I'll start with the credit question

Signet Jewelers Limited

Fiscal 2017 Third Quarter Earnings Conference Call

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PRESENTATION

Operator:

Ladies and gentlemen, thank you for standing by. Welcome to the Signet Jewelers Limited Q3 Fiscal 2017 Results Conference Call. During the call all participants will be in a listen-only mode. After the presentation we will conduct a question and answer session. Instructions will be provided at that time. If at any time during the conference you need to reach an operator, please press the star, followed by zero. Please note that this call is being recorded today, November 22, 2016 at 8:30 AM Eastern Time.

I would now like to turn the meeting over to your host for today's call, James Grant, Vice President of Investor Relations. Please go ahead, James.

James Grant:

Good morning and welcome to our Third Quarter Fiscal 2017 Earnings Call. On our call today are Mark Light, CEO, and Michele Santana, CFO. The presentation deck we will be referencing is available under the Investors section of our website signetjewelers.com.

During today's presentation we will in places discuss Signet's business outlook and make certain forward-looking statements. Any statements that are not historical facts are subject to a number of risks and uncertainties and actual results may differ materially. We urge you to read the Risk Factors, Cautionary Language and other disclosures in our Annual Report on Form 10-K. We also draw your attention to Slide 2 in today's presentation for additional information about forward-looking statements and non-GAAP measures.

Now, I will now turn the call over to Mark.

Mark Light:

Thanks, James. Good morning everyone. I'd like to start by discussing some of our key points we would like you to take away from our third quarter financial results presentations. While we are never pleased with low year-over-year results, our sales and earnings exceeded our expectations. In a challenging environment our team delivered some solid results, especially in the fashion jewelry categories, our outlet locations, our online business, our UK stores and finally our kiosk business. We also managed our SG&A and inventory well which not only helped earnings but also increased our free cash flow substantially year-over-year. We initiated fourth quarter guidance consistent with our thinking in August. That is when we gave fiscal year and third quarter guidance on our August call, we obviously implied a fourth quarter guide, and today we are formally guiding the fourth quarter consistent with our thinking back in August. Our fiscal year earnings guidance is updated to reflect only the flow-through of our third quarter earnings.

Our Zale division delivered a variety of wins in the third quarter. Our sales increased on an inventory decrease which was driven in part by our continued focus on our integration efforts.

Piercing Pagoda delivered nearly a 10% comp sales gain. We saw unfavorable impact to sales lessen in the energy regions where the Zale division stores have a large presence.

Lastly and perhaps most importantly, our holiday season initiatives are numerous, well-tested and our team members are well trained and prepared to deliver a wonderful customer experience.

Now, let's get into some more detail on these high-level takeaways.

We achieved some wins in the third quarter starting with the diamond fashion jewelry category. Our Ever Us two-stone diamond jewelry collection produced significantly more sales year-over-year. We also saw contributions from bracelets as we continue to lean into the bracelet trend of stacking with fresh looks and innovative fastening systems in both branded and non-branded collections. Our earrings of all types are resonating with customers including the growing trend in earring climbers.

Third quarter sales were also driven in part by select bridal collections; Vera Wang and Neil Lane led the way and a variety of other bridal collections also contributed.

We continue to drive forward on our omni-channel initiatives to deliver a seamless experience to our customers. In the third quarter our omni-channel selling approach continued to deliver results. Our e-commerce sales increased but more important we continued to connect with our customers through an enhanced digital experience.

Our new Clientelling system was launched in our Kay and Jared locations. The system provides a single view of the customer with the capability to holistically capture customer information. This enables our team members to improve their interactions with customers before, during and after their visits to our stores or our sites. We've also broadened our affiliate marketing relationships with other retail shopping sites.

Finally, the diversity of our real estate footprint served us well. The UK division delivered a 3.6% comp sales increase. Outlets were up too with very broad-based gains, and Piercing Pagoda delivered strong results in diamond and gold jewelry and we continue to see growth opportunities in the children's jewelry classification.

In the third quarter our team did a nice job in continuing to drive synergies on the Zale integration. To review, a synergy as we define it is a net contribution to operating profit. I won't go into depth on each of the examples listed here on Slide 5 and the workstream detail behind each one, but as you can see we have got a lot of energy and a lot of activity going on to fully optimize the business operation.

Due to the synergy work being done on our Zale division store inventories, they're operating on a much more productive basis which is assisting in increasing our free cash flow. We also continue to enhance our organizational structure as this has led to leaner, more efficient teams delivering consistent execution of processes. Some of the departments that have streamlined operations are Human Resources, e-commerce, Inventory Management, Real Estate, Legal, Finance, Supply Chain Distribution and Repair. These are just some examples of the many other projects that are positioning us well to build upon our long history of growth and improving profitability.

