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SIG - Signet Jewelers First Quarter Fiscal 2014 Results Conference Call

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OVERVIEW:

SIG reported 1Q14 total sales of $993.6m and fully diluted EPS of $1.13. Expects 2Q14 EPS to be $0.79-0.84.

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PRESENTATION

Operator

Welcome to the Signet Jewelers first-quarter fiscal 2014 results conference call. My name is Larisa and I will be your operator for today's call. At this time, all participants are in a listen-only mode. Later, we will conduct a question-and-answer session. And I will turn the call over to Mr. James Grant, Vice President of Investor Relations. Sir, you may begin.

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

Good morning and welcome to our first-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 from the financial 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 2 in today's presentation. I will now turn the call over to Mike.

Mike Barnes - *Signet Jewelers Limited - CEO*

Thanks, James and good morning, everyone. We are very pleased with our outstanding first-quarter results. We delivered a strong financial performance in the first quarter driven by the excellent execution of our strategies, which led to sales growth and expense leverage. Our comps at Signet increased by 6.4%. The US division comps grew 8.1% on top of a 1.2% increase last year and in the UK, comps declined by 2.3%.

We also had tremendous continued momentum within our consolidated e-commerce space as we grew by 40.7%. Of significance, as of 2012, Signet is now the number three largest e-commerce retailer in the jewelry category. That is up from 2009 when we stood at number 11. It is a great

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performance for our e-comm team. Altogether, this led to operating income of $142.8 million, up $13.4 million, or 10.4% and diluted earnings per share were a record $1.13, up $0.17, or 17.7%.

So let's begin by taking a look at the US division performance. In the US, total sales were $858.6 million, up $107.1 million, or 14.3%. Our sales growth was driven by broad-based strength across all merchandise categories in both Kay and Jared, as well as the Ultra acquisition. Kay and Jared experienced increases in transaction counts and Kay, in particular, increased in average transaction value.

US same-store sales increased by 8.1% in the first quarter. Kay comps increased 10.2% while Jared increased by 6%. The success in both concepts was driven in part by a successful Valentine's Day period, but also by broad-based strength across all merchandise categories through most of the quarter, particularly in bridal and a strong lead into Mother's Day.

And in the US, as I mentioned earlier, e-commerce performed strongly with sales up $8.3 million to $25.6 million, an increase of 48% for the US division. The US division also delivered operating profit growth of 11% with a 17.8% operating margin. Excluding the dilutive effect of the Ultra acquisition, operating income increased 13.7% and operating margin was 19%, up 70 basis points, a record level for the first quarter. It was another great quarter for the US team members.

The drivers of our performance were our sustainable competitive strengths, in particular our great customer experience, our investment in marketing and broad customer acceptance of our powerful merchandise offerings. The customer experience is central to our success and we remain focused on training and development of our store teams, including the best use of in-store sales-enhancing technology.

Branded, differentiated and exclusive merchandise continued to perform very well virtually across the board. Our marketing investment for Valentine's and Mother's Day again proved very effective with increased impressions helping us drive strong sales performances and building the value of the brand equity at both our store concepts and our merchandise collections. We also saw success selling across channels. As I mentioned, US e-commerce sales were up 48%. This was driven in part by 18 million visitors to our sites and over one-third of those were through mobile devices.

Now I will turn to the UK. Total sales in the quarter were $135 million, down $13.5 million, or 9.1%. Comp sales decreased 2.3% compared to an increase of 1.2% in the first quarter of last year. The total sales decline was due to a same-store sales decrease, primarily in H. Samuel, the impact of closed stores and currency fluctuation.

In Ernest Jones, the number of transactions increased and we experienced strength in the bridal business and watches, excluding Rolex, which is being offered in fewer stores in the UK. In H. Samuel, the number of transactions declined resulting in lower sales across most merchandise categories.

E-commerce sales were $5.5 million, which was up $0.7 million, or 14.6%, a nice double-digit gain. Our UK websites attracted 7.7 million visitors in the quarter and 42% of those were through mobile devices. Operating loss was $4.1 million, an increase of $1.1 million from the last year primarily due to lower sales, but partially offset by cost reductions. I would like to thank our UK team members for their strong efforts in what continues to be a very challenging market.

We are well-positioned to achieve our fiscal 2014 financial objectives. This is due to our excellent first-quarter results in both top and bottom line, strong Mother's Day results as we have moved into the second quarter and our consistent ability to execute initiatives by focusing on our competitive strengths, which are - our people, it always starts with them, our brands and the overall strength of our merchandise offerings, our sector-leading advertising, the strength of our real estate portfolio, our supply chain leadership, particularly in the US, our in-house customer finance programs and finally, our strong financial position. And now I will turn the call over to Ron for a little more color.

Ron Ristau - *Signet Jewelers Limited - CFO*

Thanks, Mike and good morning, everyone. I will start by explaining sales in more detail. For the quarter, total sales for Signet increased 10.4% to $993.6 million compared to $900 million last year. Same-store sales increased 6.4% compared to 1.2% growth last year. In the US, total sales increased

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14.3% or $107.1 million to $858.6 million, which included a same-store sales increase of 8.1% Mike discussed. Our non-same-store sales were up 6.2% with non-comp stores generating an increase of 1.6% and Ultra adding 4.6%.

The US sales increases again were driven by broad-based strength across all merchandise categories in both Kay and Jared, as well as the Ultra acquisition. Kay and Jared experienced increases in transaction counts of 6.6% and 10.3% respectively. In addition, Kay increased average transaction value by 4.9%.

In the UK, total sales decreased 9.1%, or $13.5 million, to $135 million while comp store sales decreased 2.3%. The total sales decline was due to a same-store sales decrease of $3.1 million, primarily in H. Samuel, the impact of closed stores of $4.8 million and currency fluctuations of $5.6 million, which were unfavorable. Signet e-commerce sales were $31 million, up $9 million, or 40.7% continuing their strong trend as Mike referenced.

