

Dollar Tree Inc, Q1 2022, Earnings Call

2022-05-26

Presentation

Operator

Good day, everyone. Welcome to the Dollar Tree, Inc. First Quarter 2022 Earnings Call. Today's conference is being recorded. At this time, I'd like to turn the call over to Mr. Randy Guiler, Vice President-Investor Relations. Please go ahead, sir.

Randy Guiler

Thank you, Alan. Good morning. And welcome to our call to discuss results for Dollar Tree's first fiscal quarter 2022. With me on today's call are Executive Chairman, Rick Dreiling; President and CEO, Mike Witynski; and CFO, Kevin Wampler. Before we begin, I would like to remind everyone that various remarks that we will make about our expectations, plans, and prospects for the company constitute forward-looking statements for the purposes of the safe harbor provisions under the Private Securities Litigation Reform Act of 1995. These statements are subject to risks and uncertainties and our actual results may differ materially from those indicated in these forward-looking statements. For information on the risks and uncertainties that could affect our actual results, please refer to the Risk Factors, Business and Management's Discussion and Analysis of Financial Condition and Results of Operations sections in our annual report filed March 15, 2022, our Form 10-Q for the most recently ended fiscal quarter, our most recent press release and 8-K and other filings we make from time to time with the Securities and Exchange Commission. We caution against reliance on the forward-looking statements made today, and we disclaim any obligation to update or revise these statements except as required by law. Following our prepared remarks, Mike and Kevin will take your questions. Please limit your questions to one and one related follow up. And before I turn the call over to

Rick, I want to make one quick clarification to our earnings release. As I've received a few questions this morning, our original fiscal 2022 EPS outlook of \$7.60 to \$8 per share did not include the \$0.43 per share of cost outlined in today's earnings release. \$0.13 of the \$0.43 per share was incurred in Q1 and reduced our Q1 earnings. Our updated outlook for EPS of \$7.80 to \$8.20 per share does include the \$0.43 per share of cost. And I'll now turn the call over to Rick.

Rick Dreiling

Thank you, Randy, and good morning, everyone. It's been an extremely busy 10 weeks since joining the Dollar Tree team. I've been actively meeting with the leaders throughout the organization to get to know them and their businesses and to discuss priorities and opportunities. We see a massive opportunity ahead of us to drive long-term sustainable value creation through the combined Dollar Tree and Family Dollar brands. It's abundantly clear to us that to deliver this long-term opportunity, we're going to be going from a great company and that change is needed. We are fully committed to transform Dollar Tree from a good company today to a great company tomorrow. We have this unique opportunity to become a growth engine that delivers profitable growth with attractive returns on capital for many years to come. However, to get from here to there, we must build the foundation to fuel this engine. We need to invest in the areas that most positively impact the associate and shopper experience. These investments are intended to greatly improve the performance of the Family Dollar segment and our supply chain, as well as support the continued momentum at Dollar Tree. We'll be focusing on our people. Most importantly, our teams from store and distribution center associates to field leadership through competitive wages, improve store and DC conditions and enhanced safety. The distribution center network and supply chain presents us with a golden opportunity to amplify efficiencies and deliver greater support to our stores in elevated service to our shoppers through improved in-stock positions. Pricing at Family Dollar and the value proposition at both banners, we need to be right on price at Family Dollar on par with

our primary competitors. And we will work directly with our suppliers to drive greater store productivity. Dollar Tree has a long history of exceeding customer expectations by offering extreme value. We will continue to place a great emphasis on the value proposition at Dollar Tree and finally, technology. We are simply not where we need to be from a systems perspective to reach our potential. We have recently begun a comprehensive review of all of our systems and infrastructure to make the right decisions and investments to take Dollar Tree and Family Dollar to the next level. I felt great about the long-term opportunity for Dollar Tree and Family Dollar before I got here. Now that I've been inside the organization for two months, I feel better than ever. I have full confidence in the team and our Board of Directors as we embark on this much needed transformational growth journey. The Dollar Tree banner is generating renewed momentum, and we will be retaking the necessary steps to enable Family Dollar to seize the opportunity to deliver long-term operating performance improvements. We are in the midst of a very challenging time for consumers, as many are living paycheck to paycheck. They're facing the highest inflation since the early 1980s, record high gas prices, the effects from the pandemic, geopolitical uncertainty, and much more. In tough times, value retail can be part of the solution to help family stretch their dollars to meet their evolving needs. Dollar Tree and Family Dollar provide convenience as our 16,000 plus stores are located close to where millions of households live and work. Mike and I view our organization as a growth company, now is the ideal time to shift gears for us to make change happen, to unlock shareholder value and enable the next wave of profitable growth for Dollar Tree and Family Dollar. With that, I'd like to turn the call over to Mike.

