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Signet Jewelers Limited

Fiscal 2017 First Quarter Earnings Conference Call

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PRESENTATION

Operator:

Ladies and gentlemen, thank you for standing by. Welcome to the Signet Jewelers First Quarter Results Conference Call. During the call all participants will be in a listen-only mode. After the presentation we will conduct a question and answer session. Instructions will be provided at that time. If at any time during the conference you need to reach an operator, please press star, followed by zero. Please note that this call is being recorded today, May 26, 2016 at 8:30 AM Eastern Time.

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

James Grant:

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

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

I will now turn the call over to Mark.

Mark Light:

Thanks, James. Good morning everyone. There are five key messages I would like you to take away from our presentation today. First, in what has been a choppy retail environment, we were able to deliver record EPS at the high end of our guidance. Our operating income, our net income and our earnings per share were all up over 20% year-over-year. This was due in large part to managing our expense structure in a disciplined fashion and realizing synergies that position Signet well for the long term. This prudent expense management included good results in credit which Michele will speak about in more detail later.

Second, we delivered solid sales for the quarter. Although our sales were slightly below our guidance, they were still strong enough to deliver on our earnings expectations. Year-to-date we are gaining profitable market share.

The third point I want you to take away is that we remain a growth story, a prudent, measured and profitable growth story. We remain on pace and are committed to growing our store square footage. Our disciplined rate of return requirement on new stores of 20% remains firm. The growth this year will be led by Kay Jewelers outside the enclosed mall. This is a departure from many other retailers that are having to reduce square footage these days.

Fourth, we are reaffirming our annual earnings guidance. Our first quarter results and sales flow-through keep us positioned to achieve our year-end goals around EPS, adjusted EPS and synergies, despite a lower sales outlook.

And fifth, we are conducting a strategic evaluation of our credit portfolio as we are always looking for ways to optimize our operating business model. Goldman Sachs, who has vast experience in this area, has been engaged as the Company's advisor in this process. We will consider a full range of options as we evaluate our in-house and outsourced credit programs. These options include but are not limited to optimizing credit offerings, optimizing allocated debt and equity capitalization of the credit portfolio including potential incremental securitization; bringing all credit function in-house over the long term; in-sourcing some credit functions and outsourcing others, and outsourcing all credit functions. This evaluation is a top priority and as we move through this we will remain focused on executing our operational plans and driving profitable growth in our business.

Moving on to Slide 4 and the financial highlights, I leave the specific numbers and details for Michele but the main headlines and accomplishments from a financial perspective lays our first quarter out as follows. We delivered a good sales gain which include a 2.4% comp increase. We delivered operating margin expansion and we leveraged both gross margin and SG&A, coupled with meaningful buyback, which demonstrates our confidence in our business and the value we see in our shares. This led to record first

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quarter EPS with a double-digit percentage increase, and we have sound cash and liquidity levels and we continue to possess a strong balance sheet with clean inventory and a responsible amount of debt.

Next I'd like to discuss the main sales drivers of the first quarter. Like the fourth quarter, results were led by our Ever Us, which is our two-stone diamond ring collection. Ever Us is now testing line extension in stores for the holiday season and some are already showing significant promise. Bracelet and earrings as well as necklace with on-trim looks and innovative fastening systems were also very successful in the first quarter. Branded bridal also grew in Q1. The bridal business is a stable grower and insulates us from some of the volatility that traditional retailers face. Brands such as Vera Wang Love and Neil Lane led the way.

Before I go into what's to come for the back half for our company, I want to take a few moments and make a few comments about our place in the jewelry industry. Our internal research shows definitively that consumers still find jewelry gift giving as one of the best ways to celebrate life and express love, and the numbers support this. As shown on the left side of Slide 6, with three- and five-year compounded annual sales growth rates in the teens and 8% growth for 10 years when figuring in the recession, Signet has been gaining and continues to gain market share profitably. We consistently outperform the jewelry market and the total retail market, and based on results to date, we appear poised to deliver another year of industry outperformance.

Given the fragmented jewelry industry, we believe we have many years of profitable market share gains ahead of us. Our brands, our scale and our people give us a sustained competitive advantage.

Signet is relatively Amazon-proof as consumers have consistently shown a desire to touch jewelry and get educated by trusted and trained professionals before making a highly emotional purchase.

We are in a consolidating industry. Jewelry in the US is growing in dollars and declining in the number of doors and we have three of the most pre-eminent brands in the space. We know that there are growth opportunities and we also know how and where to get them, which makes us even more attractive for investors.