Let's discuss the fourth quarter where we have historically made about half of our annual profit. As I mentioned, the team is prepared and focused on the opportunities in front of us and we are ready to serve and delight our customers.

This is the season when our competitive positioning and our ability to invest in growth enhancing, innovative, new products and initiative really allow Signet to capture profitable market share. One of our biggest initiatives is Year 2 of the Ever Us collection. In our experience, beacon or industry trend driving strategies like this tend to perform even better in their second year as compared to their first. We are selling additional jewelry categories and styles, higher carat weights and more inventory supported with greater digital, print, social and TV marketing of the Ever Us collection. We also expanded the Vera Wang Love Bridal collection into the fashion jewelry category in Zales. This collection includes diamond jewelry as well as pearls supported with new in-store displays. Zale is also introducing the new iconic Vera Wang Kindred Heart collection.

This holiday season, bracelets are sure to continue their momentum. We have beautiful new collections which include the LeVian Ombré Exclusive which is pictured here which is exclusive in Jared on this slide. Also, all eyes are on the ear this fourth quarter as we continue to drive the trend in earrings, earring climbers, studs and hoops. We also see a lot of promise in our Radiant Reflections and our Endless Brilliant collections which create bigger looks with smaller stones and innovative settings.

In all of our Jared stores we have reset our Pandora presentation with beautiful new Pandora store-in-stores or boutiques managed by our Pandora specialists. We are selling a broader collection of Pandora products and fashion jewelry including exclusive products and exclusive collections, and it's all supported with new TV advertising creative.

The new Chosen Diamond is now in all Jared stores also which shows customers each stage of the diamond's journey from a rough diamond to a finished piece of beautiful jewelry. This is in total alignment with the Jared customer who tends to value this type of product and information. We also designed a brand new TV ad to support the Chosen.

We significantly improved websites for Kay and Jared which incorporates fully responsive design to work seamlessly across all devices. We also significantly increased investment in digital marketing across all of our channels and all of our store banners with more effective targeting and personalization than ever before.

Lastly, we have many targeted marketing plans tying in the 100th anniversary of Kay Jewelers. We have contests, promotions and awareness campaigns using all forms of media.

You can get a great sense of the powerful emotion behind each of our store banners' TV advertisings by viewing them at signetjewelers.com. Just click on the Media sign and you'll see our ads.

Moving on to the strategic review of our credit portfolio, I will focus on a few very high level points. As you can imagine this is a very intense and complex process to analyze. We are motivated to move as quickly and as prudently as possible in order to remove uncertainty around this issue for all of our constituencies, but we must make a thoughtfully analyzed decision taking into account near-term and long-term economics as well as our ability to continue serving our customers. We are analyzing opportunities to create shareholder value by optimizing or monetizing our credit portfolio and we are confident that we will deliver shareholder value regardless of the direction that we choose. Importantly, we are pleased with the interest expressed by several different financial institutions.

That concludes my prepared remarks. I'll now turn the call over to Michele.

Michele Santana:

Thank you, Mark. Good morning everyone. Let me just start by putting our third quarter in perspective. Our third quarter represents less than 20% of sales and about 5% of operating profit on an annual basis, so as a result of the relatively small size of the quarter this can have some distortion on our ratios. With that in mind I'll cover our operating performance starting with sales.

For the third quarter Signet's comps decreased 2% against an increase of 3.3% in the prior year third quarter and that compares to a two-year comp hurdle rate of 7.5%. Of our comp sales decline, about 80 basis points was driven by oil and gas reliant regions. Total Signet sales decreased 2.5% and on a constant exchange basis, total sales decreased 0.5% for the quarter.

Sales on an operating segment basis were as follows. In Sterling Jewelers total sales declined 2.9% to $712 million. Comp sales decreased 3.8% compared to an increase of 3.5% last year and compared to a two-year comp hurdle rate of 10.3%. Sales weakness was most pronounced in the non-core regional store brands, Jared to a lesser extent and energy dependent regional economies across all store banners. Fashion jewelry including select branded diamond jewelry performed relatively better than the rest of the merchandise portfolio. From a channel perspective, outlets in e-comm performed a little better than the rest of the selling channels.

The Zale Jewelry's operating segment's total sales increased 0.2% to $282 million and that was flat on a constant currency exchange basis. Comps were down 1.4% against a two-year comp rate of 0.7%. On a geographic basis, our Zale US total sales increased 0.3% while comps decreased 1.5% and that's and that compares to a two-year comp hurdle rate of 0.7%. In Canada, total sales declined 0.4% or 1.7% on a constant currency basis. Canadian comp sales declined 0.9% against a two-year comp rate of 0.3%. For the Zale Jewelry operating segment the modest increase in total sales was driven primarily by select diamond jewelry collections with fashion jewelry in total slightly outperforming Bridal. Q3 results in both US and Canada were also unfavorably impacted by energy-dependent reliant regions.