Mike Witynski

Thank you, Rick, and it's good to have you here with us and good morning, everyone. Thank you for joining us today. The team delivered a solid start of the year with a 6.5% top line sales expansion, 19.2% lift to gross profit and a 48.1% increase to earnings per share. During the quarter, the Dollar Tree team successfully completed its conversion

to the \$1.25 price point, contributing to both sales and margin improvements. Shoppers are responding favorably as the new greater value products hit our shelves. Importantly, other key strategic initiatives, including the expansion of the \$3 and \$5 plus assortment in our Dollar Tree stores, as well as our Combo Stores and H2 Renovations at Family Dollar are all working. Rick outlined the types of additional strategic investments we will be making over the next several years that are designed to position the company for improved operating performance and long-term sustainable growth. Before I discuss Q1 performance by segment, I want to share a few details regarding a very eventful quarter for the company. In mid-March, our Board was reconstituted. We now have a new Executive Chair, a new Vice Chair and Lead Director – Lead Independent Director, and a total of seven new directors. We also have two new Board committees, a Finance Committee and a Sustainability and Corporate Social Responsibility Committee. This week, we published our new 2022 CSR report. I am proud of the progress we are making as a company and the team's effort on sustainability. Please check out the new CSR report and the corporate governance portion of our website at dollartreeinfo.com. Rick and I have been working very closely together. We share a common vision for a long-term growth opportunity for the Dollar Tree organization. That value will be created by a combination of Dollar Tree's unique and resilient business model that is demonstrating its earnings power and momentum with its recent initiatives. Along with the material improvement over time and the operating performance of our Family Dollar banner. We are well underway with plans and priorities to address the performance at Family Dollar. I will share more detail later on this call. Also two weeks ago, we announced the addition of two key executives to our leadership team. John Flanigan joined the company as Chief Supply Chain Officer. John brings decades of leadership experience and retail logistics, including grocery, drug-store and the value sectors. John will be extremely focused on elevating our supply chain capabilities through improved distribution operations, hiring and retaining of teams, the efficiency improvements throughout supply chain, design to drive greater store produc-

tivity through improved in-stock positions. He plans to lead productivity improvements across the logistics function by the use of data analytics, process improvement and automation. Additionally, Larry Gatta has joined the team as Chief Merchandising Officer for the Family Dollar segment. Larry brings more than 35 years of retail, merchandising and marketing experience. He is well known and respected throughout the vendor community and will be leading plans to drive our business and in turn the business of our supply partners. Larry will be focused on improving Family Dollar's operating performance and productivity through sales driving initiatives that provide great value for our shoppers. In addition to the investments we are outlining today, components of our transformation were driven by a number of factors, including continuing to enhance our culture, elevated store standards, better use of private brands, improved category adjacencies, enhancing our product mix, optimizing our vendor partnerships, and many, many more. To some degree today and especially in the quarters ahead, you can expect to receive more details, improve transparency and greater management engagement in shareholder communications as we progress on our plans to improve the operating performance and reassess the long-term opportunities for the company. We are currently in the process of planning an Investor Day targeted for October timeframe. Now to Q1 performance, the Dollar Tree banner delivered a strongest quarter in company history among the highlights an 11.2% comp the best quarterly comp performance in more than 20 years, which is including our largest sales day ever, which was the day – the Saturday before Easter, a 46 – a 40.6% gross profit margin nearly 700 basis points above the prior year's quarter and a company record 20.2% operating margin more than 800 basis points over Q1 of last year. Margins in Q1 did receive an outsized temporary benefit from the initial transition to the new price point, as well as selling through the current inventories. We are modeling a moderation of the margin level as we focus on providing our shoppers with new assortments at greater value for the \$1.25 price point. The 11.2% comp sales increase was driven by a 15.4% increase in average ticket, partially offset by a traffic decline of 3.6%. For the quarter, the

discretionary side of the business delivered a strong 14.1% comp increase, while consumables increased 8%. April, which benefited from the later Easter holiday this year was the strongest month in terms of both sales and traffic. Importantly, we successfully completed the conversion to a primary price point of a \$1.25 across the chain, credit to our teams. This project was announced in September of 2021 and was completed by the end of February with minimal disruption. By the end of Q1, our customers have already seen more than 960 of our projected 2,000 new greater value product SKUs on the shelves. Our shoppers are responding to the new items. We are seeing much improved results in the categories since rolling out the enhanced offering. Examples of the consumables of category comp improvements, where we've put in these new items, carbonated beverage from a 3% decline to a 12% increase now. And snacks and cookies before the new SKUs, we had a decline of 8%, now a 12% increase in comp. And in our food category from a 10% decline before to now experiencing a 2% increase. The majority of the changes at this early stage are now traffic driving consumable side of the business. The discretionary changes will occur throughout the back half of the year. The \$1.25 assortment changes are notable and easy to see when you visit Dollar Tree stores. And today's environment where consumers are seeing higher prices everywhere shoppers know they can rely on Dollar Tree as their destination for extreme value and evolving meaningful assortment, and a thrill of the hunt. The Family Dollar banner had a big hurdle to climb in Q1. In 2020, Family Dollar had a 15.5% quarterly comp increase at the onset of COVID. And in last year's quarter, there was a record release of stimulus dollars that positively impacted both top line sales and margin with the lift in discretionary sales. For Q1, Family Dollar's comps declined 2.8%, which represents a nearly 10% comp since 2019. The 2.8% comp sales decrease was comprised of 3.7% decline in traffic partially offset by a 1% increase in average ticket. For the quarter, the consumable side of the business delivered a 1.2% comp increase while discretionary comps were down 14.7% as we cycled the massive release of stimulus dollars last year. February represented the best comp month for the quarter

and April was slightly better than the quarter's comp. Importantly, Family Dollar's comp sales for the quarter were negatively impacted by an estimated 200 basis points by the temporary closures of approximately 400 Family Dollar stores served by our Arkansas distribution center. All of these stores have now reopened. Last week, we announced that we will be closing the 30-year old West Memphis, Arkansas distribution center that we have deemed is no longer part of our go forward strategy. We are working closely with the impacted associates to support them with their transitions by providing severance plans to those eligible, helping associates with opportunities in our other distribution centers and in our stores, as well as providing outplacement services and employee assistant programs. We are relocating stores to other DCs to fulfill the store deliveries and have sufficient capacity to serve all stores in our remaining fleet of distribution centers. We appreciate the hard work and support of West Memphis associates committed during the transition process. I will now hand the call over to Kevin to provide more color on Q1 and our updated outlook.