So why invest in Signet? Firstly, we are the clear jewelry market leader with less than 8% of the total market share in the US and it's a highly fragmented and growing middle market industry. We are a square footage grower and will be for years, and we are consolidating in a growing industry. During calendar 2018, after synergies are done and the Zales business model is ready and operating consistently, we intend to grow Zales outside the mall.

We continue to deliver high quality financial results. Our financial flow-through is powerful with consistent comps and market expansion expanded by the Zale acquisition. We believe this will lead to long-term EPS growth. Coupled with a solid balance sheet including prudent inventory management and our financials compare pretty well with most of retail.

We continue to have confidence that we will deliver on our annual earnings guidance. We have many competitive advantages that we leveraging around our store teams, our marketing and our exciting merchandise programs. But allow me to discuss just a few of our exciting, compelling merchandise line extensions and test that should help us deliver on the year by making the bulk of their contribution in the fourth quarter.

As I mentioned earlier, we are successfully testing Ever Us line extensions such as new diamond ring styles, necklaces, bracelets and earrings, and in our experience, beacon, or industry-trend that's driving type strategies like this, tend to perform even better in Year 2 versus Year 1. We are also testing a line of

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Vera Wang fashion diamond jewelry and pearls and pearl jewelry to capitalize on her strong name and her design expertise.

In all of our Jared stores, we are resetting our Pandora presentation with beautiful new Pandora store-in-stores. As a part of it, we are selling a broader collection of Pandora products and fashion jewelry and we'll support it with new TV advertising and creative in the fourth quarter.

We're rolling out the Chosen Diamond program to all Jared stores which shows the customer each stage of a diamond's journey from a rough diamond to finished jewelry. This is in total alignment with the Jared customer segment who tends to value this type of product and information moreso than some of our other store banners. We are also designing brand new TV creative to support the Chosen also for the fourth quarter.

Lastly, we have new technology for our store teams in Kay and Jared for the fourth quarter that will enable our teams to interact with customers more intelligently based on their previous purchases and special life occasions. We call it Clienteling, and we are very excited about its potential to drive sales and build relationships with our customers and our team members.

Okay, now back to Signet's overall investment merits as we continue down Slide 7. Our integration is progressing as planned and delivering the synergies along the way. We are living up to the expectations that we've articulated. Where Signet has pockets of underperformance, we have strategies. For example, at Jared, merchandising, marketing and store operation plans will help us to deliver a strong holiday season.

Finally, we have a thoughtful and balanced capital allocation policy that accounts for strategic investments, meaningful stock repurchases, dividend increases and a preservation of capital.

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

Michele Santana:

Thank you, Mark. Good morning everyone. So we'll start with our first quarter sales performance. Signet's comps increased 2.4% and that's on top of a 3.6% comp increase in the prior year first quarter with all three of our divisions delivering positive comp sales. Total sales increased 3.2% and on a constant exchange basis, total sales increased 3.9% for the quarter.

In looking at total sales and comp performance by operating segment, let me share some additional color. In Sterling Jewelers total sales increased 3.8% to $980 million which included a comp increase of 2.3% on top of a prior year increase of 2.3%. Sales increases were driven principally by strong sales of select branded bridal jewelry as well as fashion jewelry.

The Zale jewelry operating segment's total sales increased by 2.3% to $381 million and 3.2% on a constant currency exchange basis. On a geography basis, our Zale US sales increased 3.7% and comps increased 2.4% and that's on top of a 5.4% comp increase in the prior year. Our Canadian total sales declined 6.2% but increased 0.2% on a constant currency basis with comp sales decline of 0.6%. Canada sales continue to be impacted primarily by the Western Region of Canada due to the struggling energy industry. Across stores, sales were driven primarily by diamond fashion jewelry and branded bridal.

Our Piercing Pagoda total sales increased 7.5% to $69 million with comp sales of 5.6% on top of 6.1% last year. Sales increases were driven primarily by gold chains and diamond jewelry.

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In the UK, our total sales decreased 1.7% to $144 million but increased 4% at constant currency rates. Comp sales grew 3.4% and that's on top of a 6.2% comp increase in the prior year. Diamond jewelry and prestige watches were the primary drivers of sales increases in the UK.

Moving on from sales, we'll look at Signet's consolidated Q1 performance and then we'll turn and we'll look at Signet's adjusted results.