Now let's take a look at the components of operating income. Our gross margin was $382.8 million, an increase of $29.1 million. The gross margin rate was 38.5%, down 80 basis points. The inclusion of the results for Ultra increased gross margin dollars by $8.8 million. However, it reduced the consolidated gross margin rate by 50 basis points and the US gross margin rate by 60 basis points. The Ultra gross margin is lower than the core US business due to lower store productivity and the impact of the integration. Ultra gross margins are expected to improve as the Ultra integration and conversion to Kay outlets is completed.

The remaining 30 basis point reduction in the consolidated gross margin was attributed to the following changes in the US and UK businesses -

Our gross margin dollars in the US, excluding Ultra, increased $24.1 million, reflecting higher sales, partially offset by a gross margin rate decrease of 70 basis points. The gross merchandise margin was impacted by merchandise mix, new bridal in Jared test programs, which were designed to further increase our competitive positioning in the bridal category and the impact of the Mother's Day sales shifts.

Gross margin in the UK decreased $3.8 million primarily reflecting the impact of decreased sales and currency fluctuations. Currency translation costs were $1.5 million of the $3.8 million decline. The gross margin rate declined 20 basis points as increased gross merchandise margins were offset by deleveraging of expenses on lower sales.

Our selling, general and administrative expenses were $287 million, and as a percentage of sales decreased 50 basis points to 28.9%. This is primarily due to leverage on advertising and store staff costs. I will discuss this in more detail in a moment.

Other operating income was $47 million, or 4.8% of sales compared to $40.2 million, or 4.5% of sales last year. This increase is primarily due to higher interest earned from higher outstanding receivable balances.

So our consolidated operating income in the first quarter increased $13.4 million to $142.8 million, representing 14.4% of sales, which was flat to prior year. However, excluding Ultra, our consolidated operating margin would have been 15.3%, up 90 basis points over the prior year.

The US division's operating income, including Ultra, was $152.8 million, or 17.8% of sales, compared to $137.7 million or 18.3% of sales in the first quarter of fiscal 2013. When we exclude Ultra, the US division's operating income was $156.6 million, or 19% of sales, up 70 basis points.

The operating loss for the UK division was $4.1 million, an increase of $1.1 million.

Our consolidated operating income increase led to fully diluted earnings per share of $1.13, up 17.7%. If we were to exclude Ultra, fully diluted earnings per share were $1.16, up 20.8%. Under either scenario, it was a very strong performance.

Now some additional detail on SG&A expenses. Again, the SG&A expenses are $287 million compared to $264 million in the first quarter of fiscal 2013, up $22.5 million and as a percentage of sales, they decreased by 50 points to 28.9%. SG&A spending was well-controlled and leverage was realized on both advertising and store expenses, particularly in the US. SG&A expenses in the UK were reduced by $2.7 million, reflecting the impact of cost reductions and currency fluctuations while they did deleverage slightly on lower sales.

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The inclusion of the results for Ultra increased SG&A in this quarter by $12.6 million and increased the consolidated SG&A rate by 30 basis points. We expect a reduction in Ultra SG&A going forward as the integration is completed. If we exclude Ultra, the rate was 28.6%, an improvement of 80 basis points. So SG&A spending was well-controlled in the quarter.

Turning to our share authorization. Of course, we continuously look at a variety of ways to deliver shareholder returns. Beyond reinvesting in our operations, we have taken a shareholder-friendly view towards our use of cash. In the first quarter, we completed the $350 million share repurchase program by repurchasing approximately 749,000 shares of Signet stock at an average price of $66.92. Over the life of the program, which launched in the fourth quarter of fiscal 2012, we have repurchased 7.4 million shares at an average cost of $47.10. We ended the quarter with cash of $263.7 million and we remain committed to ending the fiscal year with cash on hand equal to 7% to 9% of our annual sales. We will continue to review with our Board future options for the creation of shareholder value.

Net inventories ended the quarter at $1.426 billion, an increase of $91.4 million or 6.8% from a year ago. Again, this increase is primarily due to a $49.8 million increase in inventory for Ultra, $31.5 million of diamond inventory associated with our strategic sourcing initiative, expansion of our bridal programs and new store growth. Partially offsetting these increases were management actions to improve turn.

Excluding Ultra, our inventory increased only 3.1% and was very well-controlled. We continue to believe our inventory remains the best controlled in the specialty jewelry industry. Our credit portfolio also continued to perform strongly. Accounts receivable were 1,157.5 billion, up 12.9% due to higher credit sales driven principally by an increase in our bridal business.

Credit participation as a percentage of US sales, excluding sales from Ultra, which doesn't provide credit currently, was 57.7%. This compares to 55.8% in the first quarter of last year and 56.9% for the full fiscal 2013. The increase again was primarily driven by higher bridal sets.

Our average monthly collection rate was 13.4% compared to 13.8% last year and net bad debt expense, which was $21.3 million, represented 2.5% as a percentage of US sales, flat to prior year.

Finally, our other operating income increased primarily due to higher interest income from higher outstanding receivable balances.

Now turning to our second-quarter guidance, as we referenced in the 8-K we filed back on January 15 of 2013, the Company continues to expect a shift of the Mother's Day sales this year partially into the first quarter to impact our second quarter sales and earnings performance. In addition, integration costs and the seasonality of the Company's newly acquired Ultra stores are expected to be dilutive to the second quarter EPS. The Company continues to expect the integration of Ultra store systems and conversion to Kay outlets to occur as planned in the second quarter and Ultra to contribute positively to performance by the fourth quarter of the year.

As such, for the second quarter of fiscal 2014, the Company currently expects same-store sales to increase in the low-to-mid single-digit range. Earnings per share is expected to be in the range of $0.79 to $0.84, which includes a $0.06 per share negative impact from the Ultra acquisition referenced above. The Ultra loss expectation is approximately $0.03 greater than originally anticipated due to a potential decrease in sales short term as we complete key steps in the transition this quarter.