Kevin Wampler

Thanks, Mike, and good morning. For the quarter, consolidated net sales increased 6.5% to \$6.9 billion, comprised of \$3.78 billion at Dollar Tree and \$3.12 billion at Family Dollar. Enterprise same-store sales increased 4.4% despite cycling the large outflow of stimulus from the prior year's quarter. This represented a 190 basis point sequential improvement from Q4. Comps for the Dollar Tree segment increased 11.2%, Family Dollar same-store sales decreased 2.8%. And on a three-year stack basis, Dollar Tree is at a 15% comp and Family Dollar is at a 9.9% comp. Gross profit improved 19.2% to \$2.34 billion for the quarter. Gross margin was 33.9%, compared to 30.3% in the prior year's quarter. Gross profit margin for the Dollar Tree segment increased 690 basis points to 40.6% compared to 33.7% for the same period last year, as a result of the net of the following. Merchandise costs, including freight decreased 590 basis points primarily due to increased initial mark-on and increased sales of higher margin, discretionary merchandise partially off-

set by higher freight costs. Occupancy cost decreased 80 basis points from leverage on the comp sales increase. Distribution costs decreased 50 basis points from leverage and higher capitalized balances, resulting from inventory increases in the current quarter, partially offset by higher hourly wages. And markdown costs increase 30 basis points, primarily from markdowns for clearance items as we move to a higher value assortment at the \$1.25 price point. Gross profit margin for the Family Dollar segment decreased 100 basis points to 25.8% compared to 26.8% for the same period last year. Markdown cost increased 75 basis points due to higher clearance activity related to the shipping delays for seasonal items and slow moving merchandise. Occupancy costs increased 45 basis points from deleverage from the comparable store sales decrease and higher real estate taxes. Shrink increased 25 basis points for more favorable inventory results in relation to accruals in the prior year's quarter. These increases were partially offset by distribution costs that decreased 15 basis points primarily from higher capitalized balances from inventory increases, partially offset by our higher hourly wages and merchandise cost including freight decreased 35 basis points primarily due to higher initial mark-on partially offset by higher freight costs and higher sales of lower margin consumable merchandise. Consolidated selling, general and administrative expenses as a percentage of total revenue increased 100 basis points to 23.3% compared to 22.3% in Q1 last year. For the first quarter, the SG&A rate for the Dollar Tree segment improved 120 basis points to 20.4% when compared to the prior year's quarter. Payroll costs improved 100 basis points from leverage on the 11.2% comp, partially offset by hourly wages and investments in store payroll. Facility costs improved 25 basis points from leverage. Depreciation cost decreased approximately 10 basis points, partially offset by other SG&A, which increased approximately 15 basis points resulting from higher store supply costs. For the Family Dollar segment, the first quarter SG&A rate as a percentage of total revenue increased 280 basis points to 23% compared to 20.2% in the prior year's quarter. Payroll expenses increased 90 basis points, primarily due to hourly wage and investment store payroll, as

well as deleverage on the comp sales decline. Other SG&A expenses increased 85 basis points due to asset impairment for the West Memphis DC along with higher store supply expenses for store projects and higher legal fees. Store facility costs increased 65 basis points, primarily from costs associated with removal product from stores in connection with the voluntary product recall, as well as deleverage on the comp decline. Depreciation and amortization increased 40 basis points due to increased depreciation related to capital expenditures for store renovations and improvements. Corporate support and other expenses as a percentage of total revenue were 1.8% compared to the prior year quarter of 1.4%. The higher costs related to increased legal fees, including the reconstitution of our board and incentive compensation. Operating income improved 40.7% to \$731.5 million or 10.6% of total revenue in the first quarter. Non-operating expenses totaled \$34 million comprised of net interest expense and the effective tax rate was 23.1% for both the current and prior year's quarter. Net income for the quarter improved 43.2% to \$536.4 million or \$2.30 per diluted share, which includes \$0.13 per share for cost related to the West Memphis DC. This compared to net earnings of \$374.5 million or \$1.60 per diluted share in the prior year's quarter. Looking at the balance sheet, combined cash and cash equivalents at quarter end totaled \$1.22 billion compared to \$985 million at the end of fiscal 2021. Outstanding debt as of April 30, were \$3.45 billion. The company repurchased approximately 90,000 shares in Q1 for approximately \$14.2 million under share repurchase authorization. Compared to last year, inventory levels at Dollar Tree are up 39% due to increased capitalized rate costs plus Dollar Tree Plus inventory, and a catch up in past due inventories. Inventory levels at Family Dollar increased 27% compared to last year due to increased capitalized rate and an increase in the average unit cost. Both banners have less average inventory units in store than at the same period in 2019 pre-pandemic. Capital expenditures were \$253.4 million in the first quarter versus \$224.9 million in Q1 of last year. And for fiscal 2022, we currently expect that consolidated capital expenditures will be approximately \$1.4 billion, slightly higher than our initial outlook