Turning to Slide 9, the table provides a reconciliation of Signet's adjusted results to consolidated results and we're continuing to present this reconciliation in fiscal year 2017 to reflect the impacts of purchase accounting as well as severance and IT implementation expenses associated with our global systems that will drive future synergies. The difference between adjusted Signet and Signet are in the columns reflecting purchase accounting and integration costs. Starting in the lower left portion of the slide, on a GAAP basis, EPS was $1.87 per share and that's up 26.4% over last year. In the next column over, purchase accounting adjustments were worth $0.04 of EPS dilution and this was driven primarily by deferred revenue adjustments related to acquisition accounting.

The next column over reflects our integration cost and as I had just mentioned relate to severance that's associated with our organizational design changes and consulting costs related to information technology implementation. Integration costs were also responsible for $0.04 of EPS dilution.

So on an adjusted Signet basis in the far right column, by adding back the $0.08 worth of adjustments, adjusted EPS was $1.95, an increase about 20.4% over last year.

Now looking below our sales line at Signet's adjusted P&L results, our adjusted gross margin was $604.4 million or 38.2% of adjusted sales, and that's up 40 basis points due primarily to the Zale division and a variety of synergies such as sourcing, discount controls and vendor terms as well as some favorability in commodity cost and leverage on store occupancy.

Sterling Jewelers gross margin increased by 20 basis points due primarily to commodity cost. The Zale division's adjusted gross margin rate increased 90 basis points as synergies favorably affected many areas including our merchandise margins, distribution costs and store operating cost.

Our UK gross margin decreased 30 basis points driven principally by lower sales and merchandise margin deleverage as a result of currency exchange rates.

Adjusted SG&A was $456.1 million or 28.8% of adjusted sales and that compares to $451 million or 29.3% of adjusted sales in the prior year. The 50 basis points of leverage was due primarily to lower store and corporate payroll expenses associated with our organizational realignment as well as lower advertising expenses. This was offset in part by information technology expenses related to Signet's IT global implementation.

Other operating income was $74.3 million or 4.7% of sales. This increase of $10.8 million was due principally to higher interest income earned from higher outstanding receivable balances.

Adjusted operating income was $222.6 million and increased 14.7% over prior-year first quarter. Our adjusted operating margin rate was 14.1% of sales. This 150 basis point expansion over prior year was driven primarily by the increase in sales as well as gross margin expansion and SG&A leverage.

Adjusted EPS was $1.95 which compares to $1.62 last year, an increase of 20.4% driven principally by our stronger business performance.

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So now let's move on to the balance sheet and we'll take a look at our inventory. Our strong first quarter end inventory position reflects the success of our continued focus on inventory optimization. Net inventory ended the period at about $2.5 billion, an increase of just 1% compared to our sales growth of 3.2%. This relationship to sales was driven by solid inventory management across virtually all of our product categories, divisions and locations, but most notably in branded bridal. We increased Zale inventory turn by reducing unproductive inventory, right-sizing store level inventory closer to Kay averages and improving clearance inventory management. As we move through Q2, our inventory levels and merchandise assortment for fiscal 2017 are very well positioned.

Now we'll turn our attention to our in-house credit metrics and statistics. Our first quarter credit sales were $605.1 million compared to $573.1 million in the prior-year quarter, reflecting an increase of 5.6% which compares to an increase of 9.2% in the prior year. The higher credit sales was driven primarily by growth in bridal and Ever Us, both which have higher average transaction values. The average monthly payment collection rate for the first quarter fiscal 2017 was 12.3% compared to 12.6% last year. Our monthly collection rate is calculated as cash payment received divided by beginning accounts receivable. The change in rate over prior year is due primarily to merchandise mix, as bridal, especially higher priced branded bridal increases, this creates a higher average initial balance. By design, the minimum payment rate declines as the price point of the merchandise increases. Bridal has higher average credit sales, therefore the repayment period is slightly longer and cash collected as a percentage of the receivables decline slightly.

The combination of growth in credit sales and collection rate led to an increase of 11% in our net accounts receivables compared to an increase of 14.7% in net receivables in the prior-year quarter. Our quarter ended net accounts receivable increased to $1.65 billion compared to $1.49 billion last year.

Interest income for finance charges, which makes up virtually all of the Other operating line on our income statement was $72.8 million compared to $64.4 million last year. The increase of $8.4 million was due primarily to more interest income on the higher outstanding receivables base.

Our net bad debt was $33.6 million compared to $28.1 million last year. The increase of $5.5 million was driven by our higher receivable balances, but more specifically, our bad debt provisioning establishes a 3% reserve at origination of the receivables based on historical experience. The higher our credit sales, meaning the more new volume in accounts receivable, the greater the amount contributes to our allowance for doubtful accounts.

Now, the net impact of bad debt in finance income generated operating profit of $39.2 million and that's compared to $36.3 million in the prior year.

