. We have over 1,000 lease events occurring over the next 3 years, which provides us maximum flexibility to continue to optimize our fleet. We closed 4 additional locations in the quarter and expect to close approximately 45 by year-end. This leaves an additional 86 closings to go as we work toward our plan to close 300 locations by the end of 2020. We continue to model our fleet optimization program to contribute 200 basis points of operating margin in total when completed, with over half that amount already realized.

Tariffs. There has been a lot of discussion regarding how the announced China tariffs on select accessories will impact us in 2019. As a result of our diversified sourcing base, we see only nominal risk from the tariffs announced on September 17. Recall this tranche of product included items like backpacks, fashion bags, lunch bags and hats where we have modest exposure. As a reminder, when Jane first arrived at The Children's Place, over 40% of our product was sourced in China. We have recently indicated that our exposure is currently in the mid-teens, and we anticipate that we'll only have mid-single digit exposure to Chinese sourcing by 2021. Therefore, we believe we have much less exposure than many of our competitors to Chinese tariffs, which should provide another competitive advantage. Including the tariffs on select items from China implemented to date, we project that our apparel AUCs for the first half of 2019 will be down low-single digits versus last year, and we have no intention at this point of raising any of our prices for 2019.

Moving on to labor. We've been asked about labor pressure. In our stores, the team has set a good job managing wage pressure across our fleet as we continue to tweak both senses and associate structure. As a result, our overall wage increases are well below the national average for retailers. We have had no issues with seasonal hiring this holiday season in our stores. The same cannot be said for the labor situation at our distribution center. As you know, our U.S. business is serviced out of a single center in Fort Payne, Alabama. Over the past 12 months, as unemployment in Fort Payne has dropped almost in half to under 4%, we have been challenged to hire the seasonal labor needed to handle our rapid e-commerce growth and to satisfy the speed of delivery demands of our customers. This has added staffing and wage pressure on our distribution center with notable pressure occurring in the peak periods of back-to-school and the Christmas holiday season.

Now let me spend a few minutes discussing the fourth quarter fulfillment situation, and its impact on our P&L. Our digital business has far surpassed our initial expectations, and continues to show accelerating growth in the most recent quarters at 41% and 38%, respectively. The stronger-than-anticipated digital demand has forced us to accelerate the exposure of our brick-and-mortar inventories online and utilize our ship-from-store capabilities in order to meet our customer demand. Said in another way, the outsized growth of the digital business has caused low levels and stockouts of e-commerce inventory and has forced us to make brick-and-mortar inventory available to our digital customers online in order to meet their demand. Our capability to fulfill online orders from store inventory was tested during various points of the year with a handful of orders fulfilled by each store across the fleet. We had factored into our original plans the utilization of ship from store on approximately 2% of our digital demand in the quarter to help with the anticipated backlog in our distribution center and to ramp up our stores' capability for what would be the first significant utilization of ship from store in the back-to-school 2019 season. We now anticipate fulfilling close to 30% of our digital demand from our store inventory in the fourth quarter. This store fulfillment is close to 15x the volume we had anticipated when we last provided our full-year financial guidance.

These capabilities are clearly working for us. Based on our ability to expose brick-and-mortar inventory online, we continue to see significant increases in our digital channel in November, with the extended Thanksgiving holiday weekend of high-teens versus last year. And thus far in the quarter, we have successfully shipped over 2 million units from our stores. The fulfillment cost associated with ship from store and the fulfillment of store inventory carries a higher cost per unit than shipments made via our distribution center. We project the incremental fulfillment cost in the fourth quarter will be approximately $5 million above our previous guidance, primarily as a result of the utilization of ship from store. Although, we are incurring higher fulfillment costs this holiday season, it was necessary to may demand and to better service our customer through more complete and timely deliveries. Also as a result of exposing retail inventory across our digital platforms, we will be reducing potential stranded inventory, which is expected to help drive gross margins in Q1 of 2019. This capability also has a long-term impact on our supply chain. More to come on that.

I'll now provide an update on Q3 results and discuss our forward outlook. In Q3, we generated adjusted EPS of $3.07 compared to $2.58 last year. Our Q3 2018 adjusted EPS is impacted by $0.27 or $7 million of costs associated with our accelerated digital transformation spend.