Our Piercing Pagoda total sales increased 11.3% to $53 million with comp sales of 9.5% on top of a 10% comp rate last year and a two-year comp rate of 8.5%. Sales increases in Pagoda were driven primarily by gold chains and diamond jewelry.

In the UK, our total sales decreased 12.8% to $130 million but increased 4.2% at constant currency rates. Comp sales grew 3.6% on top of a 4.1% in prior year and compared to a two-year comp hurdle rate of 7.8%. Diamond jewelry and prestige watches were the primary drivers of the UK comp sales increases.

Moving on to Signet's consolidated and adjusted results. On Slide 9, we're continuing to present this reconciliation through the end of Fiscal Year 2017 to reflect the impact of purchase accounting as well as IT implementation expenses associated with global systems that will drive future efficiencies and cost benefits. The difference between Signet and adjusted Signet are in the columns reflecting purchase accounting and integration cost.

Starting in the lower left portion of the slide, on a GAAP basis earnings per share was $0.20. Our third quarter EPS benefited by $0.02 due to a lower tax rate of 12.4% compared to the prior year quarter rate of 31.5%. The Q3 rate is attributed to a lower annual effective tax rate for Fiscal 2017 which I'll discuss further prior to wrapping up my commentary.

In the next column over, purchase accounting adjustments were worth $0.03 of EPS dilution. This was driven primarily by deferred revenue adjustments related to acquisition accounting.

The next column over reflects our integration costs which relate to consulting costs related to information technology implementation. Integration costs were responsible for $0.07 of EPS dilution.

On an adjusted Signet basis, in the far right column, by adding back the $0.10 worth of adjustments, our adjusted EPS was $0.30 for the third quarter.

Looking below the sales line of Signet's adjusted P&L results, our adjusted gross margin was $352.5 million or 29.6% of adjusted sales, down 100 basis points. The lower rate was due principally to lower sales, higher bad debt expense and deleverage on store occupancy. This was partially offset by favorable merchandise cost and merchandise mix.

Adjusted SG&A was $377.3 million, down $10.3 million. The rate was 31.7% which is flat to prior year rate. The decline in dollars and steady rate was driven by lower variable compensation and a few other factors which I'll elaborate momentarily.

Other operating income was $68.6 million or 5.8% of sales. This increase of $7.7 million was due principally to higher interest income earned from higher outstanding receivable balances.

Adjusted operating income was $43.8 million, down 7%. Our adjusted operating margin rate was 3.7% which is down 20 basis points due primarily to lower top line. Adjusted earnings per share was $0.30 which compares to $0.33 last year, a decrease of $0.03 or 9.1%.

Moving on, we'll take a closer look at SG&A. Our teams continue to focus on cost control and savings. Our SG&A expense declined by $10.3 million as I mentioned or 2.7% in the third quarter. Although the dollar reduction in SG&A wasn't quite enough to leverage our SG&A rate on lower sales volume, it does reflect prudent use of expenses nonetheless. Within SG&A, the biggest expense component is payroll. Our store and corporate payroll declined due in part to a variety of factors which also include lower variable compensation which flexes with sales and a lower corporate incentive compensation. A one-time accrual reversal that I had briefly mentioned on our last quarter call related to harmonization of Signet's compensated absent policies and lower merchant fees in the Zale credit program. Also embedded throughout SG&A is favorability for foreign exchange.

Our Q3 advertising expense was also slightly lower and that's due primarily to a timing shift of spend out of Q3 to post-election period in Q4.

Other expenses increased driven predominantly by information technology projects.

Moving off the P&L we'll hit a few balance sheet highlights before touching on capital considerations and guidance. Our strong third quarter ending inventory position reflects the success of our continued focus on inventory optimization. Net inventory ended the period at $2.6 billion. Our teams did a good job of managing inventory levels in a slower sales environment. The decline of 2.8% in inventory compared 30 basis points favorably to Signet's decline in total sales of 2.5%. We saw sound, prudent management of inventory across categories and division, and it's worth noting the Zale division inventory declined at a faster rate than Signet overall. This is directly related to the synergy producing initiative that Mark previously discussed which we call our Inventory Turnover Improvement.

Finally, Signet benefited from foreign exchange on inventory procured in currencies other than the relatively strong US dollar.

Now let's move on and turn our attention to our in-house credit metrics and statistics.

Our third quarter in-house credit sales in the Sterling division were $476 million and that's down 2.3%. Although lower, the in-house credit sales were more favorable than the division's total sales decline and therefore gained relative share in the mix of tender. In-house credit participation was 66.8%, up 40 basis points. This was due to faster growth and higher spending among our highest quality cohorts. As a result, we continue to see growth in the credit sales mix within our best credit tiers.

