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EDITED TRANSCRIPT

SIG - Q3 2015 Signet Jewelers Ltd Earnings Call

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OVERVIEW:

Co. reported 3Q15 GAAP loss per share of $0.02 and adjusted EPS of $0.21. Expects FY15 adjusted EPS to be $5.51-5.61 and 4Q15 adjusted EPS to be $2.95-3.05.

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PRESENTATION

Operator

Welcome to the Signet Jewelers third-quarter fiscal 2015 results conference call. My name is Ellen and I will be your operator for today's call. (Operator Instructions)

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

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

Yes, welcome to our third-quarter fiscal 2015 call. On our call today is Mark Light, CEO, and Michele Santana, CFO. The presentation deck we will be referencing is available under the Investors section of our website, SignetJewelers.com.

During today's presentation we will in places discuss Signet's business outlook and make certain forward-looking statements. Any statements that are not historical facts are subject to a number of risks and uncertainties and actual results may differ materially.

We urge you to read the risk factors, cautionary language, and other disclosures in the annual report on Form 10-K that was filed with the SEC on March 27 of this year and in the quarterly report on Form 10-Q that was filed with the SEC on September 10 of this year. We also draw your attention to slide number 2 in today's presentation.

And now I will turn it over to Mark.

Mark Light - *Signet Jewelers Limited - CEO*

Thank you, James, and good morning, everyone. In the third quarter we delivered solid top-line results. Signet comps increased by 4.2%, led by the Sterling and UK divisions.

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From a merchandise perspective, Signet's branded bridal, fashion diamonds, and watches all performed well. Our strength by selling channel was broad-based with outlets and e-commerce delivering strong results.

Signet's third-quarter profits, as anticipated, was diluted by the seasonally low sales volumes and high fixed costs of our Zales division as well as the UK, to a lesser extent. Signet did not own Zales in the third quarter of last year. As a result, year-over-year profit metrics were lower, but importantly, adjusted EPS of $0.21 exceeded expectations. And when measured on an apples-to-apples basis versus last year, our EPS was up $0.05 or 11.9%.

Our acquisition and integration activities are progressing well and we remain well prepared for the holiday season. I will take you through some of our initiatives in a few minutes.

Let's now take a closer look at Signet's third-quarter sales performance by our divisions and SEC operating segments.

Sterling's third-quarter total sales were $692.8 million. That was up 9.7%. Same-store sales increased by 6.8%. Kay comps led the way with a strong 7.5% increase, while Jared increased by 6.5%.

The Zales division delivered total sales of $331.4 million and a comp decline of 0.9%. This was due primarily to the late timing of new inventory replacing slow-moving collections as well as some distractions from initiatives implemented in the third quarter to position us for the holiday period.

Our UK division's third-quarter total sales were at $151 million, up 8.4%, or 4.7% on a constant currency basis. Same-store sales increased by 3.7%, which was, by the way, the best in seven years for a third quarter, which was driven by diamonds and watches. Signet's sales growth was driven in part by e-commerce sales of $44.8 million, which is an increase of 96.5% due to the addition of Zales this year, but the growth rate was at 27.6% if you exclude our Zales division.

We had a variety of drivers behind our third-quarter Sterling results. Most notably, it was due to our sustainable competitive strengths that include our superior customer experience, exciting merchandise offerings, creative marketing, and a multichannel approach.

The guest experience is central to our success and we remain focused on the training and development of our store teams. We had a very successful and well-received managers leadership conference in the September/October time frame to kick off our fourth-quarter holiday preparations at the store level.

The main merchandising initiatives which drove third-quarter results in the Sterling division were bridal brands Neil Lane and Leo along with fashion brands Le Vian and Diamonds in Rhythm. We introduce new TV bridal ads in the third quarter, but the real payback for those ads will be in the fourth quarter. Not only because of the fabulous new creative, but also because of the efficiency of the buys and the placement of those ads.

We also saw success in the cross-selling channels in e-commerce, in outlets, in malls, and in freestanding stores.

In the UK the initiatives around store operations, merchandise, and an omnichannel approach are all making a difference. We have made a variety of store operations improvements that are driving better sales productivity. The UK sales increases were driven principally by the benefits of strategic moves we've taken around diamonds based upon a better understanding of our customers and the type of products, pricing, and promotions that they require.

Our store team member training is more focused on diamonds. Our point-of-purchase displays are more powerful. We are dedicating more space to diamonds, and bridal diamond brands performed well such as Forever and Perfect Fit in our H.Samuel stores and Le Vian, Tolkowsky, and Neil Lane in our Ernest Jones stores.

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Our success in diamonds in bridal is not coming at the expense of watches. We are seeing increased results in watches with our luxury brands performing strongly. We also relaunched the H.Samuel and Ernest Jones websites in October. They are designed to be cleaner, deliver more content and education, and present our brands better, while maintaining the ease-of-use that we have always possessed.

