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SIG - Q3 Fiscal 2014 Signet Jewelers Ltd Earnings Conference Call

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OVERVIEW:

SIG reported 3Q14 total sales of $771.4m and fully diluted EPS of $0.42. Expects 4Q14 EPS to be $2.30-2.40.

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PRESENTATION

Operator

Welcome to the Signet Jewelers third-quarter fiscal 2014 results conference call. My name is Cliff and I will be your operator today. (Operator Instructions)

I would now like to turn the call over to Mr. James Grant, Vice President of Investor Relations. Sir, you may begin.

James Grant - *Signet Jewelers Ltd - VP, IR*

Good morning and welcome to our third-quarter fiscal 2014 earnings call. On our call today are Mike Barnes, CEO, and Ron Ristau, 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 the annual report on Form 10-K that was filed with the SEC on March 28, 2013.

We also draw your attention to slide number two in today's presentation. And I will now turn the call over to Mike.

Mike Barnes - *Signet Jewelers Ltd - CEO*

Thanks, James, and good morning, everyone. We are pleased with our third-quarter results driven by the excellent execution of our strategy. The team has done a great job on delivering results.

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Now we remain focused on our important fourth-quarter holiday selling season. We are very pleased with the start of the fourth quarter during the first three weeks. We continue to feel well prepared and we are looking forward to a good holiday season. Of course notwithstanding any type of negative macro events, as the largest part of holiday is still in front of us, but again we are very pleased with our start to date.

Turning back for little color now on the third quarter, our third-quarter comps at Signet increased by 3.2%. US division comps grew by 4.2% compared to a 1.2% increase last year, while UK comps declined by 0.9%. E-commerce sales were up 16.3% and that is an impressive growth rate considering the US anniversaried its website relaunches last year.

This all led to operating income of $51.6 million and earnings per share of $0.42. Excluding Ultra, our diluted earnings per share were $0.45.

Now let's break this down, starting with the US division performance. US total sales were $632.1 million and that was up $56.5 million or 9.8%. US same-store sales increased by 4.2% in the third quarter. Kay comps led the way with a 5.8% increase, while Jared increased by 3%.

The success in both concepts was driven by particular strength in bridal, colored diamonds, and watches. And US e-commerce performed well, with sales up $1.7 million to $16.2 million, an increase of 11.7%. The e-commerce team was not only up against the Kay and Jared website relaunches in prior year, but also incremental marketing support to drive those relaunches.

The US division operating profit declined by 7.7% with a 9.5% operating margin. Ron is going to add a little bit more color to this here in a few minutes. Excluding the dilutive effect of the Ultra acquisition, operating income was $64.2 million and operating margin was a double digit 10.6%. It was another very solid quarter for the US team members.

Now moving on to a few comments about our outlets. Our strategy continues to be validated every day. We are pleased with the Ultra integration and we have executed a variety of initiatives to increase outlet sales productivity.

Early on we put in place the systems, store signage, and the field operations training, and we are continuing to see the benefits of the Kay rebranding in the majority of the stores. Also, we are progressing on our merchandise assortment and specialized marketing programs specifically for the outlet programs.

As we move forward with our outlet strategy we continue to see benefits in our real estate site selection. By the end of this year we expect to have approximately 160 outlet stores with good long-term potential for more. Also, by year-end, the portfolio of stores should be a business in excess of $200 million in sales.

Now I will turn to the UK for a little bit of color. Total sales in the third quarter were $139.3 million, down $1.3 million or 0.9%. Comp sales decreased 0.9% compared to an increase of 2.3% in the third quarter last year. E-commerce sales were $6.6 million and that was up $1.5 million or a very strong 29.4%.

Our UK websites attracted 8 million visitors in the quarter and out of those 52% were through mobile devices. The operating loss was $4.4 million and that was an improvement of $1.1 million from last year. As a reminder, the UK division typically makes all of its annual profits in the fourth quarter. I would like to thank our UK team members for their continuing efforts to improve our business there.

Now to wrap up my remarks, we feel strongly that we are well prepared to win this holiday season. It all starts with our well-trained, enthusiastic sales teams and they are primed and ready to support our merchandise initiatives.

We have got many exciting new collections that are well tested and in-store now. Most of these programs were rolled out during the third quarter and so their first full quarter of impact will be Q4. Examples, you see some of the example shown here on the slide.

In bridal, we introduced larger center stones for Neil Lane, inserts and wraps for Tolkowsky, and the Leo Artisan Diamond at Kay. We expanded our successful colored diamonds and these have been extremely hot. These programs are branded Artistry at Kay and Vivid at Jared.

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In Le Vian, one of our better fashion brands, we have rolled out proven styles in new colors supported by special events. Our Open Hearts Waves collection by Jane Seymour, which has done very well since its introduction last year, incorporates blue diamonds now into each design and it is offered at wider price ranges.

We are also driving success across selling channels. We have enhanced our digital ecosystem by enhancing the Kay and the Jared mobile websites, we have created mobile apps now for both Kay and Jared, and in the UK we are rolling out tablets to our stores.

We have new, exciting, and memorable ad campaigns as well launching in the holiday season on television. In fact, you may have seen some of those ads already. And they are also launching within our digital ecosystem.

Finally, we are securing and manufacturing additional, reliable, and consistent supplies of diamonds for our customers through our direct diamond sourcing initiative. The new factory in Gaborone, Botswana, is an exciting part of this initiative. I tell you, with all these great initiatives in place, again, we believe we are well positioned for a great holiday season and beyond. And we have had a good start so far.