The average monthly payment collection rate for the third quarter of Fiscal 2017 was 10.6% compared to 11.1% last year. Our monthly collection rate is calculated as cash payment received divided by beginning accounts receivable. The decline in the collection rate is due principally to credit plan mix and an increase in the average transaction value of what is getting financed. As a result, monthly payments are higher in dollars but lower as a percent of balances, thereby resulting in higher receivables outstanding to be collected.

With that said, our credit plan mix is driving a higher FICO score customer with the rollout of our 36-month bridal plan to select customers. The combination of collection rate decline and a growth in credit participation contributed to an increase in our accounts receivable of $109 million or 8% to $1.55 billion.

Interest income from finance charges, which makes up virtually all of the Other operating income line on our income statement was $67 million compared to $61.3 million last year. The increase of $5.7 million was due primarily to more interest income on the higher outstanding receivables base.

Net bad debt was $57.2 million compared to $53.1 million last year. As a percent of receivables, the nearly flat bad debt allowance which you'll see on the next slide in just a minute was driven primarily by low receivable growth which was a symptom of the overall sales decline. The net impact of bad debt and finance income generated operating profit of $9.8 million and that is up $1.6 million from last year.

Now, let me take you through some of the key Sterling division allowance for doubtful account metrics. Our total valuation allowance as a percent of gross receivables was 7.9% in the third quarter. This slight increase of 10 basis points from prior year was driven by a variety of nearly offsetting factors. The impact of lower sales leading to lower receivables growth as well as a lingering effect from the Q2 IT glitch slightly offset the impact of higher quality new borrowers. On a sequential basis, the ratio was up 50 basis points, the same as prior year reflecting seasonality changes.

For the non-performing portion of our receivables as a percent of gross AR, Q3 was 4.9%. This was flat to last year and better by 10 basis points on a sequential basis.

In summary, we remain confident in our ongoing credit portfolio performance based on the visibility that we have into our daily collections, weekly roll rate and other key performing metrics. Our portfolio continues to enable responsible and profitable growth of our merchandise sales and earnings.

Just a few highlights in terms of our capital allocation. Year-to-date through the third quarter we repurchased nearly 10 million shares of our common stock. Albeit all of Q3 activity was related to offsetting dilution from our preferred stock issuance. As mentioned in the release our buyback activity is in line with expectation and our $525 million accelerated share repurchase program is continuing.

Regarding cash and borrowings, the significant increase in free cash generation was driven primarily by favorable changes to working capital and higher net income. Separately, we borrowed from our revolving credit facility for seasonal working capital needs during Q3. This is normal activity and also within our expectations.

Finally, our capital allocation policies remain unchanged. Signet maintains a balanced approach to investing in the growth of its business as well as returning capital to our shareholder via a growing dividend and share repurchases. With that, let's turn to our financial guidance.

As Mark indicated, our fourth quarter guidance is consistent with the guidance implied on our August call. Signet's fourth quarter comparable store sales are expected to decrease between 2% to 4%. We feel well prepared and focused for the fourth quarter in what remains a relatively uncertain environment. Fourth quarter adjusted EPS is expected to be $4.00 to $4.20. The weighted average common shares outstanding is expected to be about 76 million. The increase in our fourth quarter shares from third quarter is driven by the inclusion of the effect of the underlying common stock issuable upon conversion of our preferred security. In the third quarter, these shares were anti-dilutive and therefore were not in the calculation. EPS guidance for both Q4 and the full year implies a flow-through of synergies, general cost controls and higher finance income partially offset by unfavorable FX.

Below the operating profit line, our earnings per share guidance also is favorably impacted by first, a lower tax rate of 25% to 26% due primarily to profit mix, and secondly, fewer shares from repurchase activity in the first half.

The fiscal year earnings per share and adjusted earnings per share increase in guidance are attributed solely to the third quarter actual results exceeding our previous expectations.

Again, we are reaffirming the multi-year synergy guidance. In Fiscal 2017, we intend to deliver $158 million to $175 million cumulatively. That means the $60 million from last year plus another $98 million to $115 million this fiscal year. Then by the end of Fiscal 2018, we expect to deliver $225 million to $250 million of cumulative synergies.

That concludes my prepared remarks and with that I'll turn the call back over to Mark.

Mark Light:

Thank you, Michele. I want to conclude by thanking all the Signet team members for their hard work and their dedication of third quarter, and for their preparation and training to deliver a wonderful customer experience for all of our customers this holiday season.

With that, we'll now take your questions.

Operator:

At this time, those with questions should lift their phone receiver and press star followed by the number one on their telephone keypad. To cancel a question, please press the number sign. Please hold for a brief moment while we compile the Q&A roster.

Our first question today comes from Oliver Chen from Cowen & Company. Please go ahead.