for the year based on additional supply chain projects and construction cost pressures. Depreciation and amortization totaled \$188.9 million for Q1 compared to \$172.7 million in the first quarter of the last year. And for fiscal 2022, we expect consolidated depreciation and amortization to be approximately \$770 million. In March, our initial outlook for fiscal 2022 diluted EPS was a range of \$7.60 to \$8. We expect incurred cost tolling an estimated \$0.43 per share, which were not included in our original outlook. These costs represent in Q1 \$0.13 per share for asset impairment and the product recall costs related to our West Memphis DC. For Q2, an estimated \$0.22 per share for lost sales, freight, merchandise disposal, payroll and legal costs associated with the West Memphis matter. And for full year fiscal 2022, a total of \$0.08 per share for stock compensation expense related to an option grant issued to our new Executive Chairman. Diluted earnings per share for the full year is now expected to range from \$7.80 to \$8.20, which includes the \$0.43 of cost I just outlined. Consolidated net sales for the year are now expected to range from \$27.76 billion to \$28.14 billion compared to our previous range of \$27.22 billion to \$27.85 billion. We expect to deliver a mid single digit comparable store sales increase for the year comprised of a high single digit increase in the Dollar Tree segment and a more or less flat comparable store sales in the Family Dollar segment. Selling square footage is expected to grow by approximately 3.9%. For Q2, we estimate consolidated net sales will range from \$6.65 billion to \$6.78 billion based on a low to mid single digit increase in same-store sales for the enterprise. Diluted earnings per share for the quarter is expected to be in the range of \$1.45 to \$1.55 per share and this estimate includes approximately \$0.24 per share for cost for the West Memphis matter and stock compensation expense. Considerations for our updated 2022 outlook include the following: We anticipate that we will continue to experience uncertainty related to inflation, the global supply chain and geopolitical factors. For example, we have seen diesel costs continue to rise and natural gas price increases are affecting utility costs throughout the business. We are once again, experiencing shortages and availability of helium, and have not been able to procure the

volume and the needs which will negatively affect balloon sales. Our outlook includes our best current estimates of the pressures from these factors. Recycle the third round of stimulus checks that totaled an estimated \$386 billion in March of 2021. In Q2, we will begin cycling the monthly advanced child tax credit payments that began in mid-July of 2021. We noted that our original outlook in March that we expected to invest \$195 million in store and DC associate wages in 2022. As an update, given the competitive retail environment, we expect that we will likely exceed this amount as we invest in our associates. Import and domestic freight will present cost pressures due to annualization of fiscal 2021 rates in the first half of 2022. As noted in March, we plan for diesel fuel prices to be higher this year. We have increased the forecasted amount for the remainder of the year based on the current market. Additional color for the year regarding our expectations include for the enterprise, we are forecasting improved operating margin for the business driven by gross margin improvements, partially offset by higher SG&A costs as a percentage of total revenue. The Dollar Tree segment gross margin in Q1 included an outsized benefit from the transition to the new \$1.25 price point. We expect to see a gross margin moderation from the Q1 level as new greater value assortments are incorporated into the business. The Dollar Tree segment is expected to deliver improved operating margin for the year with gross margin benefiting from its strategic initiatives, as well as leverage on SG&A. The Family Dollar segment gross and operating margins are expected to be lower year-over-year impacted by the following: Higher costs, including freight and needed investments in the business such as labor and improved store conditions; The impact to product mix as a result of stimulus dollars, driving discretionary sales in the prior year; and the impact on sales and expenses related to the West Memphis DC matter. Net interest expense is expected to be approximately \$33 million [ph] in Q2 and \$123 million for the year. Our outlook assumes a tax rate of 24.2% for the second quarter and 24% for fiscal 2022. Weighted average diluted share counts are assumed to be 226.4 million shares for Q2 and 226.5 million shares for the full year. Our outlook does not include any

share repurchase. And as of April 30, we have \$2.5 billion remaining in our existing share repurchase authorization. I'll now turn the call back over to Mike.

Question and Answer

Mike Witynski

Thanks, Kevin. As Rick mentioned in the opening, we are committed to transform Dollar Tree from a good company to a great company. Our initiatives are working and providing increased profits and cash flow. Rick and I both believe now is the ideal time to accelerate investments focused on driving growth through improved associate and shopper experience, while propelling greater efficiencies. These strategic initiatives will be designed to position Dollar Tree for long-term sustainable growth. And we are going to invest and incur costs associated with making this journey. It's the right thing to do. And this is the ideal time to invest in our future. Again, to reiterate, we'll be investing in our associates and our stores, the DC network and supply chain, Family Dollar pricing, and the value proposition and our technology. Both Rick and I are committed, aligned and extremely focused. The ability to execute our key strategic initiatives is paying off and setting a solid foundation for improved operating performance and accelerated growth. We believe an – we delivered an EPS of \$5.80 in fiscal 2021. And the midpoint of our guidance range this year is \$8, representing a 38% increase. I believe we are at an inflection point to exhibit our earnings power into the years ahead. We are committed to meeting our customers' need while investing in initiatives that are delivering the best returns. These initiatives combined with our robust balance sheet will position us to deliver long-term growth for our stakeholders, associates, customers, suppliers and our shareholders. We all know it is incredible challenging and uncertain time for the businesses today. We believe our company offers the following as we manage through these times; stable and resilient business model that has worked at good times and in bad, a 16,000 store footprint that is convenient for shoppers buying their needs, a tremendous value assortment that helps