EPS, excluding Ultra, are in the range of $0.85 to $0.90. I would like you to please note that the majority of the $0.09 loss that we are expecting for both the first and second quarter combined of Ultra is attributed to nonrecurring costs for duplicative overhead, severances and unnecessary office space and will not repeat next year or into the second half of this year.

For the full fiscal 2014 year, the Company continues to expect capital expenditures in the range of $180 million to $195 million, which includes costs related to the opening of now 70 to 80 new Kay and Jared stores, up from our previous expectations of 65 to 75, store remodels, digital and information technology infrastructure and Ultra capital spending, which we now expect will range at approximately $14 million representing a reduction from our previous expectation of $18 million. Thank you and I will now turn the call back to Mike.

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Mike Barnes - *Signet Jewelers Limited - CEO*

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Jennifer Davis, Lazard Capital Markets.

Jennifer Davis - *Lazard Capital Markets - Analyst*

Hey, guys. Congratulations on a good quarter. A couple of clarifications. First of all, Ron, how should we think about the other operating income going forward? Should we kind of think of it as 4.5% to 5% of sales in general or --?

Ron Ristau - *Signet Jewelers Limited - CFO*

Yes, it's not going to move that much, Jennifer. I think you should think about it in the range of last year. This quarter was a couple of tenths of basis points up, but I don't think the range is going to move substantially.

Jennifer Davis - *Lazard Capital Markets - Analyst*

Okay, but we should think about it in terms of a percent of sales rather than a fixed dollar amount?

Ron Ristau - *Signet Jewelers Limited - CFO*

It does fluctuate by quarter somewhat, but I would follow the actual results from last year as a guide.

Jennifer Davis - *Lazard Capital Markets - Analyst*

Okay. And then, sorry, if I missed this, what was the -- how come the Ultra acquisition is going to be about $0.03 -- how come the impact will be about $0.03 greater than originally anticipated? Did you say that was because --?

Ron Ristau - *Signet Jewelers Limited - CFO*

Sure.

Jennifer Davis - *Lazard Capital Markets - Analyst*

Sorry, go ahead.

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Ron Ristau - *Signet Jewelers Limited - CFO*

I'm sorry, that is a great question. Thanks. It really relates to when we originally -- we were originally expecting it to be about $0.03 in each quarter. What we have now come to realize or are anticipating in our second quarter guidance is that we are going to be completing the majority of the transition of the systems and inventory cutovers in the second quarter as we've always indicated. We think there could be a little more of a disruptive effect on sales as that happens. And also, I believe that we could have -- we should have done a little bit better job in anticipating the Mother's Day shift in Ultra, which was as strong for them as it was for us and our original budgets that we worked on with them didn't really include that.

Mike Barnes - *Signet Jewelers Limited - CEO*

One thing I would add, Jennifer, this is Mike, is that it is an exciting opportunity for us because we have been waiting a long time now to get this transition completed and we are expecting to have it done in the second quarter. And once we get the majority of these stores switched to Kay nameplate and are able to leverage the great equity that we have in Kay, it is going to be a big opportunity for us going forward. So we are very excited. We have been waiting for this moment and we are glad it is almost upon us.

Ron Ristau - *Signet Jewelers Limited - CFO*

Yes, and another thing I would add to that, Jennifer, is that --

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Jennifer Davis - *Lazard Capital Markets - Analyst*

Absolutely.

Ron Ristau - *Signet Jewelers Limited - CFO*

-- of the $0.09 there were -- the $0.03 in the first quarter and $0.06 in the second quarter we are anticipating, the majority of that, close to $0.08 of it is related to nonrecurring costs again on duplicate overhead, severances and accruals for unnecessary office space that we will be incurring particularly in the second quarter and these costs for sure will not be repeating in the second half of the year or in the next year. So that is a good strong help to us.

Jennifer Davis - *Lazard Capital Markets - Analyst*

Right. And absolutely we are really excited about the opportunity you have with Ultra as well or I should say Kay outlets now. One last question on -- well, actually two. On Mother's Day, what was the impact of the shift? I think I kind of mismodeled that a little bit maybe.

Ron Ristau - *Signet Jewelers Limited - CFO*

Well, there is no effect -- once again, there was no effect on comp. The comps were --

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Jennifer Davis - *Lazard Capital Markets - Analyst*

Right, right.

Ron Ristau - *Signet Jewelers Limited - CFO*

-- correctly shifted, but the dollar sales move ranges between $32 million and $35 million is our best estimate.

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Jennifer Davis - *Lazard Capital Markets - Analyst*

Okay. All right. And then bridal, it sounds like it has increased as a percent of sales. Could you talk a little bit about that and how do margins on bridal compare to the rest of the assortment. Are they a little bit lower or are they about the same? Thanks.

Mike Barnes - *Signet Jewelers Limited - CEO*

Well, I will start off and let Ron finish up with margins. On the sales, we had a very strong quarter for bridal and that is very important because what we saw in this quarter, it was not just driven by the big holiday events of Valentines and the lead into Mother's Day. We had a great continuity business throughout the quarter and bridal was a really big part of that.

We continued with our usual strong promotions. We also, because we are so focused on bridal, we tested some new promotions that were related specifically to bridal in both the mall and in the Jared stores and we had really great results from that. So we think there is a lot of opportunity for us to continue driving the bridal. Ron, do you want to talk about the margins, any other points on that?

Ron Ristau - *Signet Jewelers Limited - CFO*

Yes, our bridal margins are a touch lower than the overall Company, just a touch because of the fact that there is a lot of -- there is loose stones involved in that and loose stones tend to be one of our lower margin businesses. It is not really that -- it is not all that different.

Jennifer Davis - *Lazard Capital Markets - Analyst*

Right, okay. And then, theoretically, you'll get greater I guess rents and fixed cost leverage on the sales?

Ron Ristau - *Signet Jewelers Limited - CFO*

Oh, absolutely. I mean driving bridal sales is a very important part of our business, representing more than 50% of our sales and it is something we continue to stay focused on because we believe it is a natural intersection of all of our competitive strengths, our great store experiences, the credit offerings that we have and the quality of our merchandise all combine for a great bridal experience and is something that we are best at. So it is a very good thing for us.