Now I will turn the call over to Ron.

Ron Ristau - *Signet Jewelers Ltd - CFO*

Thanks, Mike, and good morning, everyone. I will start by explaining sales in more detail.

For the quarter, total sales for Signet increased 7.7% to $771.4 million compared to $716.2 million last year. Same-store sales increased 3.2% compared to 1.4% growth last year.

In the US, our total sales increased 9.8%, or $56.5 million, to $632.1 million, which included a same-store sales increase of 4.2%. Our non-same-store sales were up 5.6%, which includes a 4.8% increase due to Ultra and a 0.8% increase for the US excluding Ultra. The US sales increases were driven by particular strength in bridal, colored diamonds, and watches. Both Kay and Jared experienced increases in transaction counts and average transaction value.

In the UK, total sales decreased 0.9%, or $1.3 million, to $139.3 million. Comp store sales decreased by 0.9%. Bridal and diamond sales increased in the third quarter and in our concepts the number of transactions increased while the average transaction value declined, with Ernest Jones particularly impacted from Rolex being offered in fewer stores. Watches, however, were strong in Ernest Jones when we exclude the impact of Rolex.

As Mike mentioned, Signet e-commerce sales were $22.8 million, up $3.2 million, or 16.3%, for the quarter.

Now let's review the components of operating income. Signet gross margin was $239.2 million, an increase of $3.8 million. The gross margin rate was 31%, down 190 basis points. The inclusion of the results for Ultra decreased the consolidated gross margin rate by 60 basis points and the US gross margin rate by 80 basis points.

In the US, gross margin dollars increased $6 million compared to the third quarter of fiscal 2013, reflecting higher sales offset by a gross margin rate decrease of 220 basis points. The lower US gross margin rate was primarily attributed to the following: a gross margin rate decline of 100 basis points, 60 points of which were attributed to Ultra, with the remaining decrease primarily due to the net impact of gold hedge losses associated with the decline in gold prices earlier this year.

In addition, lower gold spot prices reduced the recovery value on trade-ins and inventory, causing a further 40 basis points decline in the gross margin. Store occupancy deleveraged by 20 basis points, primarily due to the inclusion of Ultra, and a change in the US net bad debt expense reduced gross margin by 20 basis points as the US net bad debt ratio to sales increased to 5.6% compared to 5.4% of sales in the prior year third quarter. The increase in ratio was primarily due to growth in the outstanding receivable balance from increased credit penetration and a change in the credit program mix.

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In the UK, gross margin dollars decreased $2.2 million, primarily reflecting the impact of decreased sales and a gross margin rate decline of 140 basis points. The lower gross margin rate in the UK was primarily attributed to a 60 basis point decrease in the gross merchandise margin rate due to increased promotional sales and a 50 basis point decline due to lower recovery value on inventory scrapped, with the remaining decrease primarily deleverage of expenses on lower sales.

Signet's selling, general, and administrative expenses were $233.4 million, an increase of $10.8 million. And as a percentage of sales, improved 90 basis points to 30.2%. I will discuss this in more detail on the next slide.

Our other operating income was $45.8 million, or 5.9% of sales, as compared to $39.7 million, or 5.5% of sales, last year. This increase of $6.1 million was primarily due to higher interest earned from higher outstanding receivable balances in the United States.

So our consolidated operating income in the third quarter was $51.6 million, representing 6.7% of sales, which was 60 basis points lower than prior year. However, excluding Ultra, our consolidated operating margin was 7.5%, up 20 basis points over the prior year.

By segment, the US division's operating income, including Ultra, was $60.3 million, or 9.5% of sales, compared to $65.3 million, or 11.3% of sales, in the third quarter of fiscal 2013. When we exclude Ultra, the US division's operating income was $64.2 million, or 10.6% of sales.

The operating loss for the UK division was $4.4 million, an improvement of $1.1 million, and our fully diluted earnings per share were $0.42. Excluding Ultra, fully diluted earnings per share would have been $0.45.

Now some additional detail on SG&A expenses. As I stated earlier, SG&A expenses were $233.4 million compared to $222.6 million in the third quarter of fiscal 2013, up $10.8 million, and as a percentage of sales improving by 90 basis points to 30.2%. In the US SG&A expenses increased by $9 million, primarily due to higher sales, and as a percentage of sales, they were essentially flat as spending remained well controlled.

The inclusion of the results for Ultra increased SG&A by $8.4 million, which was partially offset by expense reductions in the UK and corporate totaling $6.6 million. Our SG&A remains effectively controlled and well focused.

Net inventories ended the quarter at $1.6449 billion, an increase of $136.4 million, or 9%, from a year ago. The increase is primarily due to a $41.4 million increase in inventory for Ultra and a $19.5 million increase in diamond inventory associated with our rough diamond initiative. Excluding these items, our base inventory increased by 5%. Our inventory is well positioned for the holiday season and we expect to end the year with inventory at appropriate levels go forward.

Now credit. Credit remains an important component of our business. The net accounts receivable increased to $1.1235 billion, up 12.6% for the quarter. In the quarter the credit penetration, excluding Ultra, was 64.2% compared to 62.7% last year. This is attributed to increases in the bridal and branded product sales and strong consumer acceptance of our credit offerings.