Oliver Chen:

Thank you. A solid quarter, congrats in a challenging environment. We had a question regarding the comp in terms of the dynamic between higher sales in terms of selected branded diamond product versus lower prices and down transactions. Do you expect that dynamic to continue and was that—did that play through how you expected?

I also wanted to ask you just about Jared and where you feel like you are in the selling process, in the journey in which you've been engaged in in terms of just ensuring that you've modernized the approach to selling in line with what you've been thinking it should be. Thank you.

Michele Santana:

Oliver, why don't I start with your first question in terms of what we saw in Q3 with select diamond fashion jewelry, and you saw in the release we continue to see a higher ATV, lower transactions. Let me talk about that and then I'm going to flip the question to Mark and he can add and talk about the Jared.

Our initiatives as Mark talked about on the call for fourth quarter, we are fully loaded with initiatives and those initiatives are really aimed at driving both transaction value and transaction count, so we feel good and we feel very well prepared as we move into the Q4 in terms of what the comp sales will consist of.

Mark, do you want to add anything in terms of …

Mark Light:

Jared? Hi Oliver. Thank you for the kind words. Our teams are well trained and well prepared for the fourth quarter. We have a lot of exciting initiatives that we've been discussing with you and have introduced to our managers, whether it be the Chosen Diamond or the new Pandora shop-in-shops and a lot of other programs that we have out in the Jared stores including a new wonderful system called Clientelling that I mentioned. All of those initiatives are all built into the guidance for the fourth quarter and we believe Jared is prepared to deliver within our guidance.

Oliver Chen:

Okay. In-house credit has been an incoming topic amongst investors. You've done a good job really laying out the retain/optimize versus monetize. What has been a little bit different in terms of the last few months when we last checked in with you on this topic, and I think the question on people's minds is a little bit regarding timing, just being respectful of really making a decision that prepares your business model for the long term.

Michele, you did a great job kind of giving us the parameters around 3Q being a smaller quarter but it seems like this bodes really well for fourth quarter. If you could just help us understand how we should think about expectations for fourth quarter relative to what you just printed, which was a better comp for third quarter, that would be helpful. Thanks a lot.

Mark Light:

I'll start with the credit question, Oliver. As you can imagine, this is a very important and a very complex decision for us and we are literally analyzing all the opportunities and what's changed is we have several interested banks involved and we are analyzing the opportunity through all those banks. The review is going well. These take time, as we said previously. From other companies that have gone through a similar review, it can take anywhere from 10 to 12 months to do a good job in analyzing information, but we are motivated to move as quickly and as prudently as possible in order to remove the uncertainty around this issues for all of our constituencies. We firmly believe that with either outcome we will create shareholder value and we will provide an update in due course. Michele?

Michele Santana:

Yes. Oliver, in terms of your question on the Q4 expectations, what I would say is really our Q4 guidance as you saw is no different from our earlier thinking that was implied on our August call and so we're really just bolting on our better-than-expected results in Q3 in terms of the full-year EPS guide.

We're very confident in terms of our team executing in a very important Q4. Mark talked about the initiatives that we have in place and given the investments that we've made to drive growth, therefore we feel our expectations are very reasonable for Q4.

Operator:

Our next question comes Scott Krasik from Buckingham Research. Please go ahead.

Scott Krasik:

Hi guys. Thanks for taking my question. Just sort of following on top of Oliver's last question, you always have an expectation for an acceleration in comp 3Q to 4Q. I think you do have a shift in advertising from 3Q to 4Q. Is there anything from a competitive perspective or is it the consumer at large? Maybe if we could just dip into that a little bit deeper.

Michele Santana:

I did mention on the call there's a very small shift I would characterize it from advertising into Q4, but at the end of the day I'll just repeat what I mentioned to Oliver. Our guidance on Q4 really is no different from our earlier thinking that we had on our August call and we feel very confident and the teams feel very well prepared, focused on the initiatives for the all-important fourth quarter and holiday season and we just believe our expectations we have out there are very reasonable given the environment that we're in.

Scott Krasik:

Is there anything, just given the election I guess, and some of the other uncertainty in November? Would you characterize this November as maybe a little bit more controversial or confusing for customers? Maybe you could see a bigger snap than you'd normally see in this holiday season?

Mark Light:

Scott, we're glad the election is behind us. That being said it is an interesting environment right now. We believe all of our best thinking is built into our guidance that we have in place for the fourth quarter.

Scott Krasik:

Could you just remind us—I know in some of this recent communication with the SEC you talked about it's not constructive to deliver sort of contractual metrics on your portfolio given the way you lend, so can you just remind us what are the biggest differences in how you would lend if you were reporting under a contractual accounting basis versus recency accounting basis?