In addition to e-commerce progress, the first few Ernest Jones outlet collection stores have opened, which is strengthening our UK multichannel approach.

Now I'd like to talk about our Zale acquisition and some of the competencies that we made recently. In the third quarter the Zale division brought together almost 1,500 of our store managers, along with our field and home office leadership, and this was the first time this was done in over 10 years. What we did is we brought the managers to focus in on our strategy and make sure they were ready for the holiday selling season.

All of our store managers underwent Vision 2020 training to gain an understanding of how they fit into the wider Signet organization and to align their efforts to the Company's strategy. The multi-day session featured a breakout session on best in bridal.

The managers refreshed their product knowledge around the division's two premier bridal brands, which are the Vera Wang Love and the Celebration Diamonds, with a focus on sales behaviors that drive improved closure rates. The meeting also provided the managers with tools to better coach and develop their teams in order to improve the guest experience.

We have also strengthened our fourth-quarter marketing approach. Holiday TV started for Zales on November 5 and for Peoples on November 10. Zales and Peoples -- by the way, Peoples are our stores in Canada -- both have new commercials for Vera Wang Love and the Unstoppable Love program. In addition, Peoples also has a new commercial featuring Arctic Brilliance, which is a Canadian-mined diamond.

We also targeted our TV ad placements more appropriately to our customers. In addition, our Black Friday activities, print advertising, and in-store events are all much more robust. A study with Bain & Company is underway to increase our understanding of our store brand positioning, our value propositions, and the opportunities for growth with a primary focus on our Zales, Kay, and Jared store brands.

Regarding merchandise, we continue to test cross-selling of certain collections. Some of the more high profile brands of Zales are testing in Kay and vice versa. We look forward to more actionable data through the high-volume fourth quarter.

We have also made some aggressive changes, stepping up the merchandise mix of Vera Wang and Unstoppable Love and eliminating nearly 10% of the division's inventory in favor of faster-moving collections such as those I just mentioned.

We are making strides in our integration and, as I said in a news release this morning, we expect to deliver $150 million to $175 million in cumulative three-year synergies from January year-end 2015 to January year-end 2018. And I am confident about the position that we are in today and the position where we are heading.

As for the fourth quarter, we are ready to win this holiday season. We have several initiatives to drive business that are underway in each of our divisions.

I spoke to you moments ago about the power and the value of the Zale leadership conference. We also completed conferences in our Sterling and UK divisions as well with just as much enthusiasm and accomplishment.

Also in the area of store operations, this will be an exciting holiday selling season for roughly 150 new Kay stores that have our brand-new Kay store design, which is shown here on slide 8. The stores feature side-by-side selling, branded boutiques, and innovative use of technology within the store. We have been testing this concept for nearly two years, and after very successful results, we have been rolling this concept out during the year and will continue to do so into the future.

In merchandising, we have a strong balance of line extensions on existing product bands and we are also testing two exciting new brands, Earthly Treasures Smithsonian Collection in our Jared stores and So Sofia collection by Sofia Vergara in our Kay stores.

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In marketing, we have developed dynamic new creative for our TV ads including an ad that we produced for our Kay stores called penguins that was ranked by Advertising Age as one of the top new ads in the first week of November. We have also launched new advertising creative for our H.Samuel stores in the UK, and we have increased viewer impression in the holiday selling season for our store brands H.Samuel, Zales, Peoples, and Jared.

In all our divisions, we believe we have improved upon our store events as well as the content and cadence of our seasonal promotions.

For my final topic, I would like to just say a few words on our diamond procurement. Today we announced that we entered into an agreement with DeBeers. Our DeBeers site advances our strategic diamond sourcing efforts to the next level, and following last year's purchase of a diamond cutting factory in Botswana, we believe, as a DeBeers site owner, that we are now far ahead of most of our industry peers.

We will continue to expand our vertical integration and procure more rough or unpolished diamonds over the long-term. This provides us greater access to supply in a growing supply and demand gap.

Now I will turn the call over to Michele for a run through on our financials.

Michele Santana - *Signet Jewelers Limited - CFO*

Thanks, Mark. Good morning, everyone. Let's start by reviewing the third-quarter sales. Mark had just offered a similar overview of the numbers on slide 4, so I will point out just a few highlights.

In the Sterling division, total sales increased 9.7% to $692.8 million, which included a same-store sales increase of 6.8%. Sales increases continue to be driven by a balance between both the number of transactions and the average transaction price. The number of transactions increased in Sterling by 3.7% and the average transaction price increased by 2.7%, driven by fashion jewelry collections and branded bridal.

Zales division total sales were $331.4 million for the quarter, which also included an $11.5 million unfavorable revenue impact due to purchase accounting adjustments. Under purchase accounting rules, Zales deferred revenue was reduced on its opening balance sheet earlier this year by $90.5 million, resulting in a permanent reset of the associated revenue to be recognized. This adjustment will continue to have an unfavorable non-cash impact to Zale revenue over the next several years and will diminish thereafter.