Details for the third quarter are as follows. Net sales increased by $32 million or 6.6% to $522 million from $490 million last year. This increase was primarily driven by a positive comp retail sales increase of 9.5% and approximately $5 million due to the new revenue recognition rules, partially offset by a $14 million adverse impact from the calendar shift related to the 53rd week in fiscal 2017. U.S. comp sales increased 10.6% and Canada comp sales increased 1.6%. Comps were driven by strength in traffic, transactions and conversion.

Once again, e-commerce had a very strong revenue growth of 38%. For the quarter, e-commerce represented 29% of total net sales, up over 650 basis points from Q3 of '17. Retail comps were relatively flat in the quarter with low single digits traffic growth in Place stores, offset by a negative mid-single digit decline in outlet traffic. We experienced strong consolidated comp gains in each month of the quarter.

Gross margin. I'd like to now provide a little color on the factors driving the gross margin performance in Q3. Adjusted gross margins declined 220 basis points to 39.1% of sales from 41.3% in Q3 of 2017, as a result of stronger sales in e-commerce and our decision to compete aggressively for market share, partially offset by fixed cost leverage on better-than-expected comps and the reclassification of certain items due to the new revenue recognition rules. Additionally, the calendar shift associated with the 53rd week resulted in an adverse impact of 40 basis points.

Adjusted SG&A. Adjusted SG&A was $122 million versus $117 million last year and leveraged 60 basis points to 23.3% of sales. This was a result of fixed cost leverage based on the stronger-than-expected comps and lower incentive compensation expenses as a percent of sales, partially offset by $7 million of incremental digital transformation spend and the $5 million related to the reclassification of certain items due to the new revenue recognition rules. Adjusted depreciation and amortization was approximately $17 million in the quarter.

Adjusted operating income for Q3 '18 was $65.5 million or 12.5% of sales versus $68.4 million or 14% of sales in Q3 of 2017 as lower gross margins were partially offset by SG&A leverage.

Our adjusted tax rate in the quarter was 21.7% versus 31.6% last year, primarily as a result of the new tax legislation.

Moving on to the balance sheet. Our cash and short-term investments at the end of the quarter were $93 million compared to $273 million last year, reflecting the impact of $190 million in cash repatriated year-to-date, which was utilized to fund our accelerated share repurchase program and working capital. We ended the quarter with $65 million outstanding on our revolver compared to $56 million last year. Our inventory was up 4% at the end of Q3 2018, in line with our guidance. We are anticipating to exit Q4 with inventories flat to up low single digits, which will position us well as we move into Q1 2019.

Moving on to cash flow. We generated $83 million in cash flow from operating activities in the first 9 months of '18 compared to $130 million in the first 9 months of last year, primarily driven by the timing of inventory purchases. Capital expenditures in the quarter were $28 million, and 72% of our capital year-to-date has been dedicated to our transformation strategy. We repurchased $26 million of stock in Q3, which brings our year-to-date total to $213 million. We made dividend payments of approximately $8 million or $0.50 per share in Q3.

Now let me take you through our outlook for 2018. Full-year guidance. We now anticipate adjusted net income per diluted share to be in the range of $7.69 to $7.79 compared to our previous guidance of $8.09 to $8.29. This compares to 2017 adjusted net income per diluted share of $7.91. Our 2018 EPS includes $1.24 or approximately $30 million in costs associated with our accelerated digital spend. The company now expects total net sales for the year to be in the range of $1.955 billion to $1.960 billion. This guidance assumes a positive mid-single digit comp retail sales increase. We project digital penetration to grow from 23% to 27% of net sales. The company expects adjusted operating margins to be in the range of 7.7% to 7.8%. The updated margin outlook reflects $5 million in higher fulfillment expenses to support stronger demand in our digital channels and ship from store activities during the fourth quarter. Additionally, the outlook takes into account the potential margin impact of increased competitiveness in light of possible liquidation events and as the industry attempts to secure market share abandoned by distressed competitors. We expect our adjusted tax rate to be approximately 13% for the year as compared to 19.6% in 2017 as a result of the new tax legislation and ongoing tax planning initiatives. We expect weighted average shares for 2018 to be approximately 16.8 million shares. Our capital expenditures are expected to be approximately $70 million to $75 million for the year.