Jennifer Davis - *Lazard Capital Markets - Analyst*

Great, thanks and best of luck.

Operator

Oliver Chen, Citigroup.

Oliver Chen - *Citigroup - Analyst*

Hi, guys, congrats on a great top line here. What are your thoughts on how we should think about modeling the gross margin going forward in terms of the puts and takes and what can happen there over time? Also, if you could update us (technical difficulty) if you could update us on the commodity cost environment and if you are seeing flexibility there with respect to what you are seeing and how you may be able to adjust your average unit retail. Thank you.

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Ron Ristau - *Signet Jewelers Limited - CFO*

Well, I will take the first question. I think that, from an overall perspective, we still try to work on maintaining our margins. We can't be specific going into the third quarter and fourth quarter of the year, but we think those margins will be good. When you think about commodities and what is happening in commodities, the first thing I would like to point out is we are on an average cost FIFO basis, which takes commodity fluctuations into our P&L at different rates than some of our competitors.

Currently, when we look at our -- 55% of our cost of goods is diamonds and about 17% is gold. So right now, we can really continue to see some upward pressure on diamond prices for our quality goods. Although prices are really generally more stable on a relative basis in the near term. Long term, we really believe that this direction is up because global demand is flat. Demand is pretty strong still.

The recent gold price declines, if they hold, should be somewhat helpful to us in the second half. However, we do do some gold hedging, as I will point out, and we did have some unfavorable gold hedge positions that we found necessary to close with the reduction in gold prices. However, as always, there's a lot of multiple factors, including pricing decisions, content, how we run our promotional programs, which reflect in our overall margin. So our outlook is good, but we really have to figure out how long this all lasts and who ultimately wins the battle on gold commodity pricing. But it will be helpful eventually to us if it holds.

Oliver Chen - *Citigroup - Analyst*

Okay, thank you. And regarding your comp guidance, should we anticipate that the same kind of run rates may continue between US versus UK? And on your low to mid-single digit, is that traffic and conversion led? If you could just give us parameters from which we should think about your forecast, that would be helpful.

Ron Ristau - *Signet Jewelers Limited - CFO*

Well, if you think about our -- if you're asking me -- let me make sure I understand the question -- how the comp forecast go forward will be reflected in transactions and pricing?

Oliver Chen - *Citigroup - Analyst*

In terms of the comp levers on (multiple speakers).

Ron Ristau - *Signet Jewelers Limited - CFO*

I think if you take a look at the US division, you will say that there was a healthy mix of transaction growth and there was also some price increase, particularly at Kay on average, which went through. I would think that we would expect both transactions and price to drive in the United States as we go forward.

In the UK, we are seeing some traffic declines. We are seeing that particularly at our H. Samuel brand. We hope that we can arrest some of those as we move into the second half of the year, but we are fighting traffic declines in the UK. So I would -- if I had to bet right now, I would say that there will be some degree of transactional decline in the UK go forward. That is probably the best way I can answer that question. I mean the US is a great healthy mix. The UK is really driven by transactional decline more than anything else.

Oliver Chen - *Citigroup - Analyst*

Thanks, guys. Best regards.

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Operator

Rick Patel, Stephens.

Rick Patel - *Bank of America-Merrill Lynch - Analyst*

Good morning, Mike and Ron. Just a question on the conversion of Ultra stores to Kay outlet. When this occurs, are you going to reprice all the merchandise in the stores virtually overnight or are you going to replace and reprice the Ultra product as it is sold through? And as a follow-up, when do you expect the pressure on gross margins to wane from selling Ultra products? Will it be in the third quarter once the conversions are done?

Mike Barnes - *Signet Jewelers Limited - CEO*

Well, on the products, I would tell you that we have been working on starting to move products into Ultra as we could even before the full transition and we will continue to do that. Clearly, as we change the nameplates on the majority of the stores to Kay, they are going to look like Kay stores going forward.

But having said that, because the outlet channel is a separate channel for us to sell into, we believe that there is ways for us to optimize that channel. In the past, our Kay outlet stores have been pretty much the same as our Kay mall stores in terms of all the merchandise offerings. We think that there is going to be an opportunity for us to do some more made-for product that is more targeted towards the outlet store customer, including the great tourist opportunity that exists out there in the outlet store channel of distribution.

So it will be a little bit of a different mix to optimize it on a full go-forward basis, but that is a work in progress. Initially, it is going to be switched over and become a Kay store just as quickly as possible. And the pricing will be exactly the same as it is in Kay.

Rick Patel - *Bank of America-Merrill Lynch - Analyst*

And can you talk about the (technical difficulty) mix in the UK? Have you began to edit the assortment there as part of your strategic plan in the region and if so, perhaps highlight what you have learned from doing that?

Mike Barnes - *Signet Jewelers Limited - CEO*

Yes, on the UK, as Ron mentioned earlier, it continues to be a very challenging market for us and we have laid out the initiatives that we believe are going to help us turn that market around. Merchandise is one of the first ones. I mean we are still very, very focused on that. We are even beginning some new initiatives on how to focus even harder on the merchandise mix and possibly gain some more leverage with more of the products that we have here.

If we look at the UK market, some of the things that have been successful have been some of the branded merchandise that we have had in there, but it is a lower part of the mix than it is in the UK -- I'm sorry -- in the US and we see more focus in that direction, more focus on new products. We have to be careful with pricing. We talked about the weakness that we saw in H. Samuel in particular. Part of that was price increases for H. Samuel didn't stick as well as we had hoped that they would. And so we have got to stay very focused. I have seen -- I saw a recent article from the British Retail Consortium talking about the consumer continues to look for value in the marketplace.

So we are very focused on the merchandise offerings. We are focused on branding, we are focused on new product and we are looking at how we can be more innovative going forward and think a little bit more outside the box to really drive some more change into that marketplace in our stores.

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Rick Patel - *Bank of America-Merrill Lynch - Analyst*

Thanks very much.