UK division total sales increased 8.4%, or 4.7% on a constant exchange basis, to $151 million, and that was driven primarily by diamonds and watches. The average merchandise transaction value in the UK increased 6.3%, primarily driven by sales mix.

In terms of merchandise transactions, the UK division decreased 2.9%, driven by H.Samuel, and that related to volume reductions in watches, gold jewelry, and gifts.

Moving on, over the next couple of slides we look at Signet's consolidated Q3 performance before we turn and analyze Signet's adjusted results.

On slide 11 the table provides a reconciliation of Signet's adjusted results to consolidated results. The difference between adjusted Signet and Signet are in the three columns reflecting purchase accounting, severance costs, and transaction costs.

On a GAAP basis, EPS was a loss of $0.02 per share, and that was in line with Signet's guidance. This loss includes a $0.02 loss from unanticipated severance related to the CEO change, which is reflected in the table. Purchase accounting adjustments include a reduction to deferred revenue, amortization related to inventory fair value step up, and amortization of unfavorable contracts were dilutive to EPS by $0.12.

Transaction costs, including advisory, accounting, and integration costs, were responsible for $0.09 of dilution. The effective tax rate for the quarter was 31.6% and the forecasted effective tax rate for fiscal 2015 is 29.3%.

Next, I will walk through the breakout of operating income by division.

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Operating income of $10.7 million, or 0.9% of sales, consisted of the following components. Sterling Jewelers operating income of $68.1 million, or 9.8% of division sales, up 20 basis points from last year.

Zales division operating loss of $34.5 million, or 10.4% of division sales. Note that the loss in the quarter is consistent with Zales pre-acquisition trend of posting a loss in the third quarter, given the relatively small amount of revenue in this period. Zales Q3 loss consists of a $26.7 million loss from the Zales jewelry operating segment and a $7.8 million loss from the Piercing Pagoda operating segment.

Now that does include costs of $13.6 million related to purchase accounting adjustments, which we just discussed on the previous slide. Excluding the impact from accounting adjustments, the Zales division operating loss was $20.9 million, or 6.1% of division sales.

The UK operating loss was $2.7 million, or 1.8% of division sales, reflecting an improvement of $1.7 million from last year and was the best Q3 operating performance in four years. This performance is attributed to a focus on growing top line combined with cost control measurements.

Other primarily consists of our corporate and administrative expenses and Signet's diamond sourcing subsidiaries. It also includes $11.4 million of loss related to transaction and severance costs.

To help provide comparability to last year, we are also presenting our results on an adjusted basis, which excludes the purchase accounting adjustments, severance costs, and transaction costs.

The presentation here on slide 13 takes adjusted Signet, which is shown on the far right side and is shown on slide 11, and then breaks it into two parts. One part is Zale operations, shown in the middle two columns, and the second part, in the left-hand column, is adjusted Signet excluding Zales. Adjusted Signet excluding the Zales is the rest of Signet inclusive of finance interests and taxes.

From sale to operating income, this column gives you an apples-to-apples comparability to prior-year results. In addition, the information is provided to give you visibility as to how the Zale operations performed in the third quarter.

Now recall that we had guided for a Zales EPS dilution of $0.19 to $0.21. Actual dilution was $0.17, resulting from higher margins and lower expenses than planned in the quarter. We anticipate providing this incremental detail for you until we establish precedent for Signet results post-acquisition, when we lap these numbers in the third quarter of next year.

Continuing on, let's review Signet's adjusted P&L results below the sales line. Adjusted gross margin was $363.9 million, or 30.6% of adjusted sales, and that was down 40 basis points versus last year. The decrease in rate was driven by the addition of Zales, which impacted the gross margin rate by 80 basis points.

Sterling and UK gross margin rates were higher by 50 and 80 basis points, respectively, and that was due primarily to lower commodity costs and leverage on store occupancy costs as a result of higher sales.

Adjusted SG&A was $381.7 million, or 32.1% of adjusted sales, and that was up 190 basis points versus last year. Again, this increase was driven mostly by the addition of Zales, which impacted the rate by 110 basis points. The remainder of the increase in rate was attributed primarily to the timing of store operations expense and incremental advertising in Sterling and UK divisions.

In addition, higher central costs associated with headcount and bonuses also impacted the SG&A adjusted rate.

Other operating income was $53.5 million. This increase of $7.7 million was primarily due to higher interest income earned from higher outstanding receivable balances. Adjusted operating income in the third quarter was $35.7 million, or 3% of adjusted sales. Excluding the impact of Zales, Signet operating margin was flat to last year at 6.7%.

Adjusted EPS was $0.21 compared to $0.42 in the third quarter of fiscal 2014. On a comparable basis, that is when excluding this year's impact from the newly acquired Zales and capital structure and financing, EPS was $0.47, or an 11.9% increase over last year.