Looking at some of the key Sterling division allowance for doubtful account metrics, our total valuation allowance as a percent of gross receivables was 6.6% in the first quarter. This was up 10 basis points from prior year and down 40 basis points quarter-over-quarter, but what's most important is that as we expected we made more sequential improvement in Q1 of this year than we did in last year. Why is that?

The impact of improved collection execution and credit marketing techniques that we began late last year are making more than just seasonal progress. We improved 40 basis points Q4 to Q1 versus 30 basis points over the same period prior year. The same trend was true for our non-performing portion of our receivables as a percent of the gross receivables. At 3.6%, this was also up 10 basis points from prior year and down 40 basis points quarter-over-quarter. Again, the sequential trend of non-performing loans was better at 40 basis points down versus 30 basis points down in the prior year period.

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Building off the Q4 trends that we had discussed on our year-end earnings call in March, we continue to see the same improvement in trends in Q1 and we anticipate that these trends broadly speaking will hold true for the remainder of the year.

Moving on to our capital allocation, I want to reiterate our priorities for capital structure and our capital allocation strategy that we had first introduced 14 months ago. We have a strong balance sheet and we have also extended our ABS agreement for an additional year. The strength in our balance sheet and flexibility allows us to invest in our business, execute our strategic priorities and return excess cash to shareholders, all while ensuring adequate liquidity. Our investment grade ratings remains important to us because long term we may return to the debt markets.

Our adjusted leverage ratio target is to be at or below 3.5 times and we had ended fiscal 2016 at 3.7 times. As our EBITDA grows in fiscal 2017, we anticipate that we will have additional leverage capacity and we are actively evaluating use of this capacity under the tenet of our capital allocation policy. We plan to distribute 70% to 80% of our annual free cash flow in the form of stock repurchases and/or dividends, assuming no other strategic use of capital. In recent years we have been able to grow both dividends and share repurchases.

Our share repurchase authorization is considerably higher now given the recently announced $750 million buyback authorization to go along with what was already left on the previous program. At the end of the quarter, we had $761 million authorized after our $125 million of Q1 share repurchases.

Now we'll move on to our financial guidance. Signet's second quarter comparable store sales are expected to increase 1% to 2% which factors in our quarter-to-date performance and also assumes that the environment remains somewhat muted. Second quarter adjusted EPS is expected to be $1.49 to $1.54. For fiscal 2017 we anticipate comps of 2% to 3.5% and adjusted EPS of $8.25 to $8.55. The comp range has been reduced 100 basis points from our March guidance. We all see the trends out there and with a softer consumer environment we believe it is appropriate that we proactively reset our comp guidance.

With that said, we continue to believe that the $8.25 to $8.55 EPS range is achievable for the following reasons. First, and just as a reminder, March was the first time we had issued full-year guidance and we were just out of the gate into our new fiscal year and appropriately so we had guided to an earnings range that gave us room to achieve earnings under various scenarios. Second, we are planning for the strong earnings flow-through to come about through both gross margin expansion and SG&A leverage. We anticipate expanding our gross margin rate through higher sales and realization of synergies, and the SG&A leverage will flow due to marketing and organizational design efficiencies as well as additional expense levers within Management's control. We proved this capability in Q1 where we were able to deliver at the high end of the EPS range despite lower sales from the guidance, and as a result we remain confident in our ability to deliver our EPS guidance.

As to other aspects of our guidance, our annual effective tax rate is anticipated to be 27% to 28%. Under the recent US Treasury and IRS proposed regulations, tax treatment of related party debt and the tax deductibility of interest expense are limited to only certain related party transactions. Signet's related party financing arrangements, which stem primarily from the Zale acquisition, are grandfathered under the proposal and there is no impact on our short to medium term forecasted effective tax rate.

Capital expenditure guidance for the full year is $315 million to $365 million, driven by a combination of new stores, store remodels, information technology and facilities expenditures. Net selling square footage is projected to grow 3% to 3.5% with most of Signet's new square footage growth is slated for real estate venues other than enclosed malls.

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We are also reaffirming the multi-year synergy guidance which we increased February 29th. In fiscal 2017 we intend to deliver $158 million to $175 million cumulatively. That means the $60 million we realized last year plus another $98 million to $115 million this fiscal year. Then by the end of fiscal 2018 we expect to deliver $225 million to $250 million of cumulative synergies.

In closing, we're pleased with our earnings performance and our relative financial results to date. with that, I'll turn the call back over to Mark.