Q4 2018 outlook. The company expects adjusted net income per diluted share in the fourth quarter of 2018 to be in the range of $2.07 to $2.17. This compares to adjusted net income per diluted shares of $2.52 in fiscal 2017. Total net sales in the fourth quarter of 2018 is projected to be in the range of $547 million to $552 million. This guidance assumes a positive low single digit comparable retail sales increase. Adjusted operating margins are anticipated to be in the range of 8.1% to 8.4% for the fourth quarter of 2018. Depreciation and amortization expense will be approximately $17 million.

Our long-term outlook. In 2019, we expect to make significant progress toward our 2020 operating margin goal of 12% from our guided 7.7% to 7.8% range in 2018.

The recent competitive news may have a meaningful influence on our 2019 outlook, so we look forward to updating you in March during our Q4 earnings release.

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

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

Thanks, Mike. Our results show that we are clearly separating ourselves from the competition, many of which are lacking in strategy and/or struggling to make the investments necessary to compete in an omnichannel world. Almost a decade ago, we made the strategic decision to diversify manufacturing away from China, while others chose to stay. 6 years ago, we made the decision to launch a fleet optimization initiative and close underperforming stores and renegotiate the balance of our portfolio, while others focused on opening stores.

Years ago, we pursued a partnership with Amazon, while others chose to compete. And this year, we took 2 more bold strategic steps knowing that the returns of both will be measured in quarters and years, not months. First, we accelerated $50 million of incremental digital transformation spend with the goal of gaining additional market share through personalization. Second, we strategically invested in margin to take market share from struggling competitors and to build our customer database. A customer lost today is a customer gained across the street, and if we have the strategy to secure that customer today, it will make it very difficult to do business across the street in the years ahead.

We are managing our business for sustained growth, and we are very proud of what we've accomplished over the past several years. We hope our commentary helps dimensionalize the opportunity that lies ahead following our strategic margin and incrementally SG&A investments in 2018. Our strategy is firmly in place with a more efficient and agile management structure as we transform to a next-generation omnichannel retailer. With most of the heavy lifting behind us, we're excited about the opportunity ahead and look forward to updating you on our progress in early 2019.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Your first question comes from the line of Susan Anderson of B. Riley FBR.

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

I was wondering if maybe you can give some more color on the gross margin, just kind of the bigger driver. Was it -- was the lower gross margin the big driver from the shift to e-commerce? Or was it more promoting to gain market share? And then, I guess, on the impact from the ship from store, is it something that maybe you can reduce going forward as you become more efficient? Or is this going to be an ongoing pressure point? And then I think you mentioned some longer-term impacts on the supply chain, maybe if you could give some more color on what those changes would be and the positive or negative impacts?

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

Susan, it's Mike. Let's start with gross margin. As we've discussed in the past, we're thinking more in terms of operating margin than gross margin especially as our business continues to transform to omnichannel. During the quarter and during the last 2 years, 3 years, we've seen rapid growth of our digital penetration and thus, our gross margins and SG&A comparisons become less relevant. But that all being said, we did report a gross margin decline of about 220 basis points in the quarter. Our e-comm sales grew 38% on a total sales increase of 6.6%, so you can see that penetration grew to almost 29% of sales, up 650 basis points. That accounted for a little more than half of the deleverage in the quarter. When we look at -- when we talk about aggressively going and competing for market share, that accounted for a little -- slightly less than half the amount. As I looked at all the fixed costs that are part of the gross margins, the fulfillment costs, the occupancy costs, the new revenue recognition rules and inventory capitalization costs, they basically netted out to 0. So the 2 big impacts were penetration more than one-half and competing for market share slightly less than half. When we look at ship from store, obviously, we weren't planning to do this amount. So from an efficiency perspective, we have -- we're still learning. When we look at the pressure points where we will be utilizing ship from store, it's really around the back-to-school period and the holiday period, where our DC runs into some capacity issues. So overall, we're still learning a lot. Our -- we anticipate that we're going to drive efficiency through it and obviously, this was a little bit of a good news and a surprise, thus in terms of the utilization, we're pleased that our stores are able to ramp up and ship the amount that they're shipping. So our sense is that, we'll plan forward in '19 and '20 as we give you our forward-looking guidance, and so it'll all be incorporated in what we do. So supply chain, obviously, we've talked about some of the investment we're making this year in terms of supply chain, and we're working with outside advisers to analyze our supply chain in terms of distribution centers, what's the potential in terms of e-comm growth, what impact does that going to have on our distribution center, what does that mean from a go-forward perspective as these units continue to grow when we reach peak periods of back-to-school and holiday the impact it would have on our DC. We're looking at potentially utilizing third parties, potentially looking at new sites for distribution centers, but obviously with this capability now and it being not fully implemented and not being as efficient it is to be in a position where we can ship 5 million units in a quarter, it's going to have a big impact on the decisions we make going forward from a supply chain perspective.