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Now let's move on to the balance sheet and let's start with inventory.

Net inventories ended the quarter at $2.7 billion, an increase of $1 billion, or 62.6%, over last year's third quarter. The increase was driven almost entirely by the acquisition of Zales. To a lesser extent, inventory levels were also impacted by Sterling division increases around bridal brand extensions, loose diamonds, and new stores. We believe our inventory levels and assortment are well-positioned for the fourth quarter.

Moving on, let's turn our attention to our in-house credit metrics and statistics. In-house credit remains an important component of our Sterling division's business and a competitive advantage.

Net accounts receivable increased to $1.29 billion compared to $1.12 billion last year, up 15%, driven by higher sales and an increase in the credit penetration rate. In the year-to-date, credit participation was 61.7% compared to 58.9% last year. The increase in credit participation was attributed primarily to credit decision engine improvements made in April of this year, higher outlet credit participation, and strong guest acceptance of our credit offerings.

The average monthly collection rate year-to-date was 12.1% compared to 12.3% last year, as guests continue to opt more to our regular credit terms, which requires lower monthly payments as opposed to the 12-month interest-free program. Next I will move on to credit statistics missing on year-to-date metrics, which minimizes the effect of seasonality.

Year-to-date our net bad debt expense was $105.8 million compared to $92.9 million last year, or an increase of $12.9 million, and that was driven primarily by growth in the receivables balance from increased credit penetration and change in the credit program mix. Year-to-date, other operating income, which is primarily finance charge-related, was $161.2 million compared to $139.1 million last year, an increase of $22.1 million, and is due primarily to more interest income on the higher outstanding receivables, as well as the shift away from interest-free programs. So the net impact of these two items was income of $55.4 million year-to-date compared to $46.2 million in the prior year, or an increase of $9.2 million.

Operating improvements made to our decision engine have helped increase credit penetration without adversely affecting the net impact of our bad debt. The portfolio continues to perform strongly as evidenced by the allowance and the percentage of ending accounts receivable decreasing 10 basis points from 7.5% to 7.4%.

Now let's move on to some other highlights of the balance sheet.

We now carry $1.4 billion of long-term debt. This debt is very cost efficient at an average interest cost of 2.6% and our finance structure includes a balanced mix of short, medium, and long-term debt. In the quarter we used $145 million of our credit facility for seasonal inventory needs and we anticipate that this will be fully repaid by fiscal year-end.

In terms of Signet's capital structure, we continue to evaluate our working capital and cash flows associated with Zales. During the third quarter we did make some minimal share repurchases and we will look to the results of the holiday selling season in establishing fiscal 2016 share repurchases. We ended the third quarter with cash of $87.6 million.

Now let me share with you our guidance.

Fourth-quarter Signet comparable store sales are expected to increase 3% to 4%. Fourth-quarter adjusted EPS is expected to be $2.95 to $3.05 and adjusted EPS is EPS less the two sets of adjustments shown on slide 19, being purchase accounting and transaction costs.

Now within adjusted EPS, Zale operations are expected to be accretive in the fourth quarter by $0.36 to $0.40. Annual adjusted EPS is projected at $5.51 to $5.61 and that is up from the previous full-year guidance we provided of $5.38 to $5.54. And the fiscal 2015 annual effective tax rate is anticipated to be 29.3%.

Capital expenditures guidance for the full year is $240 million to $250 million and net selling square footage is projected to grow 45% to 47.5%, inclusive of Zales, or approximately 4% when excluding Zales. I would also reference you to see our news release for details by store concept.

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That concludes my prepared remarks on the financials and now I will turn the call back over to Mark.

Mark Light - *Signet Jewelers Limited - CEO*

Thank you, Michele. In conclusion, I would like to thank all of our Signet team members for their hard work, their efforts, their focus on our business plans, and for their contributions to a successful quarter.

Now we will take time for some questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Simeon Siegel, Nomura.

Simeon Siegel - *Nomura Securities - Analyst*

Thanks. Good morning, guys. Nice quarter.

So, given the increase in Sterling gross margins despite everything were hearing about a promotional environment, how do you view that gross margin line going forward into holiday and then beyond? How do you think about the commodity costs? What benefits you see from a more rational pricing environment, given that you no longer have a meaningful competitor?

Then just regarding the replacement of the non-productive inventory at Zales. When do you see the opportunity to get the new product fully ramped up? And any thoughts you can share on the road to positive comps, EBIT growth, etc., for Zales.

Michele Santana - *Signet Jewelers Limited - CFO*

Sure. Why don't I start with your gross margin question?

In terms of the gross margin and how we see that going forward, again for the holiday season at this point we don't anticipate it to be more promotional any more so than last year. We do see the benefits coming through of our lower gold cost, which will continue to help the rate. That is offset slightly by some of the lower trade-in recovery we get with the lower gold cost.