Michele Santana:

Let me first start with what we've said in the past as part of our credit strategy review. If we are in the optimized scenario, optimization not only considers how we would further leverage our receivable portfolio but it also would include disclosures and changes from the recency over to the contractual. I just want to kind of start there, that if we're in the optimize scenario we will move from recency over to the contractual.

With that said, the prior comments of what we've said is that the financial statement impact really would be immaterial moving to contractual. Your net realizable value is the same under recency or contractual basis.

Operator:

Our next question comes from the line of Simeon Siegel from Nomura Instinet. Please go ahead.

Simeon Siegel:

Hey guys, good morning. Mark, I know the market tends to be difficult to track from our seat can you just talk to your view on your market share and maybe thoughts on how and when you'd expect to get that returned to positive comps? Then just looking into next year and beyond, any updates to the thoughts around segment margins and long-term margin opportunity?

Mark Light:

Thanks, Simeon. I just want to remind everybody on the call that the jewelry industry has been a growth industry for the past 25 years. If you look at the jewelry industry as a whole, it's increased about 3% to 4% on a combined annual growth rate for the past 25 years. Through those 25 years there are some up quarters and some down quarters but it's been a very consistent performer, and Signet has outperformed the industry consistently over those past 25 years and in most recent times. So we believe once the jewelry market comes back to normalcy, which it will, that we will continue to gain market share like we have in the past due to our strength in marketing, our strength in supply chain, our strength in training our people. So that's our perspective, Simeon, is the jewelry industry has grown and we believe it will continue to grow. Most importantly, from all of our research, consumers still find jewelry as a wonderful way of expressing emotion and love and we're going to be able to maximize those opportunities with what's out there.

Simeon Siegel:

Thanks. Michele, any update on the margins? Segment margins looking out longer term?

Michele Santana:

Yes, we're still confident in terms of the long-term margin rates that we had previously issued at our IR day two years back, so we're confident in achieving that. Obviously as one can imagine, in terms of mid-term goals, if you're in a lower sales environment it might have some implication in terms of how quick we reach that, but from a long-term perspective we're a growth company and we're confident in being able to achieve our goals.

Simeon Siegel:

Great. Thanks a lot guys. Best of luck for holiday.

Mark Light:

Thank you.

Operator:

Our next question comes from Lorraine Hutchinson from Bank of America. Please go ahead.

Stephen Albert:

Hi guys. This is Stephen Albert on for Lorraine. A couple of questions: number one, could you just walk us through your holiday marketing strategy in greater detail? I know you really make a big push around the holidays? How is it different than last year? Are there more impressions, greater spend? Then also on the transactions piece, I know you talked about transactions decreasing, particularly within the Sterling division and that being due to lower sales on lower priced collections which are more transactional. What about actual foot traffic? How much of a headwind are you experiencing from fewer people in your stores?

Mark Light:

I'll start with the marketing question. Michele, you can take the traffic. As far as marketing, the big difference this year, and it's an important one, is that the more we focus our efforts on understanding the segmented customers that relate to each one of our different banners is what we're trying to make sure that we take those segmented understandings of those customers and we're developing marketing creative to talk and communicate to those customers more specifically and more uniquely. Our impressions are somewhat comparable but more importantly the communication to the segment customer for Jared, Zale and for Kay is more refined this year than it was last year and even our media buy is more targeted as it relates to those segmented customers.

Michele Santana:

In terms of traffic, and I'll speak to the mall side because Jared is different and we've actually been very pleased with our Pandora and the sales associated with our Pandora in our Jareds. From a mall side, it really is hard to tie mall traffic measures to our own. We don't have store traffic counters in the mall. I think we all see the traffic reports that are out there and we're definitely not immune from traffic and we see that, as you had mentioned, in terms of our lower priced items, particularly the beads and charms that tend to be more reliant on the traffic. With that said, what helps is that with our exclusive brands and with the national marketing and advertise now we have going on, we do become more of a destination purchase rather than an impulse purchase. We'll continue to focus on driving ATV and transactions as we move forward into Q4 and beyond.

Operator:

Our next question comes from Ike Boruchow from Wells Fargo. Please go ahead.

Ike Boruchow:

Hi. Good morning everyone. Thanks for taking my question. I think maybe for Michele, just wanted to talk about the Q4 plan you guys have. It seems like whether I look at the high end or the low end of the EPS range, you're looking for much better margin flow-through relative to the past quarter or two. Is there just a much more meaningful impact from the Zale synergies and Zale EBIT relative to the first nine months in Q4? Just trying to understand the dynamic that kind of plays out there for you. Thank you.

Michele Santana:

Sure, Ike. Keep in mind with Q3 I mentioned just being a relatively small quarter it does distort some of the metrics, but when you go to Q4 you've got two things going on, right? Just the size, the relative size of the quarter representing about 50% of our annual profit, and then secondly as we talked before, given the size of Q4 you do get a share of the synergies flowing through and as we've talked in the past a lot of the synergies, about half the synergies are focused on gross margin initiatives.