shoppers stretch their budgets, a strong balance sheet that enables us to invest in our business, while enhancing our ability to manage and maneuver through the current environment effectively, a roadmap to deliver shareholder value to improve performance at Family Dollar and improve supply chain and a continued momentum at Dollar Tree. We have a fantastic growth story of opening 590 new stores this year alone, driving top line sales growth through key initiatives. And again, and expect a 38% year-over-year earnings growth at the midpoint of our range. Operator, Kevin and I are now ready to take questions.

Operator

— **Operator Instructions** — We'll take our first question from Matthew Boss with JPMorgan.

Matthew Boss

Great. Thanks and congrats on a nice quarter and welcome back, Rick.

Rick Dreiling

Thanks, Matt.

Matthew Boss

So maybe just a high level one for you, Rick. I know you've only been back for a few months. But you described the Dollar Tree organization as a growth organization. So maybe just is there a way to speak to any potential timing of initiatives across the banners? How you're thinking about the team that you're assembling around you? Or just even at a high level, the degree of low hanging fruit that you see across the concepts to drive what it sounds like your goal is sustainable profitable growth?

Rick Dreiling

Yes. Matt, I'll throw a little color out here and then turn it over to Mike. We are really

taking a good hard look at the entire organization. We're looking at both banners and the goal here is sustainable long-term growth. And we've got a very good team here. A lot of really solid people and we're going to supplement them with incremental people that quite frankly I've been involved with in my career. But as I reflect on this, you have two great banners. Dollar Tree is incredibly exciting and fascinating to me. It's the true treasure hunt. The work that's been done on expanding multiple price points, I think has been great. And now what we have to do is focus on the fundamentals of consumable retailing in Family Dollar. And Mike, what would you like to add to that?

Mike Witynski

Yes. Matt, I'll just – on the timing of our initiatives, you can – the way we're thinking about it, the short to midterm will be definitely investing in our associates in our stores. And we'll be working on that throughout the quarters and that's embedded in the guidance that we gave as well as in our pricing. One of our key initiatives is to get sharper on our pricing and close that gap to our key competitors at Family Dollar. And Larry's working on that right now. And we'll be laying that plan in over the next several quarters. The longer-term things, Rick, our long-term growth is really leveraging and driving efficiencies in our supply chain. And John Flanigan actually is out in one of our DCs today assessing those things and then our IT. And we're looking at all of our systems, especially our supply chain merchandising and storefront systems. So those are bigger capital items, but they're going to take time as we assess them. And I think over the next two to three years, you'll see those improvements come into the business.

Matthew Boss

That's great color. And then Mike, just at the Dollar Tree banner, could you help break down upside in the quarter on the comp side, maybe relative to plan that drove that first quarter performance at Dollar Tree? And just speak to customer reception that you're seeing to the new product assortment or the product changes as now you're bringing in

the product that was bought for the higher price point? Just as it's been introduced, what you're seeing from the customer front.

Mike Witynski

Yes, that's the exciting part of it. Dollar Tree's got such a great reputation for delivering extreme value. Customers have responded well. Throughout the quarter units were better. Unit declined, it's better than what we had planned and expected. Unit decline is around the 10-ish mark and that we shared our transactions are down a little bit more than 4%. Our average ticket is up 15%. So those all feel good for us. And going through the quarter, we're delivering almost half of the new items and customers are responding very, very favorably. And we did – so the metrics are telling us, the customers are responded in. Those categories that we shared, we're seeing, the last 18 months prior to this change, we were seeing declines in the consumable side and declines in our traffic because of that. But now we reversed in our salty snacks, in our cookies and in our food. And also externally, we've done some more extensive research, a second round in the quarter and customers are highly likely to continue shopping at Dollar Tree after the price change, 85% express strong likelihood to shop, 77% are recommending our store. So our customers still appreciate that great find, the extreme value and the meaningful assortment for them. So we feel good about where we're at right now and as we're moving forward, we've only got one quarter under our belt and looking downstream, we're excited about the new assortment coming in. And this is going to take a while for us to really reset our assortment and our level of margin as we cycle through the new items coming in. And then of course, add it to our import items. It will really take throughout the next year as we're incorporating those into our import buys.

Matthew Boss

Congrats again, best of luck.

Mike Witynski

Thank you.

Operator

— *Operator Instructions* — We'll next go to Scot Ciccarelli with Truist Securities.

Scot Ciccarelli

Good morning, guys. And yes, welcome back, Rick. So retail transformations almost always take longer and cost more than us on the outside tend to anticipate. Can you guys provide any color regarding the magnitude of incremental investments that may be required to get Dollar Tree and Family Dollar kind of where you want them from an operational and technological standpoint?