Operator

Anthony Lebiedzinski, Sidoti & Company.

Anthony Lebiedzinski - *Sidoti & Co. - Analyst*

Good morning. In the past, you guys have been more upbeat about the regional malls in the UK versus the High Street locations. Is that still the case?

Mike Barnes - *Signet Jewelers Limited - CEO*

Well, those are still the best performing that we have. I have seen some traffic statistics -- Ron was talking about traffic being down -- across the -- it is down across the board in the UK, the last stats that I saw. The High Street and the malls were down as well. We continue to perform certainly better in the malls than we are on the everyday High Streets and we think that that is going to continue to be the direction for the UK market that these big regional malls will continue to be the biggest part of our business on a go-forward basis, notwithstanding London, which, of course, is always going to be strong with all the tourist activity going on there. But I think that the traffic itself was down in the malls, as well as on the High Streets, but it is still the better performing part of our portfolio.

Ron Ristau - *Signet Jewelers Limited - CFO*

Yes, definitely a stronger part.

Anthony Lebiedzinski - *Sidoti & Co. - Analyst*

Okay, so can you give us a sense as to what percentage of your stores in the UK are in High Street locations versus regional malls and also as you look to optimize your store base, maybe you could give us a sense of how do you think that is going to be in two to three years from now?

Ron Ristau - *Signet Jewelers Limited - CFO*

I believe that the mix now is around 60/40, 40% regional malls, still 60% High Street, but I'm going to doublecheck that number for you. As we go forward, we will have a much higher -- hopefully, it will shift, that we would end up with 60%, 65%, 70% of sales in regional malls.

Mike Barnes - *Signet Jewelers Limited - CEO*

The difference, it depends on how you asked the question. In terms of number of stores, there are fewer regional malls, but they drive a disproportionate part of the business for us. So in terms of sales, while it is fairly even last time I looked and we will check those numbers, I think it will become a bigger part of the business going forward in the malls.

Ron Ristau - *Signet Jewelers Limited - CFO*

And I will get those exact numbers in dollars for you and give you a call back.

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Anthony Lebiedzinski - *Sidoti & Co. - Analyst*

Okay, sure, not a problem. And also, in terms of your store growth expectations now, you did accelerate or are you looking to open more stores than previously? Is it more Kay and then Jared, could you give us a sense to where the increase is coming from and can you also talk about the trends that you are seeing in real estate costs?

Ron Ristau - *Signet Jewelers Limited - CFO*

Well, it is more Kay than Jared obviously because we -- it takes a long time to open up a Jared store. There are a couple more Jared stores in there. I believe we are up to about 13 Jared stores for the year and the residual is Kay and then Kay is primarily in the off-mall area. We are seeing lots of opportunities. So we are being a little more aggressive as we said we always would be if the opportunities present themselves.

In real estate costs, real estate costs remain a constant challenge for us. We work very hand-in-hand with our landlord partners and we have been reasonably successful at working continually beneficial deals, but real estate costs for good real estate have never really changed. They have always been very competitive and we are always after the best space, so there is really no new news. I wouldn't say the pressure is more or less; it has always been fairly consistent for us.

Mike Barnes - *Signet Jewelers Limited - CEO*

We don't compromise on the real estate that we go for just to open new stores. So that is what is exciting about this increase in new store openings is the fact that the team is doing a great job out there finding the best possible real estate because, again, it is just something we will not compromise on and the cost is what it is.

Anthony Lebiedzinski - *Sidoti & Co. - Analyst*

So you haven't changed your objective of your 20% IRR.

Ron Ristau - *Signet Jewelers Limited - CFO*

Oh, no, no. Not at all.

Mike Barnes - *Signet Jewelers Limited - CEO*

Absolutely not.

Anthony Lebiedzinski - *Sidoti & Co. - Analyst*

Got it. Okay. And lastly, when you look at your free cash flow generation capabilities and now you having exhausted your share buyback program, going forward, can you give us any sense as to how the Board is thinking between dividends and share repurchases?

Mike Barnes - *Signet Jewelers Limited - CEO*

Well, that is an ongoing conversation that we have with the Board and we will continue that conversation. What we have done is we have made a commitment as to what we think our capital structure and our balance sheet should look like and we continue to feel like having approximately 7% to 9% of annual sales in cash is a good flexible number for us and beyond that, we want to invest back in the business, number one. That is the

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best return we can get for our shareholders, but we will have ongoing conversations with the Board regarding other opportunities to return value to shareholders such as the continuing dividend and potential share buybacks in the future. We will update you as appropriate how those conversations continue.

Anthony Lebiedzinski - *Sidoti & Co. - Analyst*

Okay, thank you very much.

Operator

Bill Armstrong, CL King Associates.

Bill Armstrong - *CL King & Associates - Analyst*

Good morning, Mike and Ron. Ultra gross margins are expected to improve from current levels. Do you think they can get all the way up to the overall Company average in the 30s or is the outlet sector just structurally a little bit lower?

Ron Ristau - *Signet Jewelers Limited - CFO*

Well, I think they can get substantially closer. I think the outlet does tend to be a touch lower than the overall mall, but this will be still a smaller percentage of our business. So I think it will go up substantially from what it is today. It will approach closer to the levels, but obviously because the product mix is a little different, it won't get all the way to the same level.

It's just a different gross margin model. Of course, we have other costs that are lower and in particular, one of the things I think we are very pleased with -- we really are going to have a very -- the SG&A structure of the outlet operations is something I would urge you to think more about too is that because once we integrate, we will need very little additional incremental SG&A other than our store operations people to run the business. And that is a big part of the savings as we move into the third and fourth quarter of the year.

Bill Armstrong - *CL King & Associates - Analyst*

In terms of SG&A leverage you mean?

Ron Ristau - *Signet Jewelers Limited - CFO*

Yes.

Bill Armstrong - *CL King & Associates - Analyst*

Got it. How about in e-comm? That is obviously a growing piece of your business. Are the gross margins on e-commerce similar to margins at retail?