Operator

Your next question comes from the line of Dana Telsey of Telsey Advisory Group.

Dana Lauren Telsey ***Telsey Advisory Group LLC - CEO & Chief Research Officer***

Jane, as you look at the opportunity to gain share once in a -- we know it's a onetime opportunity, how do you look at the promotional cadence going forward? How do you see the opportunity to enhance brick-and-mortar and digital sales? Will this -- will the store closings of competitors is that acceleration allow you to gain exponential sales? How do you see that time frame of this? And lastly, is it the older kids business where you see the greatest share opportunities, younger kids, how do you think about it?

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

Sure. Thanks, Dana. Well, as we said in the prepared remarks, we consider market share -- we think there is a fundamental shift, obviously, going on in the kids wear space right now, and we don't see market share as one competitor and -- one and done or 2 competitors. We see this, as we said, as an annuity that's going to continue for some time to come. There's different ways that we look about it. Obviously, our digital business is increasing pretty dramatically. We expect to be at a mid-30s penetration, and our mom is a millennial customer and really focused on digital. So there is lot of opportunities to go after that market share through the digital transformation that we're working on. And as -- if you listened to some of the statistics that we gave out in the script, you can see, we're surging with private-label credit card applications online. Our digital -- our file is up 5%, but I think we mentioned in digital was up 22%. Our conversion is up, our visits are up, our traffic is up. And obviously, Mike just went through what we're needing to do with the ship from store. So we have good strategies in place to acquire share and to increase our files through digital efforts. But certainly, on the brick-and-mortar side, there is a lot of opportunity as well. 60% of our business still comes from malls, and as we detailed on previous calls, most of those stores were in are -- about 90% of them are in thriving fully tenanted A and B malls. So we have a lot of competitors that are struggling in those malls, be they department stores or be they, obviously, the recent news around specialty stores. Not every competitor is created equally, but there is a lot of kids share out there. And as we said on the call, we think it could be 5 to 10x as big as any single competitor. Obviously, the recent news is what we're most focused on as we talk through fourth quarter, when we talked through our outlook, we think that we have a significant tailwind. While we might take a near term impact in sales and margin, which is included in our outlook in Q4, we think that the recent news will be a significant tailwind to us as we enter into 2019. When you take the Gymboree news, to dig a little bit deeper into that, they've announced that they're going to completely shudder their Crazy 8 stores. They've announced that they are going to significantly downsize Gymboree. We don't know what does that means. Does that mean all of them or does that mean most of them, we'll keep you posted as we know more. We currently overlap with 603 of their 948 remaining brick-and-mortar stores, which is a very, very large mall-based competitor of ours. It breaks out 326 Gymborees out of their 544 and 209 Crazy 8s out of their 265. We had said previously that we were targeting $100 million opportunities from Gymboree and that was inclusive of the $30 million that we had already targeted on stores that they had closed. Obviously, that time frame seems to be moving up. So as I said, we're thinking that, that is going to be a significant tailwind as we get particularly into the back half of 2019. From a liquidation point of view to get deeper into your market share question, we anticipate that the liquidations will start almost immediately and that's why we have it in our outlook. Their business is obviously tough, inventories are most likely under stress. And when you think about it whether they call it liquidations or not, they need to get rid of their winter product. And when you look at the complexion of the business, I'm not sure it's that different than ours. December is certainly the highest traffic month. When you get to January, it's only 40% of the traffic of the month of December and then February is now much better at 60%. So like I said, they've already -- they're already very promotional and whether the call it liquidations or not, we believe that they will ramp up the promotional environment and this is what's assumed in our guidance. Once we get past that, we still have a lot of other competitors, mall-based competitors, department stores, struggling department stores, competitors, a couple of which we've called out specifically that we -- will continue to pursue share over the next years and months.