Mike Witynski

Well, on the Dollar Tree side, as I've said, we've got a lot of momentum, because we've been working on this for quite a while. In fact, last two years, what I'm excited about is during the two and a half years of COVID and supply chain disruption, we've come out of this, with two formats that we didn't have in 2019, we've got a great Combo Store and we broke the \$1 to \$1.25 and we were enhancing that with \$3 and \$5 assortments. So we've got some momentum in our strategies are working and our cash flow is strong. We've got a great balance sheet. We've got a new reconstituted board and with Rick on board and including the new talent that we talked about. So we're in a place where we're coming out of – I believe the era of COVID with great momentum in our strategies, a great balance sheet, a new board, and we're going to accelerate our growth. So we're not starting today. We're really going to accelerate this going forward. So I think on – as the investments, we will get more detail as we continue to work through this. And that's where we said we're going to have our first analyst day in October that we'll be really getting into the more of the nuts and bolts of when to expect as we look at this over next

quarters and years on how we lay that in and the benefit according to that goes along with those investments.

Scot Ciccarelli

All right. So there's no way to necessarily bracket or give a general view in terms of how much incremental investment or operating costs might be required?

Mike Witynski

No, not right now, we've got everything embedded in our outlook for this year, and then we're working really hard. Both Larry and John are looking at those items as we think about how does the beyond years look and we'll be sharing that in the future.

Scot Ciccarelli

Got it. Thanks a lot, guys.

Mike Witynski

Thank you.

Operator

Next we'll go to Rupesh Parikh with Oppenheimer.

Rupesh Parikh

Good morning. Thanks for taking my questions. So first just on Dollar Tree gross margins, I know you indicated that sequentially, you expect them to moderate versus what you saw on Q1. Is there a ballpark level you can help us frame that for maybe Q2 in the balance of year, and then just any thinking longer term in terms of where their gross margins are for the banner 35 to 36 or do you think you could do better than that?

Kevin Wampler

Rupesh, this is Kevin. As we think through this and obviously to Mike's point, we're one

quarter in, we're still learning a lot as we work through this. So moving pieces is always the marketplace continues to move as to what investment into the product is going to be necessary to begin to be a value in the marketplace. I would tell you this year, I think at a minimum, we would hope to be to the higher end of that historical range. And if we can be above it, we will be above it. I don't know that we - where that will exactly land, again the environment is such that there's enough uncertainty, that it's pretty hard to peg given the fact that the newness of the \$1.25 price point and some of the things that are going on a macro level out there, but it will be a positive in a big way for the overall company.

Rupesh Parikh

Okay, great. And then maybe just my follow up question, just on the Family Dollar banner, just given the initiatives that you guys plan to make and some of the capital investments over the coming years. Do you guys think you can close a gap with your, I guess your closest competitor on the operating margin line? Could you get to high single-digit operating margin within the Family Dollar banner longer term?

Mike Witynski

Absolutely.

Rupesh Parikh

Okay, great. Thank you.

Operator

All right. Next question will come from the line of Karen Short with Barclays.

Karen Short

Hi. Thanks very much for taking my question. I wanted to try this just a slightly different angle. So there's obviously been expectations in terms of what your new operating profit margin could look like with all the opportunities that you have at both banners. But as

I look at today's press release, everything focuses on investing. So I mean, I wanted to see if you could just triangulate that a little bit. And I mean, I see you'll talk about this at the Analyst Day, but every single header that you had in terms of strategies is investing as opposed to operating margin opportunity and then investors clearly have a high – very high number in terms of what the actual margin opportunity could look like. So any color on that would be helpful.

Mike Witynski

Yes. I'll throw it to Kevin for a little bit of color, but the way I think about it, yes, we are investing, but also we're delivering earnings EPS growth throughout the time and top line growth. So as Rick and I said, the things that we are investing, they will have a return for long-term sustainable growth. And if you look at our EPS from the midpoint range, it's a 40% – just under a 40% increase in EPS and we moved our top line up. So yes, we'll be investing in the future, but we're going to be investing with the thought of continuing to drive that top line and the bottom line at the same time.

Kevin Wampler

The other thing I would say Karen is, as Mike mentioned in his early comments, we do have a new finance committee. This committee obviously will be very focused on return on invested capital as we think about things. There are some things we have to do because we need to do it, which is you can look at our store standards. We want to make sure we have stores that are, keep the standards that we expect and our customers deserve. So those are investments you make, but if you look a lot of this is capital investment in systems and in our supply chain that, again, it's about productivity and efficiency and making it easier at the store level for that store manager and the assistant manager and that team there, that's working very hard every day. So our job at the end is to make their job easier. And that's where these investments will have a big payoff at the end of the day.

Mike Witynski

Yes. And I would just close with our balance sheet and cash flow enables us to do this. We can invest to keep growing our store account to be a growth company. We can invest in the key enablers and supply chain and IT, and we can buy, buy back shares to grow our shares. So we've got options going forward. It's not just simply investing and expenses.

Karen Short

Great. That's helpful. Thank you.

Operator

Next, we'll go to Michael Lasser with UBS.

Michael Lasser

Good morning. Thanks a lot for taking my question. So some of the skeptics are arguing that Dollar Tree is going to get a bunch of growth this year from raising its prices by 25% on the bulk of its assortment and seeing some timing benefits from selling through some older cost inventory, and now it's talking about investments. So do you think in light of all that, that the core banner or the enterprise I should say can grow both sales and margins next year while you're making these investments?