Mark Light:

Thank you, Michele. To sum up, we had a good quarter, record EPS, operating margin expansion, excellent inventory management, solid sales and profitable market share growth. I want to sincerely thank and congratulate all the Signet team members for their hard work and accomplishments.

With that, we'll now take your questions.

Operator:

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

Your first question comes from the line of Rick Patel from Stephens. Your line is open.

Rick Patel:

Thank you and good morning everyone. Can you help us think about the decline in traffic? I know it's not a new development but is this something that's going on across the whole jewelry industry? If so, what does it say about customer shopping habits? Since bridal is doing well, I guess is there some level of fatigue out there to buy fashion jewelry, or is competition just getting a little bit tougher for certain categories? Just some help on thinking about that.

Mark Light:

Thanks Rick. The decline in retail traffic, we're seeing decline as everybody else is seeing a decline that we saw in the first quarter. We do have a third party company that tracks the traffic in the malls and it is showing that retail traffic as a whole was down for the first quarter. We have some traffic counters in our Jared stores, some in our Kay stores and we're seeing declines not as much as you're seeing with some of the third-party provider out there, but to your point bridal is our stable type of business where it is a premeditated purchase and people are coming into our stores thinking about bridal and shopping beforehand. So we don't believe we're as affected by retail traffic in jewelry as are our retail competitors but there is an effect obviously if there's less people in the malls, and moreso like you said for gift giving.

Now, gift giving is also a premeditated purchase but we're just seeing less traffic in the malls as of right now and all retail traffic is down. But we still think the consumer is vibrant out there and we're seeing in our own sales that you're seeing that we had a very respectable comp increase as it relates compared to the rest of the retail industry world.

Rick Patel:

Thank you, Mark. Just a question also on the department store space and the competition there. Macy's in particular recently talked about taking a more aggressive approach with fine jewelry and engagement.

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Have you seen an impact of this on your business and can you touch upon I guess what you see as the biggest differentiators between your business and what department stores would have competitively?

Mark Light:

Sure. We are well aware of Macy's tests. We were aware of it last year. We've shopped the stores that we believe are being tested. We shopped them both from an inventory assortment and from a sales approach and a customer service perspective, and we believe we have tremendous competitive advantage against all of our competitors including Macy's and other department stores. When you just look at our assortment, whether it be in gift giving products and fine jewelry or more importantly in the engagement and bridal category, our assortment is far beyond anybody else out there. In this category, as I stated, the customer engagement is critical. The experience that they have in the stores is critical and we believe that our team members at our stores are better trained and better equipped to educate our customers on this critical emotional purchase and educate our customers on qualities of diamonds and understanding their needs.

Our competitive advantages are we believe we have a better assortment; we believe we understand diamond fashion jewelry and diamond engagement much better and we believe we have much better trained and experienced sales people to take care of that specific jewelry customer.

Operator:

Your next question comes from the line of Oliver Chen from Cowen and Company. Your line is open.

Oliver Chen:

Thanks. Congrats on really awesome results in a really tough retail tape. So Michele, I wanted to ask you, the re-affirmance of guidance - and the details are really helpful - on the gross margin and SG&A side, what are the main drivers that are enabling for that to offset some of the reality of the comp? Also, Mark, the details on the credit portfolio are helpful. Could you brief us on your thoughts on timing in terms of how this decision may unfold? Also, are there drawbacks to outsourcing the credit portfolio, just because of your very integrated selling process, and if there's any learnings you've had with Zale and ADS. It sounds like you're still encouraged by that relationship. That would be helpful. Thank you.

Michele Santana:

Thanks, Oliver. Let me start with your question in terms of gross margin and SG&A and some of the primary drivers that we're very much focused on. First, it does start back with the synergies and really pushing the synergies through to gross margin both and SG&A. I mentioned on the call on the gross margin what we're really starting to see flow through and we continue to expect to have opportunities as we move into the year on the synergy front really relate to our discounting controls that we put in place, there's repairs, our vendor terms. We did actually move from insourcing our special events to outsourcing that. That has had a favorable impact on our gross margin. So there's a lot related to synergies that we see flowing through there. In addition, there's still a little bit of favorability we're getting on the commodity cost front flowing through the gross margin.

On the SG&A side, on the synergy front we did a lot of work and we talked about this during the fourth quarter, where we had accelerated some of the work around our organizational design efficiencies and so we're starting to see those benefits. We'll continue to see the benefits flowing through related to that in terms of payroll savings. We also really have been looking and optimizing our labor scheduling as it relates to our store payroll, so we continue to expect to see favorability flowing through that in the year, leveraging our SG&A.