We have seen thus far a strong response to the Ultra credit offerings rolled out in late June. However, as a group, it is currently less than our historical base, which is why we breakout the credit penetration with Ultra which was 63.3% versus 64.2% without Ultra.

The average monthly collection rate this quarter was 11.7% compared to 12% last year as customers continue to opt for our regular credit terms, which require slightly lower monthly payments, as opposed to the 12 months interest-free program.

Our bad debt expense was $35.1 million in the third quarter, primarily driven by growth in receivable balance from increased credit penetration and a change in the credit program mix. Our consumers continue to utilize and manage credit effectively.

Offsetting the bad debt expense was an increase in other operating income, which is primarily interest income on the higher outstanding receivables and a shift away from interest-free programs. The income on these programs was $45.8 million, or 5.9% of sales, in the third quarter. The net impact of these two items was income of $10.7 million in the third quarter compared to income of $8.4 million in the prior year, an increase of $2.3 million.

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In the year-to-date we see a similar trend of increased bad debt due to growth in the receivables offset by increased other operating income with a net impact of $46.2 million versus $38.5 million last year. So the net benefit year-to-date was about $7.7 million.

Now, importantly, turning to our fourth-quarter guidance. For the fourth quarter of fiscal 2014 the Company currently expects same-store sales to increase in the low to mid single-digit range. In the fourth quarter, gross margin is expected to be, at a minimum, relatively consistent with prior year, reflecting improvement versus the third quarter. As a result, earnings per share are expected to be in the range of $2.30 to $2.40 based on an estimated 80.3 million weighted average common shares outstanding.

For the full year the Company now expects a tighter range of capital expenditures estimated in the range of $180 million to $185 million, which includes the opening of 75 to 85 new Kay and Jared stores, store remodeling, investments in digital and information technology infrastructure, outlet channel development, and the purchase of the factory in Botswana.

Just as a further note, I would like to point out that in the fourth quarter and beyond Ultra will not further be broken out as Ultra no longer existents and has been integrated into Kay, and Kay outlets will not be reported as a segment of the business.

Thank you. I would now like to turn the call back to Mike.

Mike Barnes - *Signet Jewelers Ltd - CEO*

Thanks, Ron. In conclusion, I would like to once again thank the Signet team worldwide for their contributions to a successful quarter. And now I would be pleased to take any questions that you might have.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Ike Boruchow, Sterne Agee.

Ike Boruchow - *Sterne Agee & Leach - Analyst*

Congrats on a great quarter. I guess, Mike, you talked about being very pleased quarter to date, even though a lot of the heavy lifting is ahead of you. Can you just talk about some of the trends you are seeing with your off-mall and your mall Kay and Jared locations? Mall traffic seems like it has been pretty choppy lately.

And then also any commentary on Kay with a 6% comp, Jared with a 3%? Any differences you are seeing there from your customers, or any reason why Kay should continue to outperform Jared? Just any high-level thoughts there? Thanks.

Mike Barnes - *Signet Jewelers Ltd - CEO*

I will give you a few high-level thoughts. Obviously we give our official guidance that Ron just went through and we just give a little bit of a directional outlook of how the quarter has started. And like I said, we are very pleased with the way the first three weeks have gone. We think that we are well prepared to have a full, very good holiday season, notwithstanding events that could happen out there.

Kay just led the way with a really strong comp number at 5.8%, powerful. The business was great. Jared was still very good and still well within the guidance that we gave at 3%, and it is doing extremely well also. We think that both of the concepts could have a great holiday season for us going forward.

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There is a couple of things, Ike, that really are driving this business. One of them happens to be unbelievably great merchandise offerings. A lot of this, as I mentioned in the prepared remarks, really just got set in the third quarter.

And so we feel like we are well prepared to drive those merchandise offerings into the fourth quarter. We mentioned without going into too much detail, for obvious competitive reasons, bridal continues to be extremely strong for us. Colored diamonds are really hot right now and our watch business has been good also. We have got some unbelievable offerings coming in there.

Now to support those offerings, this is the first year that we have actually moved our advertising back and started advertising in October. I think that the additional advertising and marketing that we have done -- the team has done a fantastic job with driving it. We have a lot of brand-new ads out there.

You are probably seeing a lot of them already. Any of you guys out there that are football fans certainly have seen some and a lot of the most popular network TV shows we are on. So we have very high-quality advertising supporting unbelievable merchandise offerings.

I think that is what is driving the business and I think that there is very good opportunity for us to continue to drive that business strongly for the fourth quarter. And, quite frankly, we are looking forward to holiday.

Ike Boruchow - *Sterne Agee & Leach - Analyst*

Great. Good luck, guys.

Operator

Dorothy Lackner, Topeka Capital Markets.

Dorothy Lackner - *Topeka Capital Markets - Analyst*

Thanks. Good morning, everyone, and congratulations. Just tagging on to that question, I have seen a number of Kay ads. I haven't seen Jared ads. I wonder if there were any differences in the schedule of rolling those ads out; if Jared is more skewed towards the fourth quarter versus the third.

Then just any comments you might have about the overall environment that you are seeing heading into the holiday season. Thanks.

Mike Barnes - *Signet Jewelers Ltd - CEO*

Dorothy, this is Mike. Honestly I think it is just a matter of the timing of when you have been watching, because we have had a lot of Jared ads out there as well. Now we do have more impressions for Kay than we do Jared, so there is a better chance that you would see Kay ads, but we do have Jared. We started them at the same time.