Ike Boruchow:

Okay, thank you.

Michele Santana:

You're welcome.

Operator:

Our next question comes from Rick Patel from CLSA. Please go ahead.

Rick Patel:

Thank you. Good morning everyone and congrats on the better than expected results. I was hoping you could talk about Bridal. How would you characterize performance in 3Q versus 2Q and I guess where your expectations were coming in? Can you also update us on what you see as the primary headwind in that channel? Do you think it's people delaying marriage or people just buying less expensive products? When you've been in this type of soft patch in the past, how long has it taken before it recovers?

Mark Light:

Thanks, Rick. The Bridal category is a consistent performing category. Again, similar like our overall jewelry business, over the past 20, 25 years we've seen very consistent performance in the Bridal categories. There are some quarters that it will decline over the timeframe but as a whole the Bridal performance category is very consistent. We believe we're well prepared to have good Bridal category increases this fourth quarter. We've done some wonderful enhancements in our Vera Wang collections, our Neil Lane collections. We have the Now and Forever collections in our Kay brands, so we believe we're well prepared to maximize the opportunity of the Bridal customers that are out there for this holiday season. Again, it's all built into our guidance that is there for the fourth quarter.

Rick Patel:

Michele, can you give us some color on your tax rate? Just some help on what's going on there in terms of the mix changes and what's the right go-forward rate to assume beyond this year?

Michele Santana:

Definitely. As I mentioned in the prepared remarks, the tax rate we expect that annual effective tax rate to be in the range of 25% to 26%, predominantly driven just by profit mix between US and our UK. I think as we move forward I'm not going to give long-term guidance on the tax rate but we had always projected that our tax rate would continue to be a little bit favorable year-over-year.

Rick Patel:

Great. Thank you and good luck this holiday.

Michele Santana:

Thank you.

Mark Light:

Thank you, Rick.

Operator:

Our next question comes from the line of Jeff Stein from North Coast Research. Please go ahead.

Jeff Stein:

Good morning guys. A couple of questions. First of all, looking at the sequential performance of Jared and Kay between Q2 and Q3, it looks like Jared got a little bit better and Kay got a little bit worse. I'm looking at year-ago and it looks like Kay had tougher compares than Jared slightly better, but as you look at the business internally, is one getting worse and one getting better, or is it just the year-over-year comparisons that are distorting results a little bit?

Mark Light:

Thanks, Jeff. It is worth keeping in mind if you actually look at Kay on a two-year comp hurdle rate they're actually up against almost a 15% comp on two years, so Kay is definitely hurdling much higher, much higher rate than any of our other brands, no question about it. Kay also, if you think about our guidance that we gave for the third quarter, Kay did come in the high end of that guidance.

That being said, we are very pleased where Kay is positioned right now. We believe we have a lot of initiatives out there to maximize the opportunity that presents itself out there. We also feel our Jared stores are also well prepared for the fourth quarter.

Again Jeff, it's all built in to our guidance but Kay had some very strong hurdle rates to go up against.

Jeff Stein:

How about Jared? Did you see any deterioration in their performance Q2 to Q3?

Mark Light:

Well you see the comp spread from Q2 to Q3. We do believe some of our initiatives are taking hold and we still feel confident that those initiatives will help deliver our guidance for the fourth quarter with Jared.

Jeff Stein:

Okay. One last question. You guys have been focusing a lot of you advertising on Ever Us. Are you taking away any advertising from your Bridal collections and could that possibly be hurting sales of Bridal over the short term?

Mark Light:

You are correct, Jeff. We are advertising Ever Us. While we are not taking away from our Bridal category, we see Ever Us as definitely a gift-giving type of product which is perfect for the fourth quarter. The long-winded answer is no, we're not taking away from Bridal to go to Ever Us. We see Ever Us as predominantly being in the gift-giving category.

Operator:

Our next question comes from Brian Tunick from Royal Bank of Canada. Please go ahead.

Brian Tunick:

Thanks. Good morning. I guess three quick questions. One, just on the energy markets, is your impression that the worst is behind us? I think you've called out you guys have some big volume stores in Texas so just curious about what you're seeing there. Secondly, Michele, on the real estate front, I think Simeon had asked if you think you'll return to positive comps next year but just curious what your initial are on real estate lease signing or growth per square footage next year. The third question on Zale synergies, maybe can you give us some thoughts on are there any buckets for potential additional synergies for next year? Even assuming if Zale is not a positively comping business. Thanks very much.

Michele Santana:

Thanks Brian. On the energy front, and you could see from our Q2 results compared to Q3 that we did ease up in terms of the comp impact in the energy reliant. In terms of how that plays out going forward, that's I guess anyone's speculation but we are going to start getting into territory that we're comping and I think it was a good sign that what we saw from Q3 compared to Q2 eased up a little bit.