Directionally what I would say is that on a full-year basis, we would expect to, I would say, broadly maintain maybe some slight increase in our gross margin rate, driven by the accommodation of the lower commodity costs I just spoke about as well as sales mix associated with that.

The other thing I would just add to that real quick in terms of gross margin rate on our -- primarily more so on our UK division, is again we really remain focused on driving incremental gross margin dollars in that business and less so on the rate. So I would just add that.

I will turn it over, Mark, if you want to address the second question on the unproductive inventory.

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Mark Light - *Signet Jewelers Limited - CEO*

Sure. So as far as the inventory, for the months of primarily September and October we pulled back over $100 million of slower-turning inventory out of the Zales stores and the Zales division. Then we are obviously buying back goods and we believe we are fully up to speed now in getting those goods back into place.

And the goods we are investing back in, as I mentioned in my comments, are programs like Vera Wang, programs like Unstoppable Love. Programs that we believe they were not backing the inventory as well as they could to maximize sales. And that all is in place right now and pretty much has got in the stores by November 1 or so.

Michele Santana - *Signet Jewelers Limited - CFO*

I would just add that there was a little bit of the timing; how we originally planned it and how it actually occurred was a little bit slower back ended in the third quarter. But as Mark indicated, we are fully ramped up with that inventory in the fourth quarter.

Simeon Siegel - *Nomura Securities - Analyst*

Great. Thanks a lot, guys, and good luck for the holiday.

Operator

Jeff Stein, Northcoast Research.

Kushan Akhtil - *Northcoast Research - Analyst*

This [Kushan Akhtil] calling in for Jeff. I just have a question on any takeaways from the cross-brand selling test. Are there test stores both in malls or overlap and where there is a single store are you guys seeing any cannibalization? Thank you.

Mark Light - *Signet Jewelers Limited - CEO*

In reference to the cross-selling, first of all, just remind everybody, we put Vera Wang in 50 of our Kay stores and 30 of our Jared doors. We also put Neil Lane and we put Le Vian and Jane Seymour in 50 Zales doors. And we have it also in 30 Peoples doors.

It's way too soon to take a read on it. They've been in each of the other's divisions for the last two weeks or so. It's way too soon to read. At the end of the fourth quarter we will get a better sense of what's going on on that front. So long answer to your question is it's too soon to give any read as of yet.

Operator

Rick Patel, Stephens, Inc.

Rick Patel - *Stephens Inc. - Analyst*

Good morning, everyone, and congrats on the strong momentum into holiday. Can you talk about your promotional cadence that you are planning for holiday? I know last year things were a little tricky with the winter storm during the key promotional time, so how do you expect to approach things this year?

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Then, secondly, how do you feel about the health of your consumer in general, just given we've heard so many discretionary retailers talk about difficult trends so far in the fall?

Mark Light - *Signet Jewelers Limited - CEO*

Okay. Thanks, Rick. As far as our promotional cadence, we -- as Michele mentioned and I mentioned, we are not going to promote anymore this year over last year. We don't see any reason to do so. As you can tell by our results, our customers are doing just fine and we don't see any reason to promote more.

What we are going to do specific for the Zales division is we are going to have a little bit more direct and targeted promotions to the customers that we know and how they react. So you will see some different promotions from Zales than they had in the previous years, but it won't be any more deeper discounts or any more promoting going on.

So the cadence will be the same as last year for our Sterling and UK divisions. Zales you will see some differences. We specifically have a new event that's coming up in the middle of December which is what we call a preferred customer weekend promotion, which we believe gives our sales associates in our Zales division an opportunity to trade up and add on to more of these promotions that they have had in the past.

The second -- that was?

Michele Santana - *Signet Jewelers Limited - CFO*

The customer in terms of our customer, how our outlook on our customers are doing. Again, we are seeing that customers that are turning up at our stores.

Mark Light - *Signet Jewelers Limited - CEO*

Rick, we believe, because our customers are much more of a premeditated customer, meaning that they either know that they have to get a Christmas gift or a birthday gift or an engagement ring, so it's a premeditated type of shopping experience so they are thinking about it.

And due to our incremental advertising that we have been doing and will be doing, and we believe which have better creative and better placement of our ads, that we are able to get that premeditated customer who is thinking about gift-giving into our stores more so than our competitive set due to our extra advertising, our great customer service, and some of the new brands and extension of our brands that we are offering to our guests and customers.

Rick Patel - *Stephens Inc. - Analyst*

Got it. Then a question on the diamond supply contract. Can you just touch upon how this is going to affect cost of goods over the next year or so? Given it's a strategic initiative, is it safe to assume that you will incur some higher costs to ensure diamond supply in the future?

Mark Light - *Signet Jewelers Limited - CEO*

I'm going to start of just giving a little bit of an overview and let Michele talk about the effect on cost of goods.