Operator

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

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

Jane, one of my questions is on the inventory portion of it. If you're planning inventory to be kind of flat to slightly up and you're out of stock sort of on the online piece of the business, is that a fourth quarter specific issue? How far does that carry into 2019? And then for Mike, just on the merch margin piece of it, it sounds like 100 basis points-or-so on merch margin, how is that so different from the beginning of quarter expectation and then, obviously, the fourth quarter is going to be significantly more than that. So could we expect that to be twice as much of that or just any color on that would be super helpful?

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

Sure. On the out-of-stock position, we, as Mike detailed, have several styles and categories that we have out-of-stock on e-com due to the business that we've had in the back half. What we think that, that will do is certainly play itself out through the month of December and January, which is assumed in our outlook and then the character of the business shifts pretty significantly, once you get out of January, particularly online, to much more spring forward goods. So I think that we're not going to see the same situation as we go into the spring with out-of-stock on e-comm as we're seeing now. But certainly, knowing we have this capability for the stores to chip in and help us they need to, it's good for us to know, but we anticipate that the out of stocks will really be a fourth quarter issue. We're in good shape for next back-to-school, so we don't anticipate that happening then. And I would say on the good news front, I think that the way we're looking at this is that this should help get our inventories in even better shape than we had assumed at the end of Q4, and it'll probably help us with carryover, and we're looking at it as a positive, that is a tailwind potentially to Q1 with gross margin being able to liquidate some of these goods to our stores now.

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

And then Adrienne, when I look at how we originally guided compared to the actual results for 3Q, obviously, the 9.5% comp being driven by the penetration of e-comm had the biggest impact in terms of where we expected to be from a margin perspective compared to where we ended to be, so that's from a penetration perspective. And then, obviously, some of the DC and fulfillment costs associated with that also had an impact. As I look forward to 4Q, though we're not specifically guiding for gross margins, obviously, we're going to see more of the same as indicated in terms of penetration levels. We indicated that -- November that our e-comm business was -- had a fantastic holiday extended weekend and it was up in the high-teens, so that continues to drive penetration and will have an impact on the overall margin. Obviously, the distribution costs associated with ship from store will have an impact also to a greater extent than anything that we did in Q3. And then, obviously, we are expecting that the promotional and discounting cadence is going to pick up based on the recent announcement from -- by Gymboree. So it's all factored into our guidance and so I would anticipate that margins maybe a little worse overall than what we have done over the past 3 quarters.

Operator

Your next question comes from the line of Janet Kloppenburg of JJK research.

Janet Joseph Kloppenburg ***JJK Research Associates, Inc. - President***

A couple of questions. Jane, if you could just talk a little bit about the competitive trend. I know Gymboree -- or the competitive pressures that you're talking about. I know Gymboree has been a tough spot and they're going to become more promotional. But like what are you seeing from the discounters? Are you feeling more pricing pressure from Coles or maybe, et cetera? Maybe you could talk a bit about that for me? And it sounds like you had a great Black Friday on the digital side. Do you think that -- well, maybe if you can just give us an idea of what happened on the brick-and-mortar side? And lastly, we've talked a lot in the past about what if the digital penetration become greater than expected, which clearly it is, if you would consider adding to your store closure objective. So I wondered if you could talk about that as well?