We have some new ads for Jared as well as Kay, and so they are both out there pretty strongly right now.

Dorothy Lackner - *Topeka Capital Markets - Analyst*

Okay, great. Good luck for the holiday.

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Operator

Lorraine Hutchinson, Bank of America.

Lorraine Hutchinson - *BofA Merrill Lynch - Analyst*

Thank you, good morning. I just wanted to follow up on Ultra. You had originally guided the dilution flat to a negative $0.02 and you came in at minus $0.03. Can you just give us an update on how that business is doing versus your expectations, and if you still think that will be accretive in the fourth quarter?

Ron Ristau - *Signet Jewelers Ltd - CFO*

Yes. I think the Ultra integration has been going extremely well. All of the operational aspects of it have gone very smoothly.

In the last call I estimated it would be zero to a couple penny loss and it came in at negative $0.03. The reason for the slightly lower number is that we have seen some slight disruption as we have changed the product mix and the selling methodologies and the discount structure in what was the old Ultra chain into Kay. Some of those stores are struggling a bit with sales.

We expect that this will all turnaround with additional training and exposure to our systems, and we do expect that Ultra will definitely be accretive in the fourth quarter. So what I would say is that probably just a little bit of, I would call it, growing pains in the third quarter. About a penny off of where we thought we might come out.

It will be very strong into the fourth quarter and our total outlet business, as Mike indicated, has just been terrific. So the conversion -- Ultra, in a sense, will no longer exist. It now exists as Kay.

Our Kay outlet strategy go forward is very powerful, very strong. A lot of the learnings that we have learned from the Ultra integration have been applied to our, quote, organic Kay stores which are doing terrific. And I would say that as we move into next year that is going to be a very powerful business.

We will put behind us all of the one-time transitional and disruptive costs that we incurred this year, and we should be all systems go as we move into 2015.

Lorraine Hutchinson - *BofA Merrill Lynch - Analyst*

Great. Then the fourth-quarter guidance you spoke about flat gross margins versus down close to 190 basis points in the third quarter. What are the key factors that will help you get to flat in the fourth quarter?

Ron Ristau - *Signet Jewelers Ltd - CFO*

I think that is a good question. Number one, in our fourth quarter it is often much higher than in our third quarter, primarily driven by leverage on sales. But we've also taken a very thoughtful look at our promotional pricing, our fourth-quarter product mix, and our expectations importantly for increasingly favorable commodity costs.

Because in the third quarter part of what we witnessed was that through our average system our commodity costs improved, but they didn't improve in the third quarter because of the low sales volume and slow return that we experienced. It will get much more dramatic into the fourth quarter given the change in some of the commodities that have moved. And so for all those reasons together we are very confident that our margins will expand.

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I said at least flat, by the way. I didn't say flat, I said at least flat.

Lorraine Hutchinson - *BofA Merrill Lynch - Analyst*

Thank you.

Operator

Brian Tunick, JPMorgan.

Brian Tunick - *JPMorgan - Analyst*

Thanks. Good morning, guys. Two questions. First, I guess, Mike, if you think about the consumer out there, can you talk about sort of where the price points are shaking out at Kay right now? Can you talk about what you are seeing at different price point ranges?

Then, Ron, I missed it; for the fourth quarter on your comp guidance did you say what you expected the UK business to perform at? And just what kind of changes are you making in the UK business from what you have seen through the first nine months? Thanks very much.

Mike Barnes - *Signet Jewelers Ltd - CEO*

As far as the pricing with the consumer out there, we are continuing to see really a very good mix of price and units driving our increases out there. So it is really a pretty good balance.

We are seeing continued AUR improvements. I think that that is a very positive note for us, but we are also seeing unit improvements. And we like to see that balance because we want to drive both, quite frankly. I will let Ron maybe provide a little bit more color if we have more detail on how much that has changed.

One thing I would comment on, I made this comment in the prepared remarks as well on the UK, is that the fourth quarter is far and away -- not only is it the strongest quarter for all of us, but especially in the UK. And that is really where they turn highly profitable. So we are well positioned in the UK as well and we hope to have a strong holiday season.

It is still a bit tougher over there. We had a slight negative comp, very slight at 0.9%, but we believe that we are in a good position and we are looking forward to the holiday season there as well.

Ron, do you have any other color on the AURs or the price?

Ron Ristau - *Signet Jewelers Ltd - CFO*

Of what we have experienced in the fourth quarter? No, I don't think I -- because I went through that in the third quarter.

As I indicated, in both -- in the US concepts we experienced increases in both transaction counts and average price into the third quarter and we would expect that in the fourth quarter that the mix would remain similar. That we would get both increases in transaction and some pricing benefit as we move forward. There is nothing in the fourth quarter that is substantially different than anything we have experienced all year long is I guess what I would say.

To your question on the UK, beyond what Mike has said, we essentially came in relatively flat in the third quarter. We would hope to get slightly positive, but we don't break it out separately as far as guidance for US and UK. So I couldn't go beyond that.

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Brian Tunick - *JPMorgan - Analyst*

Okay. If I could just throw in one more about the 53rd week; can you just make some comments, remind us how much in sales or earnings impact?

Ron Ristau - *Signet Jewelers Ltd - CFO*

Sure, sure. I have that exact impact. It was $0.02 in operating income, so it was $56 million in sales. It was an operating loss of $2.7 million, so that is pretax, and on an after-tax basis it had an impact of about a $0.02 loss in the 2013 year.