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Then more importantly, as I was referencing, there's additional expense levers that Management really does have control over and although we'll want to continue to preserve our more customer-facing expenses, those expenses such as our advertising line item, etc., for those that are less directly customer-facing, whether it's our travel or supplies, our support center, those are the ones that we are really able to tighten our belt and taking a more disciplined approach to give us the confidence that we'll be able to hit our EPS guidance.

Mark Light:

Oliver, in reference to your credit question, I'm going to kind of give you a holistic answer and answer your three questions about timing and drawbacks and learnings from Zales. I want to start off with stating, and I just need to start off because we said in our announcement, that our credit metrics and our credit portfolio are strong. As we said, our credit metrics are improving sequentially and within our expectations and all we've fought for and involved in our earnings guidance both on a quarterly basis and an annual basis, so our credit metrics are strong.

To answer your questions, the reason why we're doing this credit project, to your point, is yes, we have had some good experience with ADS. We've had a full quarter now under our belt where ADS has been managing our entire credit portfolio for Zales from January through now. We're having some good experiences and we're learning more. At Signet, we're an evolving company. We're always looking for ways to better improve our business model and our business. That being said, we always feel there's ways of us getting smarter and understanding more about our business, and we've also seen other major retailers out there - and I'm sure a lot of you know them - that have carried internal receivables and have sold their receivables and have done with the receivables of recent and we just understand there's an evolution out there and we want to make sure that we're on top of it.

We're a business that is constantly looking for ways to improve ourself. Actually one of our mission statements is that we're always looking to continuously improve. So we look at every facet of our business on a regular basis to make sure that we're continuously improving how we can enhance our business for our operations and for our shareholders and credit is no different; we've done major credit analysis in the past.

As I mentioned in my remarks Oliver, possible outcomes could be outsourcing of all of our credit functions; possible outcomes could be some in-housing of our credit functions, some would be outsourced. Other things that we'll be analyzing is ways of optimizing our debt structures on our accounts receivables. Can we optimize our credit offerings? We're looking at variations of options to make sure that we're improving our ability to do sales, maximizing our profitability and enhancing our business model.

As far as timing goes, Oliver, it's a top priority for us. We will be thoughtful though and we will be diligent about the work but we're going to take time and be very thoughtful, and we are working real-time right now with Goldman Sachs on this who has a lot of experience in this world and has done a lot of this type of work with other retailers. So that's why we're comfortable sharing with you today, but we're not going to share a timeline with you because we want to do this thoughtfully and methodically, but we will keep you up to date when appropriate.

Oliver Chen:

Okay. Just a quick follow-up. That's really helpful. You've given really helpful detail and more detail over time regarding your credit portfolio. Some investors are asking a lot about accounts receivable, ageing and the FICO score distribution and the reality of using the recency accounting methodology. Could you

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brief us on how you're feeling about those topics in terms of what you're seeing in your portfolio? It's an accounting method that you've used throughout many years so I understand that it's very integrated in your processes.

Michele Santana:

Thanks Oliver. So just real quick on that, we talked quite at length on the last call that at the end of the day, regardless of recency or contractual, whatever method you're on, the financial results are going to yield the same answer. The provision will be the same, our bad debt expense will be the same, but to that point, the reason why we use our recency is, one, we have done it since the beginning of time and it really has worked well for us over the years with the type of lending that we do. Jewelry lending is that emotional connection and it does optimize our collections for us. So with the use of the recency, it does help us to engage with the borrower, start collecting quicker. It leaves the customer—it gives the customer some flexibility based on the disciplined criteria that we had outlined of our recency ageing, what a customer has to remit to stay current. It leaves that customer in good standing if they are having maybe a challenging month where they can't remit a full payment, and that psychology and that flexibility of working with that customer puts that customer first and that at the end of the day really drives maximization and optimization of our collection effort. Then as I said, importantly, the financial results will be the same.

Now, we'll continue and when you see the 10-Q that we plan to file within the next week or so, in the footnote you'll see the same type of a breakdown of our ageing—so we've continued to provide that, the 30-day, 60, etc. and the 90 days.

In terms of FICO scores, that will be an annual disclosure for us but what I can tell you is the FICO scores are broadly in the same range as what we saw in Q4 which everybody would expect that you're not going to have major shifts quarter to quarter on that.

Operator:

Your next question comes from the line of Bill Armstrong from CL King and Associates. Your line is open.

Bill Armstrong:

Good morning everyone. A question on Piercing Pagoda. That's the division that arguably would be the most vulnerable to changes in mall traffic given its locations within the hallway and the impulse nature of the purchase, yet that was actually the best performing division in terms of comps in the quarter. Just wonder if you could maybe just review for us what's going on in in Pagoda and how is it that that division performed so strongly in such a weak environment.