First of all, for us this is a very exciting event. We have been, as a retail company, really working on getting a DeBeers site for years. The benefit of partnering with a company like DeBeers, who is still the leading diamond miner in the world, is they really understand rough. They have the ability of assorting the rough, literally, in over 10,000 different qualities.

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And when you can get rough assorted the way DeBeers assorts rough, it makes it easier for us to have better quality type of criteria that works better for our customers and the type of diamonds that we sell. So it's really a big thing for us to get the DeBeers site and get the wonderful assortments that DeBeers can offer. They can really cater that box as they call it or the site more so for our customers.

So the big initiative and the strategic initiative really, first and foremost, is about getting the control of the supply and understanding the rough supply market. Now, obviously, there will be some benefits in gross margin and COGS and I will let Michele talk to that as far as the future and the benefits of that.

Michele Santana - *Signet Jewelers Limited - CFO*

Yes, yes. In terms of how we would expect to see that impact our cost of sales, we really don't go and disclose the numbers and how it's kind of moving through in our expectations. But to Mark's point, we are going to be able to buy diamonds more efficiently and more effectively, so there will be some benefit that shows through on our gross margin line item.

This really is, though, about securing our source. And a consistent source of diamond supply is, first and foremost, the primary benefit of our arrangement with DeBeers.

Rick Patel - *Stephens Inc. - Analyst*

Thanks very much and good luck this holiday.

Operator

Lorraine Hutchinson, Bank of America.

Lorraine Hutchinson - *BofA Merrill Lynch - Analyst*

Thank you, good morning. I noticed that the Zales standalone operating margin was flat with last year and I was just hoping you could provide some context around that.

Michele Santana - *Signet Jewelers Limited - CFO*

In comparing to last year, again, there's a few things that you have to take into consideration because there really isn't an apples-to-apples comparison. There's a number of things flowing through their operating margin which no longer -- ceased to be the case.

One item I would call out there is LIFO. They were on the LIFO system. That no longer, so you would have had an impact in last year versus this year.

Kind of pulling that out, I would say roughly when we look at the comparisons to last year it's kind of what we would've expected, given we are really just starting to get our arms around this business, putting in initiatives, gaining traction as we move forward. So we weren't expecting to see a major, I guess, bump or increase in operating margins at this point when you do even get it down to an apples-to-apples basis.

Lorraine Hutchinson - *BofA Merrill Lynch - Analyst*

Great, thank you.

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Operator

Joan Payson, Barclays.

Joan Payson - *Barclays Capital - Analyst*

Good morning and congratulations on the strong quarter. So it looks like the Zales dilution this quarter was a little bit better than anticipated. Was hoping you talk a little bit about where the upside came from, if there was any shifting of costs.

Then also, in terms of the outlets, it looks like the remaining conversions are now finished between the Ultra stores and the Jared outlets, so if you could please talk a little bit about the performance in the quarter and what that looked like.

Michele Santana - *Signet Jewelers Limited - CFO*

So why don't I start in terms of the Zales dilution? It was favorable, as you indicated, $0.02 to the guidance we had provided. And that was primarily driven by -- there were higher margins that what we had planned and I think some of that we are starting to see the early signs of even just reengineering the merchandise assortment, that the sales mix is bringing in higher margins. So we are starting to see some of that already take shape in the Q3.

The other part is on the expense side, and it wasn't so much I would say a shift in cost from Q3 to Q4, but it was really lower expenses than what we had planned. One of it related to the leadership conference. That expense actually did come in lower than what we had planned.

We have also had some benefit coming in our broken and damaged inventory. So by pulling out the unproductive inventory from the stores, we are actually seeing the benefit with lower costs associated with broken and damaged inventory. So that would be the other expense that came in favorable for us.

With that then, Mark, if you want to address the second question.

Mark Light - *Signet Jewelers Limited - CEO*

In reference to the outlets, we don't report the sales problems separately. It will tell you that within our Sterling division we are very pleased with the outlet performance. They are doing very, very well.

And as you stated, we no longer have any Ultra stores. The whole outlet portfolio in our Sterling division are either Kay outlet stores or they are Jared Vault stores. And they are doing very well. We've learned a lot from the best practices over the last few years of what the best way of operating outlet stores to how and how they are supposed to be operated. And it's really working out very well for us.

We are also very excited that in our UK division we are going to open this year about half a dozen brand-new Ernest Jones Outlet Collection stores, first time for the division that will be opening up. And we see opportunities; there will be more of those into the future.

In our Zales division, we are looking forward to working closely with our Zales outlet stores to try to share those best practices that we've learned over several years and looking for some upside opportunity for the Zales outlet going into the future.

Joan Payson - *Barclays Capital - Analyst*

Great, thank you.

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Operator

Dorothy Lakner, Topeka Capital Markets.