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

Sure. As far as the competitive pressures, you mentioned off pricers, we don't really see that as a competitive pressure for us based on the complexion of their goods. We don't really feel it from Cloes either as well. I think that more -- it's more from the specialty players. Certainly, with issues that Gymboree has, those are pretty clear. And then some of the other people that compete with us in the kids space have elevated inventories. And it appears that their competitive posture may have ramped up in the month of November, and continues to do so in the month of December. So we don't see the promotional environment updating at all if anything as we've detailed on this call and in the prepared remarks. We think that it's going to ramp up pretty significantly in Q4, particularly with the liquidation events. In normal course, it is a promotional environment that we live in, and we will continue to approach it as the highly promotional segment that it is. I think that when you think about Children's Place, we've got some really important levers available to us, particularly our design and sourcing capabilities, and then, as Mike mentioned, with our AUCs lower in the first half of the year, I think we have some strong levers to help us continue to outperform the competition and kind of optimize our promotional cadence. From a Black Friday point of view, we had detailed that we ended the month of November up low single digits. We had, obviously, stronger performance online than we did in the stores with high-teens performance online. The stores are pretty much in line with the trends for the rest of the month. And then as far as store closures around digital penetration, I'll hand that over to Mike, but I think, for right now, we're -- we feel pretty good about numbers of store closures we have online.

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

Yes. We -- as I said, we expect to close about 45 doors this year, which brings us to 214 closures against the 300 target through 2020. We've indicated in the past that we were going to use 2018 and assess the impact of our digital -- accelerated digital transformation on the number of store closures. Obviously, the new news yesterday with Gymboree Corp., of the 86 stores that we have remaining to hit our 300 target, 32 overlap with them and 6 of the 32 are co-located with the Crazy 8 stores. So we'll assess all of this over the next month or so and we'll get back to you in March during our Q4 call in terms of any updated targets.

Operator

Your next question comes from the line of Jim Chartier with Monness, Crespi and Hardt.

James Andrew Chartier ***Monness, Crespi, Hardt & Co., Inc., Research Division - Security Analyst***

First, in terms of the overall sales impact from the low inventory online, are you going to be able to fulfill all that demand from your stores? Or isn't that still a drag on your overall sales in fourth quarter? And then, Jane, you talked about how customers progress through tiers, how long does it take for a new customer to mature?

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

Our sense from a sales perspective is that roughly half of what we're filling -- fulfilling from ship from store are due to low levels of inventory from an e-comm perspective or stockouts from an e-comm inventory perspective. So we anticipate that we may run out of some seasonal goods closer to the Christmas in terms of like Christmas pajamas, et cetera, but we don't think it's going to be a big overall impact in terms of the sales levels.

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

Yes. I would reiterate though I think, it could be a positive in Q1 on the margin side, but I do agree with Mike, there were some seasonal categories that are in high demand when you get to the last couple weeks of the -- last couple weeks before Christmas in stores and there are also high-demand goods online. Obviously, the online business shuts down before the store business does, so there could be some pockets there. But overall, it's a small percent of the total units we sell. As far as how long it takes a customer to mature, there is a lot of different path that the customer takes, but I would say, on average, it's a 2- to 3-year time frame.

Operator

We have time for one more question. Our final question will come from the line of Marni Shapiro of The Retail Tracker.

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

Could you just dive in a little bit to your international business. I'm curious as you grow internationally, are you shipping from the U.S. internationally? Will you plan to -- are your partners running their websites locally? Are you running them? What is their penetration look like online? If you could just bring us up to speed there. I'm curious you're seeing the same trends globally as you continue to expand that part of the business?

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

Marni, this is Mike. Obviously, from an efficiency perspective, we're not shipping. We ship very few goods from the U.S. to our international partners. We have drop-ship capabilities where they pick up from a third-party logistics provider that we utilize. So I'd say 1% of the shipments are being made from the U.S. As we look at e-commerce, obviously, we see China and India as the big opportunities. China especially, we're early innings with Semir, and they've just really taken over our Tmall site in the month of July. So much more to come on that. But obviously, they view that as a big opportunity. They are the #1 children's brand on Tmall today. So they know the potential of e-commerce in China. And overall, we're just really pleased with the progress that we've made in international over 200 points of distribution, 20 countries, 8 franchise partners, so we're feeling good about the business and its contribution to the overall corporation. Thank you.

Operator

I'll now turn the call over to Anthony Attardo for closing remarks.

Anthony Attardo ***The Children's Place, Inc. - Director of IR***

I'd like to thank you all for listening to the call. I'm here for follow-up question, happy to help. Wish you all a happy and healthy holiday season. Thank you.

Operator

Thank you for joining us today. If you have further questions, please call Investor Relations at (201) 453-6693. You may now disconnect your lines, and have a wonderful day.

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