Mike Barnes - *Signet Jewelers Limited - CEO*

Yes, the merchandise margins would be the same because our pricing is the same online as it is in the store.

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Ron Ristau - *Signet Jewelers Limited - CFO*

And the pricing is -- or, I'm sorry, the overall operating margins are as good as our best stores or sometimes even better.

Bill Armstrong - *CL King & Associates - Analyst*

Got it. Okay. And then just lastly just to clarify a comment I think Ron made earlier on price increases at Kay. Were those increases taken during the first quarter or were they taken last year?

Ron Ristau - *Signet Jewelers Limited - CFO*

Well, what I said was that if you'd take a look at the charts we are providing on average price and transaction costs, Kay average price went up, which is partially pricing and partially mix adjustment, so let me clear about that. The pricing -- we did take price increases on our normal cadence in the March and before Mother's Day timeframe so we did do that. We don't disclose how much in total, but they were a little less than we had in previous years.

Bill Armstrong - *CL King & Associates - Analyst*

Understood. Okay, thank you.

Operator

Ike Boruchow, Sterne Agee.

Ike Boruchow - *Sterne Agee - Analyst*

Hi, thanks for taking my question. Mike, sometimes -- if you could help us out just with the overall consumer environment right now, it was a great US comp for you in Q1. Could you maybe give us some color on what you're seeing in the environment thus far quarter-to-date?

Mike Barnes - *Signet Jewelers Limited - CEO*

The environment -- I've talked about this a lot in the last couple of weeks even. The best way I can characterize it and this is just one man's opinion is that it feels like a more stable environment than I would have spoke to 12 months ago at the same time. A lot of the noise that was going on out there kind of subdued itself a little bit with fiscal cliffs and rising payroll taxes and late tax returns and we heard a lot of that noise, especially at the beginning of the first quarter in early February. And it somewhat subsided. Who knows what the macro environment is going to bring to spook or support the purchasers at retail tomorrow. I have no idea. I don't have that crystal ball. But I would characterize it just in general as being a more stable environment than I have seen in the past and we will see where it goes from here. That is in the US market.

In the UK, it is still an extremely volatile environment with a lot of continued bargain-hunting going on. And I was just reading the UK unemployment went up more than it has gone up in a long time. I mean it is a tale of two different markets really, but the US driving the majority of our business has been much more stable. We had a great first quarter. We had a good beginning of the second quarter through Mother's Day and as we have said, we believe we are really well-positioned to make all of our objectives for the year. So we continue to be excited about the opportunities we have in front of us and we are going to just keep driving the successful business model we have.

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Ike Boruchow - *Sterne Agee - Analyst*

Great. And I guess, Ron, the Company has historically broken out their merchandise margin changes in both the US and the UK when you guys report your quarters. Is there any way you can help us out there just so we can have it updated in our models? And maybe -- and I even asked this a few times, but maybe any color on how you expect the US merchandise margin to progress throughout the year given some of the puts and takes that you have called out?

Ron Ristau - *Signet Jewelers Limited - CFO*

Well, what I would say is that the gross merchandise margin followed in the US the gross margin. So if the overall, excluding Ultra, margins in the US were down about 70 bps, the gross merchandise margins were down similar type numbers. So explaining one explains the other, if you will.

In the UK, our merchandise, gross merchandise margins are actually up about 100 bps, but that was offset by deleverage on the lower sales on some of the real estate and other costs, so they only netted up about 20 basis points, I believe. When you think about go forward, I believe that -- it depends upon the mix of what happens with gold and commodities and our stance promotionally. We did see, of course, in the first quarter that some of these very successful bridal promotions did have an impact on our gross merchandise margin, but were very, very profitable for the overall business.

So I would say, in general, you should expect them to be a little better than they were this quarter and you should start to see the dilutive effect of Ultra start to diminish at what rate I can't really predict for you, but as we convert the model in the second half of the year, you would expect or I would expect that the margins would get closer to those experienced by our core business, if that's helpful.

Ike Boruchow - *Sterne Agee - Analyst*

Okay, no, very helpful. And then just one quick last one. Ron, you talked about $0.09 impact from Ultra integration in the first half of the year. Do I hear you correctly saying that there shouldn't be any real drag as we get into Q3 and Q4? I know we lapped the acquisition, but --?

Ron Ristau - *Signet Jewelers Limited - CFO*

What I don't think is -- what will happen is a lot of the SG&A overhead costs will diminish after the second quarter as the impact of integrating the business more fully to our Akron operation occurs. I continue to believe that the third quarter is still a little bit of a risk to some degree of dilution and then we expect it to turn positive in the fourth quarter. And the only reason I hedge in the third quarter is the fact that we needed, we believe, a good couple months of learning with all the new systems and the training that has to go on in the field sales force. So it is a bit of a -- a bit difficult to predict how long that training will need to take root. Do you understand?

So the systems and everything converts during the -- the end of the second quarter. We give ourselves a couple of months to work out all the operational issues if there are any. And then we believe that, in the fourth quarter, we start to become accretive. But the overhead costs will start to diminish as we move into the third and fourth quarter for sure.

Ike Boruchow - *Sterne Agee - Analyst*

Got it. Thanks very much. Good luck.

Operator

Jeff Stein, Northcoast Research.

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Jeff Stein - *Northcoast Research - Analyst*

Ron, a question on -- I was looking at the footnote number 11 on hedging and wondering if you could just try to explain the impact that your hedging losses have had. It looks like, if I'm reading this correctly, you had a negative $17.5 million impact in Q1 versus $12.9 million in Q2 and how your open contracts could potentially affect Q2 through Q4?

Ron Ristau - *Signet Jewelers Limited - CFO*

Well, first, let me explain that what you are looking at there is balance sheet-related items, not P&L items. But what ended up happening with the -- this is the largest move in gold in 38 years that we can trace. So we had open hedging positions and we took the decision as allowed by accounting rules to close those hedges and essentially on a stop-loss basis and then, of course, we will move forward with the reset pricing levels. So we have made a lot of money in hedging over the years. As this pricing reset occurred, it was of course unfavorable to us.