Brian Tunick - *JPMorgan - Analyst*

All right, terrific. Good luck for holiday, guys.

Operator

David Wu, Telsey Advisory Group.

David Wu - *Telsey Advisory Group - Analyst*

Thanks. Good morning, everyone. First, in the UK, obviously it looks like conditions softened a bit through the quarter given that you previously talked about it being positive in the first three weeks of August. I know you had to become a little bit more promotional, which clearly impacted the gross margin.

Can you elaborate more sort of on what you are seeing there and if you expect promotions to remain high during the holiday season?

Mike Barnes - *Signet Jewelers Ltd - CEO*

Yes, David, thank you. In the UK -- again it was a touch soft with a very slight negative comp at almost flat, 0.9%. We are very cognizant of the competitive landscape over there and we watch our competitors very closely. And so we did drive promotion a little bit heavier to help drive the sales and garner the business in that market. And I believe it is certainly the right thing to do, because we need to grow our business.

It is working out okay for us. We improved the losses in the UK year over year by $1.1 million, which was very positive, so obviously a lot of the other initiatives that we have tackled in the UK have worked out for us and we are making a lot of progress.

The management team is extremely motivated over there. We had a great sales conference. We are working together more and more with our US teams. We are working to find more and more best practices and take a lot of the successes that we see over here in the US and be able to drive those more in the UK.

We are driving the brands harder in the UK. We are looking at the merchandise offerings with a much keener eye than we ever have, and we are looking at the marketing activities and how we can continue to drive that business. It is going to take some time, and we knew that, but I feel like that we are making progress and that we will see a lot more progress in the future there.

Again, the holiday quarter is so important in that market and we feel like we are definitely well positioned. The merchandise is in the stores. We have got much improved windows in our stores compared to prior years and we are looking forward to holiday there.

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So I think that we have a big opportunity to continue to turn that business around and we still believe we can drive it up to the double-digit operating income over time.

David Wu - *Telsey Advisory Group - Analyst*

It was encouraging at least to see that you were able to really tightly manage expenses in the UK during the quarter. I was wondering if you could talk about the cost cuts that are happening there, if we should expect a similar level of benefit to SG&A in the fourth quarter.

Ron Ristau - *Signet Jewelers Ltd - CFO*

You should expect that we are going to stay tight on the spending, David. We are being very careful with the costs there, but we also understand that we can't save our way to prosperity in the UK division. It is helpful and we think we did a good job in cost management, but you will see it be very tightly managed without being specific about how much more.

But we will be tightly managing it. What I would love to do is actually find ways to spend a little more money in advertising and programs that would be effective there. But that won't be for this year; that will be for the future.

Mike Barnes - *Signet Jewelers Ltd - CEO*

I think that is an important point, let me just add on to that. Ron clicked on an important point. We do want to drive our business through marketing and advertising there.

We are also -- because of the strength of our company and our balance sheet, we are continuing to invest in all the important initiatives in the UK. We continue to remodel stores that we need to. We are expanding as we see fit.

We are continuing to build out shop-in-shops, especially in the watch areas. So we are tackling a lot of initiatives over there in a very positive way and we are looking at the long term and the future of that market. As the market leader, having the largest market share in that market, it is important for us to continue to grow that business and expand our leadership model.

David Wu - *Telsey Advisory Group - Analyst*

Great. Then just lastly on the Ultra acquisition, can you perhaps talk about the introduction of the in-house credit program and the differentiated merchandise into the Ultra stores and if you have so far seen a noticeable step up in sales performance?

Ron Ristau - *Signet Jewelers Ltd - CFO*

What we are seeing is as we have converted we have, of course, put in our credit programs and changed the product mix. So right now what we have seen is the credit mix is getting traction there, the credit penetrations are in the mid-40s versus our chain, which was seasonal in the third quarter at a little over 60. That was in the mid-40s so that was very good and very helpful.

The product mix is a two-edged sword. We think that the product mix will become much better accepted over time. However, there has been some, as I have indicated, mix issues as we have been working through the older inventory because we didn't just replace all the inventory. We have been doing it on perhaps a more gradual basis.

So I believe that the product mix will become more favorable with some short-term disruption, as I have indicated, because of the fact that in some of those stores we have a higher percentage of older inventory that needs to be worked through, which should correct itself as we move through

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the fourth quarter. But, overall, the total outlet program is just terrific, as I said, with some small glitches on conversion and so on, but nothing that is in any way strategic. The strategic view of it is that it is fantastic.

Mike Barnes - *Signet Jewelers Ltd - CEO*

David, I will just add on to that a little bit. Ron mentioned that we were in the 40s in our credit mix. That jumped from the low 30s when they were Ultra (multiple speakers) I'm sorry, jumped from the high 20s when they were Ultra stores and that happened pretty quickly as we rebranded those as Kay.

We are also seeing on the merchandise side, Ron mentioned that a little bit, now that we have got a full outlet strategy we have got a team behind this. And we are really focused on how to drive the outlet business as a separate channel and how to get the right mixture of closeout products, made-for products, some full-price products, especially in the brands. We are really excited about the opportunity that we have to drive that business.

And as Ron said, we are still working through a lot of the inventories that they had when we took them over. Again, we are so excited about this outlet opportunity.

We have been through three quarters. We have gone through our first year, now we have annualized Ultra starting with this quarter, and I think the progress that we made in one short year is just pretty remarkable. And it is going to be a growth driver and a profit driver for us for the future.