Dorothy Lakner - *Topeka Capital Markets - Analyst*

Thanks and good morning, everyone. Just wanted to talk about marketing. If you could just refresh us in terms of the increase in the dollar spend year-over-year.

Then, just in terms of the timetable going forward on Zales, you have been able to actually affect quite a bit of change very early on in this acquisition. So just wondered what we should be looking for as we move into 2015 and beyond. What kinds of things you want to accomplish and what's the timetable there?

Mark Light - *Signet Jewelers Limited - CEO*

Thanks, Dorothy. I'm going to start with your last question.

Just to remind everybody we just took over Zales in June and a lot of plans were in place and inventories were in place, and there are certain things that we are able to affect such as the marketing buy. We were able to buy the Zales TV along with our Kay and Jared buys, so we were able to make a more efficient, more productive buy we believe. We were also able to place the Zale ads, which we believe were more targeted appropriately towards the Zale customer than they have done historically, so we were able to change the advertising of it.

And we are going to increase impressions on Zales TV this year. Year-over-year there will be increased impressions for Zales. So we got a more efficient buy, better targeted advertising placements towards what we think is the appropriate customer segment, and we have new creative for Zales.

But we were able to make some changes, not loads of changes. We want to keep everybody grounded on that. We've only owned the company for several months and a lot of things were in place. We are still confident and feel very good about the changes and the enhancements we can make over the next two and three years.

But for the fourth quarter we were able to change some advertising, as I stated. We've been able to invest in some more inventory, Vera Wang and some other faster-turning vehicles, and we were able to start training the team members on some of our best in bridal training tactics. Really that is a lot of the stuff we are able to do. There's a lot more to be done going into the future.

Michele Santana - *Signet Jewelers Limited - CFO*

Dorothy, just to give you a little bit more color in terms of marketing spend, in the quarter our ratio on that as a percentage of sales on marketing was up about 50 basis points over the prior year. And that's driven by a combination of increases in our Sterling division, which we have increased over bridal in Q3.

There's been some increase on our UK division as well with our H.Samuel TV ads. And then there was also an increase in terms of the Zale division and the investments that we made in the marketing side. So from a dollar perspective it is an increase of about $15 million and about 50 basis points increase on just a quarter-to-date basis.

Just to kind of give you a sense on a year-over-year basis, we are up -- our ratio is actually, as a percentage of sales, is flat to last year, but we are up about $33 million. Again, that is kind of driven by increases across all businesses, but significant dollar increases by bringing in Zales this year.

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Dorothy Lakner - *Topeka Capital Markets - Analyst*

Thanks so much and good luck for holiday.

Operator

Ike Boruchow, Sterne, Agee.

Tom Nikic - *Sterne, Agee & Leach - Analyst*

This is actually Tom Nikic on for Ike. Thanks for taking my question.

I was wondering about the SG&A expenses. I noticed that, excluding Zales, they were still up 13%. I was wondering if that's just marketing or if there was something else going on there.

And my second question was about merchandise margins by geography. It was wondering if there was a meaningful difference between the US and the UK, if one was up big or anything like that. So thanks very much.

Michele Santana - *Signet Jewelers Limited - CFO*

Sure, so let me start with your question on SG&A. Yes, our adjusted basis, and when you pull out Zales, we did have an increase in SG&A in the Sterling and UK divisions and that was primarily driven by higher advertising costs. We talked about the investments we made in the Sterling division around bridal in Q3.

The other component was timing related to store operations expense, primarily the leadership conference, and when those expenses hit this year as opposed to last year. Then the other element in there that has impacted the adjusted Signet rate when you exclude Zales is our central cost, which is higher than last year. And that is driven by a couple factors. One is associated with headcount increases and the other component is associated with bonuses and just overall performance hitting a higher bonus percentage.

Then I think your second question related to merchandise margins. Really we have steered away from and don't disclose merchandise margins in total or really across divisions. I would just reference you back to overall our disclosures on a gross margin basis where we did see an increase of 50 basis points in gross margin on our Sterling Jewelers division, and then we also saw an increase of 80 basis points in our UK division. Again, that was driven by leveraging our store occupancy costs as well as we did see a benefit coming in on lower commodity costs, particularly the gold.

Tom Nikic - *Sterne, Agee & Leach - Analyst*

All right. Thanks very much and good luck for holiday.

Operator

Oliver Chen, Cowen.

Oliver Chen - *Cowen and Company - Analyst*

Thanks a lot. Congratulations and, Mark, congrats on your elevated role.

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Regarding the longer-term picture with the Zale Corp. opportunity on increasing sales productivity, is the main category there opportunity bridal? And then I did have a question on the comp guidance. Should we assume that the run rate may be similar between Zale Corp. negative low single versus Sterling?

You guys had volatility last year on a week-to-week basis. Is there anything we -- do you anticipate the run rate being volatile off of those comparisons in terms of what you are seeing in the marketplace now?