Mike Witynski

Yes, we do.

Michael Lasser

And my follow-up question is – yes, that's helpful, Mike. My follow-up question is as you focus your price investments, how do you ensure that you're not going to spark a race to the bottom in light of the very competitive environment that you operate in with some really large competitors.

Mike Witynski

Yes. And that's important, we've got to be meaningful to our customers first and foremost. And that's what we're going to focus on. And on the other side, we've got Larry here who works very closely with the vendor manufacturers and we will balance it, right? We'll make good decisions to invest where we need to meet the customer's needs in the marketplace. We're just going to simply close the gap to where we are on our KVs, our key value items, and then just make sure the entire shopping experience is at a great value for our customer and it's a balanced.

Michael Lasser

Understood. Thank you very much.

Operator

Next we're going to Chuck Grom with Gordon Haskett.

Chuck Grom

Hey, good morning, everybody. Rick, it's really great to hear your voice after all years. My questions on the traffic decline at Dollar Tree you talked – I think you said it was down about 4%. I'm just curious how that trended during the quarter, particularly in light of you introducing more of the new products into the mix. And the follow-up to that would be, I think you said 960 SKUs, but the plan for 2,000, I think the average tree store has about eight. So I'm just curious like how many SKUs you want to change and how do we think about that rollout over the balance of the year?

Mike Witynski

Well, the 2,000 worthy, the amount that we needed to change. Remember the – my last earnings call, our merchant since last September went item by item and put our item on the table and went out and shop the entire competitive market to make sure that it's at \$1.25, it is still a great value. And our customers are telling us that in our – in the results. So the 2,000 items are the ones that we thought we needed to invest more in

and turn over and/or bring new that we had to discontinue over the last 18 months or just weren't of value anymore. So the 2,000 is what our goal was, and we're halfway through 47%, the other half are going to flow through. And as they flow through, we're getting great results. But also remember not with – and Kevin talked about it. It's a dynamic situation in market right now. So what we thought six months ago has changed already, just because of the cost pressures we're seeing. So our Dollar Tree merchants know that at a fixed price point, they don't have to carry every item and they drop the item and go get a replacement item. And at the margin that we need and our mix of items always changes out. That's the exciting thing about Dollar Tree. It's an extreme value, an ever exchanging meaningful assortment and it's – and the customers respond and it's the thrill of the hunt. That's part of our mission at Dollar Tree. They're used to it. They've always done it at \$1, \$1 just doing it at a \$1.25 and it's working very well.

Kevin Wampler

And Chuck, on your question about traffic, this quarter in particular is very affected by Easter. Easter was two weeks later, so you would've seen the best traffic in the third period. And probably the biggest decrease in traffic more likely in the second period because of the later Easter, as well as when the stimulus dollars were released. So I think those are probably kind of the two factors, which it's pretty lumpy because of those two, but that's kind of the factors that, that are in play in Q1.

Mike Witynski

One of the things that we're really seeing excitement around our seasons are accelerating more than they used to at the \$1.25 and the meaningful assortment. And then with our rollout of our \$3 and \$5 items that we're rolling out to another 1,500 stores this year. So the combination of the \$1.25, \$3 and \$5 in our seasonal business has really given us a lift that we're excited about. And in quarter two, if you think there's – in quarter one, Kevin talked about a great Easter and Valentine's, and we saw great response from the cus-

tomers. Quarter two is summer, and you got Memorial Day and July 4, but the back half of the year is when back to school and Halloween and then Thanksgiving and Christmas that we're really setting ourselves up to have a great back half.

Chuck Grom

That's great. And just my follow-up would be historically speaking, we look back at other periods of consumer — *indiscernible* — and maybe lifting them upon on this question to a degree. I'm curious how long of a lag it was before you saw that middle income customer begin to trade down. And if you think this current macro environment is going to be different than what we saw over a decade ago.

Mike Witynski

Yes. There's just – it's a different pressure this year. But you're right in 2008, 2009 and 2010 both Family Dollar and Dollar Tree saw an acceleration in their comp store sales. And there was a just a slight drag, but they saw it a little bit in 2008 when it was happening. And then 2009, 2010 and 2011, it was sustained. It's hard to predict what's going to happen now just because it's – they're being pressure for different reasons.

Chuck Grom

Okay. Great. Thanks very much and good luck.

Mike Witynski

Thank you.

Operator

All right. We have time for just a few more questions. — *Operator Instructions* — We'll next go to Edward Kelly with Wells Fargo.

Edward Kelly

Hi everyone, good morning and Rick, great day. Great to hear your voice. First thing I

wanted to ask is just about the \$1.25 and the elasticity in improving where you're adding value. Just more – a little bit more detail on the number of categories you've done in terms of adding value back and what's left to do. And then how much bigger is the opportunity within discretionary in terms of like adding value you are bringing items back? I mean it does seem like that would be the area where there's potentially more powerful impact.