David Wu - *Telsey Advisory Group - Analyst*

Excellent. Thank you and congrats on the great job.

Operator

Rick Patel, Stephens Inc.

Sal Adamo - *Stephens Inc. - Analyst*

Good morning. This is Sal Adamo filling in for Rick Patel. My question is on can you update us on which inning you are in for your real estate strategy in the UK? Can you give us an update on how many store closures we can expect next year across both of your concepts? Thanks.

Ron Ristau - *Signet Jewelers Ltd - CFO*

I am sorry; let me make sure I understood the question.

Mike Barnes - *Signet Jewelers Ltd - CEO*

Which inning we are in on our rationalization of UK real estate.

Ron Ristau - *Signet Jewelers Ltd - CFO*

Oh, which inning. I would guess that we are in the top of the fourth somewhere, because we are closing the stores and, as we have indicated, we have not seen that we would be buying out of any leases or anything of that nature because the economics are not favorable. And so most of these leases will close on lease expiration.

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We had indicated that there are probably another 75 or so stores to close, 75 to 100 stores to close in the UK ultimately. I don't have the exact numbers for next year yet. Round numbers, I would guess 30 to 40 but I wouldn't hold me to it.

We will update that as we go through our budgets over the next couple of weeks and months and have more to say about that, probably by the time we get into the ICR conferences after Christmas. But you can expect you will see more closures, because it is very important for us to stay focused in the malls in the UK where the consumers are gravitating and to reduce the non-productive real estate of which there is too much. I hope that answers your question.

Sal Adamo - *Stephens Inc. - Analyst*

It does, thank you.

Operator

Oliver Chen, Citigroup.

Oliver Chen - *Citigroup - Analyst*

Congratulations on the consistent and great results. Regarding the environment, could you update us on traffic and volatility and what you are seeing with that in the marketplace with respect to department store competition? And also how do you think you could evolve your pricing in average unit retail?

Also, from a longer-term perspective, if you could just update us on your developments in terms of purchasing the diamond polishing business and the longer-term view for the strategic logic there? Thank you.

Ron Ristau - *Signet Jewelers Ltd - CFO*

I will take the first part of it and then Mike will take the second part on the strategic policy. But relative to traffic, all we can say is that what we have seen is that traffic in our stores is positive and trends are positive and we feel we are well positioned for a very good holiday season. That is the best way I can think about it.

As it relates to pricing over the long term, our pricing depends upon the quality of the products that we introduce and the targets that we achieve relative to the products. We have had a record of slowly increasing our average unit retails and I would guess that that would somewhat continue. I don't know what else to say.

Mike Barnes - *Signet Jewelers Ltd - CEO*

I will add a little bit more on the AURs. It is not just a matter of raising prices. We are also driving -- part of driving higher AURs is the fact that we are providing our customers with more and better choices at higher price points.

A lot of the brands that we sell have higher AURs than some of the core non-branded product and the customer is gravitating more and more toward that branded environment. I think it is going to continue to become more important, not less important. Oliver, you follow a lot of brands so you know how important branding is, not only in our business, but overall in the marketplace.

So I believe that we will continue to see that drive our businesses. Some of the great brands that we have have higher AURs. You know the Neil Lanes and the bridal aspect of it; the fantastic Le Vian brand that we carry in the fashion realm, so I think that we will continue to see that for the foreseeable future. How much I wouldn't try to guess, but I think it is an important part of our business going forward.

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Let me take the second question that you had regarding the strategic diamond sourcing. What we have done is we have purchased this polishing -- cutting and polishing factory in Gaborone, Botswana, Africa, and it is very strategic for us, Oliver. We buy a tremendous amount of diamonds; in the US 75% of our products are diamond related. It is very important for us to work for the long term to have a more secure supply of diamonds.

Diamond supply is not growing in the mines, but the demand will continue to grow. And we believe that we need to get closer and closer to our supply chain.

Now this is still not material, particularly in the numbers that we are throwing out there, but this is a starting step for us to really drive our supply chain for the foreseeable future and it is very strategic and very important. And not only is it the factory that we purchased there, but also opening an office in Mumbai, India. We are going to have a permanent presence there.

We have had people going into places like Mumbai and Antwerp every four to six weeks making buys. We are going to have a permanent presence so that as opportunities come from a buying perspective we have got somebody on the ground ready to make decisions and able to secure that supply for us as they become available. So that is going to be a huge improvement for us as well. We are working the supply chain in every possible area.

And, thirdly, I would just say, from a supply chain standpoint, we have a lot of very important partners out there that we have worked with for a long time. And they are not becoming less important; they are becoming more important, too. We need to work every piece of the supply chain to the benefit of this company and optimize it.

We are working in many different directions and the partnerships that we continue to forge with our long-standing partners are just as important as the rest of it. All of these things working in concert together is what I believe is going to give us a competitive edge for the long term when it comes to getting the supply of diamonds that we need.

The last thing I would say about the factory is having control over what we decide to cut and polish is very important, because there are certain cuts that sometimes can be a little bit short in supply. For instance, we have a very strong business in princess cut diamonds and there have been times where it has been tough getting the supply we need. We have always gotten it, but it has been tight at times.

This gives us the opportunity to cut the diamonds to optimize what our customers are demanding in our stores, and that is a big win for us. So we are very excited about the opportunity going forward.