That will flow into the P&L, Jeff, over the life of our inventory turns, so it takes about 12 to 16 months for those to flow through. But on the plus side, remember, we are buying the underlying commodity. So we are getting tremendous benefit by buying gold at spot as we go along. In fact, we are doing much better than our hedging positions of course would have allowed us to do.

So that was a business decision. Nobody likes to take losses, but we figured it was the lesser of two evils, if you will and as we go forward, we are approaching the gold market with caution and we will gradually seek to reestablish our hedging positions as the market becomes a little more predictable.

Jeff Stein - *Northcoast Research - Analyst*

So Ron, based upon the losses that you took and the lower spot prices that you're paying right now, presuming that prices were to remain flat and we don't know where they are going to be, but if they remain flat, net net, are you in a plus position or a minus position for the rest of the year?

Ron Ristau - *Signet Jewelers Limited - CFO*

Net net, we would be in a plus position because the value of buying at spot far outweighs the loss that you incur in closing the hedge positions.

Jeff Stein - *Northcoast Research - Analyst*

Got it. Okay, that's great. And with regard to your credit business, can you talk a little bit about the mix of interest-free versus your traditional monthly payment and revolving payment?

Ron Ristau - *Signet Jewelers Limited - CFO*

It has been relatively stable, Jeff. We got a shift on that, which started to occur in the first quarter of last year and of course, we talked about it last year because it was resetting those other income ratios throughout the year. But right now, we are seeing stable. It hasn't really changed much from the third to fourth quarter of last year; it has been relatively stable. So the incremental income this year is really more driven by higher outstanding balances as opposed to a shift in the mix of programs.

Jeff Stein - *Northcoast Research - Analyst*

Okay, thank you very much.

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Operator

David Wu, Telsey Advisory Group.

David Wu - *Telsey Advisory Group - Analyst*

Hi, good morning, everyone. First, the gross margin contraction obviously a bit surprising, even if you exclude the impact from Ultra and I wanted to know if you could break out the impact between the unfavorable merch mix shift and the Mother's Day sales shift. I understand that bridal is a lower gross margin category, but want to know if you adjusted pricing at all to be more competitive there and if you could provide more color on the Jared test programs. And also is it fair to assume that mix should remain a headwind in the second quarter?

Ron Ristau - *Signet Jewelers Limited - CFO*

Well, let me answer that a couple of different ways -- Mike, do you want to take --?

Mike Barnes - *Signet Jewelers Limited - CEO*

I will take the last part of that first, Dave. This is Mike. On the Jared test programs, basically what we have talked about is that we did do some tests, promotional programs, especially as it was related to bridal. But we are really not going to go into detail for competitive reasons on that. We felt like we saw a lot of good success and a lot of opportunity for us to continue to tweak our business, our promotions, our merchandise and everything going forward quite frankly and that is what we do. We continue to evolve and grow as this industry changes and find better and better ways to compete effectively and gain marketshare.

But all I can tell you is that we were very pleased with both the merchandise that we have tested and some of the new promotions that were non-comped that we tested. We think we have a big opportunity going forward and I will let Ron take the gross margin.

Ron Ristau - *Signet Jewelers Limited - CFO*

What I'll basically say in the gross margin, excluding the impact of Ultra, the 70 bps adjustment that we realized, that is primarily caused by the impact of these programs and not so much unfavorable mix, but just we have decided -- we made the decision to get -- to somewhat improve some of our programs and offerings and see how they would work in the market and they worked fantastic as evidenced by the strong, strong comp that we experienced during the quarter.

We did have to give up some margin on that and we believe that was a good trade-off. Continue to believe that all those programs have fantastically high return on investment and the part of Mother's Day was really in the neighborhood of 10 to 15 bps of the 70. So the majority of it was really these programs that we were running in Jared and the bridal programs that we were initiating.

David Wu - *Telsey Advisory Group - Analyst*

So theoretically then as you continue to test these programs, that should remain a headwind then in terms of the second quarter on the gross margin in the US?

Ron Ristau - *Signet Jewelers Limited - CFO*

No. These are programs that we flex in and out of. Some of them -- depending upon what we -- I don't think you should assume that we will just be running all these programs. Like anything, they are programs that we put in at times of the year we think are effective. Some of the Jared

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programs that we ran could have some more longevity in the system, but they have lesser impact and we get tremendous -- you saw the Jared comp really start to get very strong. So all of these things we believe as business people were very favorable trade-offs for us to make for the long-term health of the business.

David Wu - *Telsey Advisory Group - Analyst*

Great. And the UK gross merchandise margin up 100 basis points, obviously a vast improvement from the prior quarter. Can you talk about the main drivers there and comment on promotional levels and should we expect a more sort of moderate decline in the UK gross merchandise margin going forward assuming that the comp maintains a similar pace?

Ron Ristau - *Signet Jewelers Limited - CFO*

Well, some of it is mix on the basis of the fact that as Rolex becomes a lower percentage of the risk, the merchandise margins of course will improve. So some of it is mix, some of it was the impact of pricing. As Mike indicated, we are not totally enthralled with the benefits of pricing we received in the first quarter.

So what I would say is, Mike, correct me if you disagree, but the jury is out a little bit on whether or not we will continue to realize incremental gross merchandise margin in the UK. We may choose to do it a little differently as we go forward.

Mike Barnes - *Signet Jewelers Limited - CEO*

Yes, I think that we are going to have to really focus on pricing in the UK market and it is something that we have got to really watch very closely. The prices didn't stick in H. Samuel as well as we had hoped that they would. There is just a lot of pressure in that market in that regard and so we have got to make sure that we remain competitive and that we are kind of leading the charge over there.

So we are going to be looking at a lot of different opportunities and different ways to move forward. So that is something that we will just have to watch and see. But I wouldn't expect to see anything in particular change for us regarding the margins there.

David Wu - *Telsey Advisory Group - Analyst*

And is credit as instrumental in driving the sales performance in the UK as it is in the US? And could there be an opportunity to potentially introduce a similar type of in-house credit program into the UK?