Mark Light:

Sure. Thank you, Bill. A great observation. First of all, it always starts off with people and we have a great leader who's running our Piercing Pagoda business named Jamie Singleton and we have very motivated team members at Piercing Pagoda. They feel great about the business and the investments we're making in the business. Specifically what's helping our cause, if you look at the release, the average price is up dramatically in Piercing Pagoda, and what the team has done in Piercing is they've invested more in 14 karat gold, more in diamonds so what they're doing—and we're training our people to be able to be able to be comfortable selling 14 karat gold and diamonds and they're motivated and excited about the business, so getting benefit in Piercing Pagoda, and even though there's less traffic in the mall, we're getting a benefit similar to what's happening in our mall stores, is that we're increasing our

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average sale dramatically and a lot of that again is due to increased assortment in 14 karat gold and diamond jewelry and increased training on how to sell that product.

Bill Armstrong:

Okay, great. Thanks. You gave some industry data in your slide presentation; the industry lost a net 700 jewelers. Is that individual stores? Are you seeing kind of regional chains going down or are these more kind of individual mom and pop type of stores, do you think, that are exiting the market?

Mark Light:

Yeah. Bill, year-on-year there is an increase in the decline jewelry store doors closing from 2014 to 2015; I believe it was about 100 basis points but it was a big decline and the vast majority of them are independent stores that were closing doors, and there's a lot of reason for that, whether it be lack of profitability, lack of a successor to turn the store over to, but the facts are the facts that the jewelry store doors are closing at a faster rate in 2015 than they did in 2014.

Michele Santana:

Let me just add to it. I mean that is one of the advantages whenever you're going through a somewhat softer environment. Given that we are so fragmented, with a lot of these independent small mom and pops that does generally put pressure on those doors, and you start to see an uptick in those door closures. So we're probably one of the few retailers that actually benefit with gaining profitable market share gains in these type of environments.

Mark Light:

Just to pile on to Michele's point, Bill, it's a good reason why, as we stated, we're expanding our stores moreso outside the malls because the vast majority of jewelry sold in this industry in this country for certain is done outside the malls, and so we see opportunity to continue to grow Kay from those doors that were closing primarily outside the mall, and as we said, after the end of 2017, an opportunity to start opening Zales stores outside the malls.

Operator:

Your next question comes from the line of Simeon Siegel from Nomura Securities. Your line is open.

Simeon Siegel:

Thanks, you guys. Good morning and nice consistency.

Mark Light:

Thank you.

Michele Santana:

Thank you.

Simeon Siegel:

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Just recognizing the synergies this year are going to be primarily expense savings related, can you talk to the ongoing opportunity to narrow the sales productivity gap? Maybe what should that do for the comps trajectory there? Then in light of what looks like an ongoing shift to higher ticket items, you specifically called out a shift from Charmed Memories. Can you just talk about that Jared/Pandora rollout? Maybe any thoughts or expectations there?

Mark Light:

Yeah. Simeon, the Zale productivity, there's a lot of initiatives out there and we still put very strong and have built good increases for Zales going forward. We continue to see benefits from our cross-selling of brands. We continue to see tremendous benefits and we think this is going to be a huge benefit to Zales is having our repair business being internal, not being done by third party contractors which will help the top line not only in the repair business but ultimately you take care of our repair customer, you have a new customer for life and you take care of that customer. So we have a lot of areas of the business that are going to increase the top line, but we're focused right now on making sure that we get the model in place and we get the appropriate level of SG&A in line for that business model, so we do see good opportunities to continue to grow Zales going forward. If you look at the comps for the Zales business itself, in this past first quarter it was up over 3.5% which is better than most of retail's. So we're still feeling very good about the opportunities for Zales on the sales line.

As far as the average sales in Pandora, we did see some beads slowing down but not in our Pandora business. We have a big bead business; Pandora is just in our Jared stores and we're very happy and excited about our Pandora partnership. As we've said, we have these new store-in-stores. It will take us a year to roll them out but we will have all the new stores, Pandora store-in-stores in our Jared stores by the first of November. Right now we just completed about 50 doors and initial—it's early but initial sales results look very good to us. So we see great opportunities with Pandora and increasing our partnership with Pandora. A big benefit of Pandora partnership that we have, Simeon, is not just selling more beads, but Pandora is doing a great job of designing new jewelry products at lower price points that we really haven't done a great job with in the past and have not had a good inventory assortment of the Pandora jewelry product and we're very excited about that opportunity for new business in our Jared stores this fourth quarter.