Oliver Chen - *Citigroup - Analyst*

Thank you. That sounds very encouraging. We think it is a great idea.

Operator

Simeon Siegel, Nomura Securities.

Simeon Siegel - *Nomura Securities - Analyst*

Great, thanks. Just another on Ultra if I can. Can you just contextualize the Q3 Ultra operating loss, how much of that was one time or integration related? Then are there any location or structural differences between the converted Ultra stores and the other Kay outlets that would keep them at different operating metrics at this point?

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Ron Ristau - *Signet Jewelers Ltd - CFO*

I wouldn't say that there were too many one-times, other than the fact that the primary reason for the loss in the third quarter was sales related. So in other words, it is just overall lower sales as we made the conversion to the new product mix so it is not like a one-time cost. It is one time, but not a one-time cost, if that makes sense.

From a structural perspective, the stores are similar. We don't see that there is any major differences in the stores. When we looked at the real estate portfolio initially we are were very pleased with it. There is always a few stores that we would have said, ghee, we wouldn't have done that store, but it is really not significant in the overall mix of things. So I wouldn't say there is any structural problems.

There is good and bad malls. There is malls that are stronger and malls that are less strong within the outlet world, as there are within any world where there is A, B, and C malls. But other than that I wouldn't say.

Mike, do you have any different opinion on that?

Mike Barnes - *Signet Jewelers Ltd - CEO*

No, I think when it comes to the outlets that what we have done has done nothing but strengthen this. Certainly, to Ron's point, there are certain malls where we have issues that we need to work on, but that is going to happen in anything. The important thing is that the majority of the acquisition of the Ultra stores has just been a huge boon to our outlet business and has really popped us up into a leadership role within that channel of distribution, which is something that we sorely lacked before we did this.

It has sped up the process tremendously and they are doing terrific. We are always going to have -- in any portfolio you are going to have the bottom 20% of your stores that you got to deal with and work on it. And it is the same with that as it is any other real estate portfolio.

Ron Ristau - *Signet Jewelers Ltd - CFO*

The other thing I think it is fair to mention and I think that you should know if you are thinking about this, is that we are about a little better than 30 stores that we did not convert to Kay outlet that we left with the ultra nameplate. What we have seen is those stores were in malls where there were two stores, so we didn't want to have two Kays so we left it a Kay Outlet and then Ultra in about 35 locations.

And it is fair to say that those stores are not doing too good because those stores have to now compete against the Kay outlet. So we have seen some lower than we had hoped for performance in the stores that stayed Ultra and we have got some plans to address it going forward. But I think that is probably a fair callout and also contributed a little bit to what we saw in the third quarter.

Simeon Siegel - *Nomura Securities - Analyst*

Thanks, Ron, that is helpful. Have you guys spoken to what your plans would be for those 30 stores?

Ron Ristau - *Signet Jewelers Ltd - CFO*

Other than to say better than what they are doing today, not really.

Mike Barnes - *Signet Jewelers Ltd - CEO*

We have got some plans to address it, but we wouldn't discuss it on the call.

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Simeon Siegel - *Nomura Securities - Analyst*

Great. Thank a lot, guys. Good luck for the holiday.

Operator

Jeff Stein, Northcoast Research.

Jeff Stein - *Northcoast Research - Analyst*

Two quick questions; one for Ron. What does the manufacturing facility that you just acquired, the polishing facility, add to the supply chain in terms of dollar inventory?

Ron Ristau - *Signet Jewelers Ltd - CFO*

It added in total -- the total amount of inventory in the third quarter incrementally was about $19 million. The total inventory was about -- sorry, do you have the number?

Unidentified Company Representative

$52 million.

Ron Ristau - *Signet Jewelers Ltd - CFO*

$52 million of total inventory in loose inventory that we purchased that we wouldn't purchase if we were not in the rough manufacturing business. But we started doing that a year ago, so it's $52 million in total, $19 million in incremental impact in the third quarter.

Mike Barnes - *Signet Jewelers Ltd - CEO*

It is important to note that we have been buying rough diamonds for some time now. We just purchased the factory recently, but we had already had inventories of rough so the incremental is not as much. It is only $19 million.

Jeff Stein - *Northcoast Research - Analyst*

I see. Okay, good. As far as -- can you talk a little bit about the sequential trend in your business during the third quarter in the US? And specifically any regional callouts, any effect that you could measure from the government shutdown at all?

Ron Ristau - *Signet Jewelers Ltd - CFO*

No, not that I could think of, Jeff, that we could see or find or point to and say it was the government did this or that. I would say that from our perspective it didn't seem to have a lot of impact on our business.

We have seen, of course, some improvement in the Northeast, which last year did experience the impact from the Superstorm Sandy. But other than that I don't know that there is any other regional callouts that are significant enough that we would make them on the call.

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Mike Barnes - *Signet Jewelers Ltd - CEO*

There are little differences here and there and there is, obviously, some regions that are a little bit stronger than others. But really, when you look at it in the aggregate, we have pretty consistent results across the portfolio across the United States. There are no particular regions that are so weak that you would want to call those out or so much stronger than other regions that you would call those out as well.

Jeff Stein - *Northcoast Research - Analyst*

Got it. Sequentially, month by month, any notable change within the quarter?

Ron Ristau - *Signet Jewelers Ltd - CFO*

Within the third quarter?