Mark Light - *Signet Jewelers Limited - CEO*

Okay, so I think there's three questions in there. I'm going to start with the first one which the question was in reference to if we believe the big opportunity for Zales, as it relates to merchandise assortments, is in the bridal category. And I would say, yes, we believe there is opportunity in the bridal category.

There's no question that they have one of the top bridal brands in Vera Wang in the country as it relates to bridal engagement rings. We believe there's opportunity to really take Vera to the next level, invest in the inventory, invest in marketing, invest in in-store training in the whole bridal category. But we also believe there's great opportunities in other parts of the business.

We think there is big opportunity to enhance their fashion assortment and enhance their fashion diamond business. We think that's an area of the business they really haven't done a great job in and we think there's upside potential there. And there's a lot of other parts of the business that there's great potential.

We believe there is a great opportunity in enhancing the repair business, which is a very important business in our industry, as it relates to not only because there is nice margins in that business, but more importantly, when you fix a customer's heirloom piece they could be a customer for life. And how you take care of their repair item is just, if not more, important than a new merchandise product.

There's a lot of areas of the business that we will share with you going down the road over the next two, three years that there's a lot of opportunities outside of just the bridal assortment. So that's the answer to that question.

Michele Santana - *Signet Jewelers Limited - CFO*

Oliver, maybe I can jump on your question in terms of comp guidance we provided. What I would steer you to is really we're providing the comp guidance on a total basis with all of our business divisions. We are really not breaking it down between Zales, Sterling, and the UK division.

But with that maybe to add little bit of color, and I think your thought process is kind of right on in line, but we do expect that we will continue to maintain our strong sales momentum in our Sterling and UK division. The other thing that I would add to it is, bear in mind, in the UK division we are up against a high hurdle rate of last year. Last year fourth quarter was 5.7% and that's when we started to launch and really focus on the selling of our diamonds and the bridal component. So we do have a higher hurdle rate there on the UK side.

Again, I would just steer you back to Mark's earlier comments on the Zale that even though we do -- we put in initiatives, we are gaining traction for holiday period, it really has been a short time period since owning Zale and we are only able to affect so much within this time period. So we are being cautious on the Zale, particularly the sales line, during this holiday selling season.

Then I think, Oliver, you had maybe one more question on the run rate or the volatility week-by-week leading up into the holiday selling season?

Oliver Chen - *Cowen and Company - Analyst*

Yes, I know last year you give a certain degree of flexibility for the store folks to give compelling values to customers. So as you anniversary that just are your thoughts that volatility may be a factor in terms of how comps are manifesting?

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Mark Light - *Signet Jewelers Limited - CEO*

I think, as we sit today, Oliver -- and I own the right to change my mind depending on what happens out in the next eight weeks or so or six weeks -- right now no. We believe that we are positioned well and we won't have to use that tool like we did last year.

Because if you remember last year, Oliver, a lot of it was because we had horrible, horrible winter storms in one of the biggest weekends, in one of the biggest promotions that have in mid-December. So we felt we lost a lot of that momentum because we lost all those customers on the East Coast so we used some flexibility on making sure we closed some deals to customers that missed out on that event due to weather, so we gave our stores the opportunity to discount more.

Unless there is a weather issue or something that happens in the macroeconomic environment, we don't believe we're going to need to use those same tactics this year.

Oliver Chen - *Cowen and Company - Analyst*

Okay. Just our final question is congrats on the strategic sourcing initiative. Is that across all grades of diamonds? Were there particular grades where you felt supply versus demand was particularly important to ensure that?

And do you see yourself having more vertical integration going forward? What are the next steps as you look to the challenges that the long-term may face in matching supply and demand?

Mark Light - *Signet Jewelers Limited - CEO*

Just to remind you and everybody that this rough initiative of ours is, in our best case scenario, this year maybe 10% of our total diamond purchases, our total loose diamond purchases. And longer-term it will never get to anywhere near the majority of our purchase.

We need to stay in the polished diamond market. It's an important part of the market, but we do plan on growing this initiative further up to -- we have stated up to 20% or more of our needs will come out of this initiative.

As far as the grades, it's primarily -- right now the goods that we are getting from DeBeers in the open market are primarily the nicer qualities, call SI1 and better, and so it's really going heavier into our Jared division. We will stay in tune to the marketplace. We would like to get into more qualities, but right now it's more the higher end type of goods that we are getting through this particular initiative.

Oliver Chen - *Cowen and Company - Analyst*

Okay, thanks. Best regards for the holiday season.

Operator

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

Mark Light - *Signet Jewelers Limited - CEO*

Thank you. Thank you to all of you who are taking part in this call. Our next event for the investment community will be our holiday sales call on Thursday, January 8, when we will review our November and December sales announcement.

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I want to wish all of you a very happy and healthy holiday and Thanksgiving and thanks again. Goodbye.

Operator

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

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