Mike Witynski

Well, actually – well, thanks for the question. Our discretionary – the value in our discretionary, our customer recognizes and there wasn't a lot of rework that needed to happen there and that's evident, that's why our discretionary business comped at 14% and we really haven't touched it that much. Where we're focusing the 2,000 items are really concentrated mostly in consumable categories. So in the salty snack and the carbonated beverage and in the food, that's where these categories, we have 47% of the SKUs in, but really we're going to add more in food. We're going to add more in carbonated beverage and more in salty snack to really drive that consumable. And it will take time. I – we believe that's a traffic driver and as the customers experience the items and appreciate the value we're giving them, over time, we believe that that will help drive traffic into the overall store, not just those categories.

Edward Kelly

Okay. And then just a quick follow-up on \$3 and \$5. Can you go faster? Why not go faster? Response seems to be good. Just updated thoughts there.

Mike Witynski

Yes. It's a great question. We would go as fast as we can. We are going as fast as we can. If you remember last year, it's really supply chain right now. That's tempering our speed. Last year, we wanted to open up 500. And if you remember, the customers responding so well that we were selling through and we – the supply chain was slowing things down. So

we slowed down our acceleration of rolling it out throughout the year, but we still ended up at 600 stores. So we're going to do, we accelerated to 1,500 and it's really depending on the supply chain, because we're buying these products 9 to 12 months out. And it's – we're excited about rolling this out, where our expectations are to get this done as soon in the year as possible. And we're going to continue to roll that out. But we have every expectation to roll this \$3 and \$5 out throughout the entire network. And that's probably something that we can share at our October Analyst Day is what that – what's that looking like? Because we really like it, where we're putting this product in our stores, we're really seeing a benefit on the seasonal side of it. So our \$3 and \$5 items combined with our great value at the \$1.25 is just lifting that entire seasonal sales in those respective stores. So we're going to keep enhancing the product, we're learning a lot and it's going to be absolutely dedicated on the discretionary side of the store.

Edward Kelly

Great. Thank you.

Operator

We'll go next to Kelly Bania with BMO Capital Markets.

Kelly Bania

Hi, good morning. Thanks for fitting us in. Just – wanted to just ask first about freight costs. There was a comment about maybe annualizing the increases from last year and I think that's consistent with last quarter. So just curious if you can help us understand just how you view the state of the global shipping backdrop from your seat, what you're expecting from contract versus spot this year and just the overall cost for that.

Kevin Wampler

Yes. Kelly, this is Kevin, and I'll start with some information on that. Really, in Q1, our freight was up, but it was very consistent with how we forecasted it. And again, as we had

talked about in March, we expected the first half of the year in particular to be affected by the annualization rates we saw in the last half of 2021. So that feels like a good place to start. Obviously, diesel fuel has increased and we've increased our forecast for the current market rates. And here's a – something to maybe give all of you a kind of a metric kind of think about diesel freight. So just a \$1 change in rate for the year would be about a \$63 million headwind. So that's the annualized number. And so you guys can do the math on what that means on a prorated basis, but that kind of gives you a feel for that. But we have the current market rates as we see it in our forecast and embedded in our guidance. In regards to ocean freight, the backlog is definitely significantly less than a year ago. It's not completely gone, but it's definitely better than it was. It's early with contract carrier performance has been pretty much unplanned at this point. We are still using chartered vessels, which has been successful and been helpful and continuing to move goods. And the NVO rates have pretty much been in line with the way we have budgeted them at this point in time. So from our point of view and the way we came into the year, looking at it, we're comfortable with where we're at. Obviously, it's the market can change rapidly, but we feel good about where we're at the moment.

Mike Witynski

Yes. I would just add that, from everything add onto what Kevin said, we've been battling this ocean freight for 2.5 years and we felt it probably before anybody else did just because of our fixed price and the amount of containers we import. So this year, we've contracted slightly more than our needs. And it's because of we're anticipating at continuation of some blank voyages that will continue to disrupt the supply chain. And as Kevin said, to fill our needs, we're using a combination of contracts, the NVO and our own dedicated charters. So – and we've smoothed out our – the purchasing of what we need. We've smoothed that out to be more consistent and dependable for the carrier. So we've gone into this year with 2.5 years of disruption experience. And as Kevin said, we're – we think we have a good handle on the cost of it without unknowing any disruption that

could happen going forward.

Kelly Bania

Thank you. That's very, very helpful. And then maybe I just ask one more about Dollar Tree. As you merchandise against this new \$1.25 price point. Are you targeting that 36% gross margin today? Or do you maybe leave a little cushion for some higher costs in the future? And as well, do you consider testing even more price points at \$1.50 or \$2? Just given how this is already going?

Mike Witynski

Well, we have a \$1.25 fixed price point that we moved after 35 years, and then we've got the \$3 and \$5 price points that are fixed price points that we are rolling out as fast as we can over the next couple years. So we feel really good that we can deliver a unbelievable assortment that's exciting and meaningful and an extreme value for our customers and still delivers on that thrill of the hunt. So we're excited about that. And we – as you think about our comments about continuing to drive top line and bottom line performance, we will always keep in mind the margins needed to deliver those two things.

Kelly Bania

Thank you.

Operator

All right. And that's all the time we have for questions at this time. So I'd like to turn it back over to Mr. Randy Guiler for any additional or closing remarks.

Randy Guiler

Thank you, Alan. And thank you all for joining us for today's call. Our next earnings conference call to discuss Q2 results is tentatively scheduled for Thursday, August 25, 2022. Thank you and have a good day.

Operator

That does conclude today's conference. We thank everyone again for their participation.



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