From a real estate perspective, we're not at a point that we're ready to guide what next year's square footage space is but with that said I would go back to we are a growth company and in terms of how we're going to achieve that growth it really is through organic growth or to the potential that we see acquisitions that fit well within our core. That should obviously imply that we expect our square footage to continue to grow into next year, at least comparable to what you see in terms of the guide this year, that 3% to 3.5% of square footage space growth.

Then on the Zale synergies, I'm not going to get ahead of ourselves on the Zale synergies. We're very confident in terms of achieving our $225 million to $250 million synergy range by the end of next year. We'll continue as we go through the synergies. There's a list, a significant list of initiatives that we're continuing to work through but I think it would be premature to start calling out if there's anything incremental or if there's new buckets to add to it.

Brian Tunick:

Great. Thanks and good luck.

Michele Santana:

Thanks, Brian. Appreciate it.

Operator:

Our next question comes from Bill Armstrong from C.L. King and Associates. Please go ahead.

Bill Armstrong:

Good morning everyone. So your same store sales for the third quarter were obviously better than your original guidance. What divisions outperformed your expectations and do you see those divisions continuing to show additional strength in the fourth quarter?

Michele Santana:

I'm not going to go down into in terms of how the divisions compared to how we guide. All-in you could see we delivered a negative 2% comp and although as Mark said in his comments, we're not overly pleased with a negative 2% comp it was better than what we had originally guided or expected during Q3. Right now, we are just focused and prepared on our initiatives for all of our divisions for the Q4 period.

Mark Light:

As I said in my prepared comments, Bill, our Piercing Pagoda division did very well in the third quarter, out outlet business did well across the board, our UK business did well and our e-commerce business did well, so those are the ones that performed well in the third quarter.

Bill Armstrong:

Got it, okay. Then just housekeeping in terms of modeling EPS, you mentioned the 76 million average share for the fourth quarter. For preferred dividends should we be modeling about 7.8 million per quarter? Is that about right?

Michele Santana:

Yes, that's absolutely correct is at the 5% rate, yes.

Bill Armstrong:

Got it. Okay, thank you.

Michele Santana:

You're welcome.

Mark Light:

Thank you.

Operator:

Our final question in queue at this time comes from Paul Lejuez from Citi. Please go ahead.

Jennifer:

Hey guys, it's Jennifer on for Paul. I was wondering if you could talk a little bit more about what you see going on in the US jewelry industry. Do you think jewelry total sales are down or do you feel like maybe department stores are taking share? Are there more mom and pops closing that might be pressuring your stores near term? Or is there something larger going on with jewelry in general?

Then I was just wondering if you exclude the energy space would Zales Jewelers have comped positively? Thanks.

Mark Light:

Thanks, Jennifer. Again, I said this earlier but the jewelry industry has consistently grown for the past 25 years, consistently grown. Again, not every quarter is up but on a compound annual growth rate I think it's anywhere between 3% to 4% that the industry has grown.

As far as new information that we have, there was just a report out for the Jewelry Board of Trade that there was an increase in stores that closed during the third quarter year-on-year. I think it was a 14% increase year-on-year in store closures, so stores are closing at a faster rate this year versus the prior year in the same timeframe. That being said we just believe that gives us an opportunity to continue to gain market share in the long term.

Michele Santana:

In terms of your other question on the Zale side, what would the results have looked like excluding the oil and energy region, I'm not going to get down into the numbers or the level of impact but as we know Zale, two things on the Zale side. Canada we still see a relatively large impact in the Western Canada region and then they do have a heavy concentration in Texas. So if you were to pull out that impact I think we would have been closer to probably flattish.

Jennifer:

Okay. Then quickly, could you talk about synergies you've seen year-to-date? I know say $98 million to $115 million for this year. Just trying to get an idea of maybe how much you've seen year-to-date and how much we should expect in the fourth quarter. Thanks.

Michele Santana:

Again, in terms of the synergy front they are progressing well. The integration is going well and we are very confident in terms of the guidance that we've issued both for achievement of this year as well as our three-year cumulative total. We don't go through and disclose or quantify the synergies by quarter. We really think you've just got to take the full year view, and so when we get to our year-end reporting we'll break out more detail in terms of the achievement of synergies and where the synergies are coming from.

Jennifer:

All right, great. Thanks and best of luck.

Michele Santana:

Thank you.

Operator:

We have no further questions at this time. I will now turn the call back to Mr. Light.

Mark Light:

Thank you. Thank you all for taking part in this call. Our next call is on holiday sales which is scheduled for January 11. I wish all of you a very happy and healthy holiday season. Thanks again to everyone and good-bye.

Operator:

Thank you, ladies and gentlemen. That concludes today's call. You may now disconnect.