Mike Barnes - *Signet Jewelers Limited - CEO*

We use a third-party provider in the UK and it is a very, very low percentage of our business, in the single digits, I believe.

Ron Ristau - *Signet Jewelers Limited - CFO*

Very low, yes.

Mike Barnes - *Signet Jewelers Limited - CEO*

And it is just a different type of customer profile over there. I think that they are much more inclined to use their bank cards for those type of purchases whether it is to gain miles or -- but certainly some of the big, big retailers have private label, I guess, but it is not near the successful

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impact that it is in the United States. It is just a different customer profile and it wouldn't be large enough for us to even consider going in-house with just by the fact that it is such a low part of the mix even in the third-party credit that we do offer.

David Wu - *Telsey Advisory Group - Analyst*

Great.

Ron Ristau - *Signet Jewelers Limited - CFO*

(inaudible).

David Wu - *Telsey Advisory Group - Analyst*

On the second-quarter guidance, will the $0.06 negative impact from the Ultra acquisition, will that come more from the gross margin versus SG&A, so similar to what we saw in the first quarter?

Ron Ristau - *Signet Jewelers Limited - CFO*

More from SG&A.

David Wu - *Telsey Advisory Group - Analyst*

More from SG&A. Okay.

Ron Ristau - *Signet Jewelers Limited - CFO*

In my opinion. That is why I make the point that when you looked across the two quarters and I look into the components of it, I say there is a couple of things. Number one, I have got lower productivity stores in general than I have in my main Kay operation, but I also have costs that will -- we were not able to take out of the system until we make the transition. We will be making the transition more by the end of the second quarter. So therefore, some of our costs and then some of our one-time costs for -- that involve severance and excess real estate and things like that, once we are through all that then I believe that the cost structure will get better. And we know because I can control that virtually 100%. We just know that is going to happen.

David Wu - *Telsey Advisory Group - Analyst*

Great. And then just lastly, the higher ticket that you saw in the US, was that tied mainly to particular strength out of bridal or did you also benefit from a higher ticket in fashion jewelry?

Ron Ristau - *Signet Jewelers Limited - CFO*

I would say in Kay a little bit more because of bridal. A little bit because of the stronger bridal business, which carries a little bit higher ticket.

David Wu - *Telsey Advisory Group - Analyst*

Great. But on the fashion jewelry side, how did ticket trends perform?

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Ron Ristau - *Signet Jewelers Limited - CFO*

That's a little -- I don't want to give it -- I would say nothing -- they didn't move much at all, they didn't really move much on average as far as I know.

Mike Barnes - *Signet Jewelers Limited - CEO*

Clearly, we had strong fashion trends throughout the quarter as well. I think that is important to point out and again, some of the branded merchandise -- Le Vian did very well for us and bridal, as Ron mentioned, that certainly helped the ticket price because we had again strong brand bridal with Leo and Tolkowsky and Neil Lane and Neil Lane Fashion did well on the fashion side. So that is really what is driving it. And we are seeing a lot of strength out of all of those great brands that we have and we are very pleased with the partnerships and the opportunity going forward to continue driving that.

David Wu - *Telsey Advisory Group - Analyst*

Excellent. Thank you very much.

Operator

Warwick Orkines, Deutsche Bank.

Warwick Orkines - *Deutsche Bank - Analyst*

Yes, good morning. Thanks for taking my questions. Actually just following on from the last one, could you say what the mix was at branded and exclusive in the US in the quarter please?

Ron Ristau - *Signet Jewelers Limited - CFO*

We don't generally disclose it in the quarters. We tend to do it on an annual basis because it tends to fluctuate on the quarters, but it was positive, significantly positive as the penetration in the first quarter. So those products, as well as our non-branded and our more fashion products. So across the board, branded, nonbranded, bridal, everything worked well for us in the US in the merchandise offerings in the first quarter.

Mike Barnes - *Signet Jewelers Limited - CEO*

Very broad-based.

Warwick Orkines - *Deutsche Bank - Analyst*

Right, right. I guess I was trying to -- you talked for the full year last year I think 27.4%. I was just trying to work out whether that was -- that kind of underrepresents the progress you have made in the last few quarters.

Ron Ristau - *Signet Jewelers Limited - CFO*

Well, I would say -- what I am basically telling you is that our penetration relative to the penetration a year ago in the first quarter was up in branded and exclusive if that makes sense.

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Warwick Orkines - *Deutsche Bank - Analyst*

Yes, yes it does.

Ron Ristau - *Signet Jewelers Limited - CFO*

So we are all trying to keep improving, but we have to see how the rest of the year develops.

Warwick Orkines - *Deutsche Bank - Analyst*

Okay, thank you. And finally, could you tell us whether, at the AGM, you will be seeking further authorization to repurchase shares?

Mike Barnes - *Signet Jewelers Limited - CEO*

Yes, we mentioned earlier our capital structure and our balance sheet are going to be ongoing conversations with the Board. We have made a commitment again to keep approximately 7% to 9% of cash we think is appropriate to keep on the balance sheet. Beyond that, we want to invest in our business first and then we will have going discussions with the Board about how best to return other value to the shareholders beyond anything that we are investing in the business.

So I would just say again stay tuned. As we have further discussions with the Board, we will see what decisions are made. We were very pleased with the buyback that we concluded and it was very successful in our opinion. We are very pleased with the dividend that we have and we will continue having those discussions with the Board and we will update you as appropriate.

Warwick Orkines - *Deutsche Bank - Analyst*

Thank you very much.

Operator

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

Mike Barnes - *Signet Jewelers Limited - CEO*

Thank you very much. I appreciate that and thank you all for taking part in this call. We really appreciate your time this morning spending it with us. Our next scheduled call is going to be on August 29 and we will review our second-quarter results at that time. So thanks again and goodbye. Have a great day.

Ron Ristau - *Signet Jewelers Limited - CFO*

Thank you.

Mike Barnes - *Signet Jewelers Limited - CEO*

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

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