Jeff Stein - *Northcoast Research - Analyst*

Yes, within the third quarter. In other words, when you look at August, September, October.

Ron Ristau - *Signet Jewelers Ltd - CFO*

We generally don't get into month-by-month trends. I don't think there is anything significant that we would call out.

Jeff Stein - *Northcoast Research - Analyst*

Okay, great. Thank you.

Operator

Andrew Hughes, UBS.

Andrew Hughes - *UBS - Analyst*

Ron, I think you alluded earlier on on the gross margin to be flat in Q4. (multiple speakers) when all of the gold hedges --

Ron Ristau - *Signet Jewelers Ltd - CFO*

Andy, there is a backup noise that is coming through. That's better. It seems like there is someone talking in the background; we just couldn't understand, I'm sorry.

Andrew Hughes - *UBS - Analyst*

I will try again. Talking about gross margin (technical difficulty) seems to be at least flat. Does that include any currency hedges (technical difficulty)?

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Ron Ristau - *Signet Jewelers Ltd - CFO*

No, that includes the impact of gold hedges, of course. What we will be seeing in the fourth quarter is we will be still having this impact from gold hedges being written off, but what will happen is that the average costing system will have greater impact in the fourth quarter than it did in the third and that will be more of an offset or more benefits realized in the core, let's call it the core buying process.

We will still be left with the problem of writing off for these gold hedges over a period of time, but the other activity will offset it and, therefore, it should be a net positive we believe in the fourth quarter. And into the first and second quarters next year, by the way.

Andrew Hughes - *UBS - Analyst*

(technical difficulty)

Ron Ristau - *Signet Jewelers Ltd - CFO*

Well, I think -- well, what I'm saying is that I think that the -- right now, provided there is no changes, we should start to see some more favorable commodity costs rolling forward. That is correct.

Andrew Hughes - *UBS - Analyst*

Just a second, going back to Ultra as well (technical difficulty)?

Ron Ristau - *Signet Jewelers Ltd - CFO*

The impact of Ultra as we go forward, since we annualized against Ultra from the fourth quarter of last year when we made the purchase, it no longer will have the distortive impact that it did throughout the first three quarters of this year where it was essentially non-comp. As we move forward into the fourth quarter and all of next year we probably would not be calling that out any further, because it is no longer macro distortive to the overall margin rate of the Company.

Andrew Hughes - *UBS - Analyst*

Would you expect (technical difficulty) from here you would expect to make a profit in every quarter?

James Grant - *Signet Jewelers Ltd - VP, IR*

Will Ultra be profitable each quarter next year?

Ron Ristau - *Signet Jewelers Ltd - CFO*

Will be profitable every quarter of next year? I don't know if it will be profitable every quarter of next year, the outlet business is a bit seasonal. We are trying to make it more like our Kay stores so it will become very -- it won't lose a lot of money like it did this year, because this year the first and second quarter were driven by about $0.09 of one-time costs and our total loss was almost $0.09. So it is very similar to the one-time costs.

It should do better than breakeven, but it is going to be accretive in the fourth quarter and we will have more to say about how the total outlet business develops. We will no longer be addressing Ultra. Ultra, again, is only a subcomponent of our total outlet business and our total outlet business will be profitable each quarter of next year.

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Mike Barnes - *Signet Jewelers Ltd - CEO*

And as we said, really it is an outlet business and it has been consolidated now so going forward you will be hearing us talk about our 160-store outlet change in terms of any directional comments that we give about it. And our outlet business in aggregate is doing fantastic for us.

The organic Kay stores that we had opened were doing well before we made the acquisition; they continue to do well. And the ones that we converted to Kay, which is the majority of those Ultra stores, also are doing very well. The ones that are left as regional stores are a little bit more difficult, but we have plans to address that and we believe some very good plans to address it.

In total, our outlet business is extremely strong. It is a big growth driver for us and it is a big profit driver for us, and so we have an opportunity to continue to grow real estate in that channel of distribution, grow sales, and grow profits.

Ron Ristau - *Signet Jewelers Ltd - CFO*

I think in the future we just need to -- we will be trying to change the dialogue to reflect that and less focus on Ultra, which no longer exists.

Operator

Bill Armstrong, CL King & Associates.

Bill Armstrong - *CL King & Associates - Analyst*

Good morning, guys. So on Ultra, I mean it sounds like other than some of these lingering inventory transition issues your integration process is pretty much complete. Is that fair to say?

Ron Ristau - *Signet Jewelers Ltd - CFO*

I would say that the integration process is a slamdunk. It has been done with excellence and operational excellence, and hats off to our team that worked on it. We are very pleased with every single aspect of that conversion. Now we just have to work out the residual operational details so that they are no longer with us.

Mike Barnes - *Signet Jewelers Ltd - CEO*

And we look forward to a very good year next year with it.

Bill Armstrong - *CL King & Associates - Analyst*

Okay, great. Thanks.

Operator

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

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Mike Barnes - *Signet Jewelers Ltd - CEO*

Thank you. Thank you all for taking part in this call. We really appreciate your interest and your support.

Our next scheduled call is on January 9 and there we will review our holiday sales results. So with that I wish you all a very happy Thanksgiving and happy holidays. We will look forward to speaking to you early next year. Thank you.

Ron Ristau - *Signet Jewelers Ltd - CFO*

Thank you all. Bye-bye.

Operator

Thank you, ladies and gentlemen. This concludes today's conference. Thank you for participating. You may now disconnect.

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