Operator:

Your next question comes from the line of Jeff Stein from Northcoast Research. Your line is open.

Jeff Stein:

Hey, good morning guys. Michele, question for you with regard to ADS. I'm curious what kind of approval rates you've seen on the ADS credit metrics relative to your in-house credit? Then I've got a couple of follow-ups.

Michele Santana:

Yeah, so really excited with partnering with ADS and this is really the first full quarter that we've had them in play. Overall, what we've seen with our Zale credit penetration rate for Q1 is it's about 48%. Now, that's inclusive with primary—with ADS as well as our in-house second look that we're doing. But that 48% penetration rate compares to about 41% last year and that increase in rate is really driven by the primary lending that ADS is doing. So what we're seeing and what we expected to see as part of the benefits with ADS is it's driven by both a higher application and higher credit lines with ADS. First, when you think about the change over to ADS there was the relaunch of the credit cards to customers. So one, you generally get that that drives customers into the stores. In addition, we did some field training related

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to the ADS roll-out. I'd also say that when we think about the credit value proposition related to ADS, it really is more appealing than traditionally what we've had as it allows for lower minimum purchases that are required. Then also, the application process, it is much more quicker and easier for that applicant. Previously it was a paper application where now we utilize technology and the driver's license punch-in data and then they're off to the races with ADS.

Then I would also add to that when we think about the benefit of ADS and their relationship is the reduced or the lower expenses associated with that which is flowing through our P&L.

Jeff Stein:

Perfect. A question on the bump that you may have received from expanded service plans in the first quarter, both from a comps store standpoint and an earnings per share standpoint, since I don't think would anniversary that change until Q2.

Michele Santana:

You're correct Jeff. We'll anniversary that in Q2, so we did see the impact in Q1. On a consolidated basis it was about 70 bps to comps and about $0.07 or so to EPS.

Operator:

Your next question comes from the line of Ike Boruchow from Wells Fargo. Your line is open.

Ike Boruchow:

Hey everyone, good morning. Thanks for taking my question. I guess maybe for Michele, I'm just curious do you have data on your credit customer about what percent of credit customers would be fine buying something without that option but maybe just likes the 12-month interest-free or something like that versus the ones that would actually need the in-house financing arm to buy his or her item? Then just a follow-up to that, I guess to Mark. When you guys guided, I think Valentine's day was already over. I assume that's a big part of the quarter. So I'm just kind of curious, can you comment on April? I mean it was tough for most of retail. It seems like it was probably tough for you guys. I'm just kind of curious about how the quarter may be played out?

Michele Santana:

Good morning, Ike. In terms of your question with the data that we have with our customers, and I think the question was would they use another form if we didn't have our credit. We have a lot of information on our customers and we look at the data in a lot of ways. That's one that becomes a little bit difficult to track, if we didn't have it would the customer still make that purchase. It really is challenging to be able to kind of quantify that but it is information that we're always looking at very closely to understand to benefit and the competitive advantage of the credit offering.

Mark Light:

Ike, how are you? In reference to your question about our guidance and Valentine's Day, to your point Ike, you're right. We guided so we had to beat a 3% to 4% and we put that guidance out there on March 26th so we Valentine's under our belt. That being said, we had April ahead of us which leads up to obviously some critical shopping for Mother's Day and there was a slowdown in April. If you just look at what we've accomplished compared to what our guidance was, at the time we gave the guidance there was no doubt

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there was a slowdown in April that we experienced like all of retail. We've all been exposed to all the retail number out there for the first quarter. So our numbers slowed down but were better than most.

That being said, going into May, we're seeing a similar level to May; not better, not worse. We're seeing a little similar level, so the guidance that we're giving you for Q2 is assuming that things don't get better and things don't get worse from an economic environment basis.

Even though you didn't ask, I want to say to you that we still feel very strongly about our earnings guidance for the year and we believe that we have great opportunities in the second half. As I stated, we have a lot of initiatives, Ike. We have more initiatives this year than we even had last year. As I mentioned with the extension of Ever Us; as I mentioned with the Chosen Diamond for Jared that tested wonderfully. We're very excited about the Pandora store-in-stores. We're very excited about the Vera Wang extension going into diamond jewelry and pearl jewelry, and we're very, very excited about this new technology that we're enabling our people in our stores to really be more sophisticated and more knowledgeable about their customers' past experience and what they bought and what they can go buy in the future, to help them communicate better with our customers.

So, yes, we saw a slowdown in April but we're still outperforming most of retail and we still feel very bullish, assuming the economy stays stable, that we're going to have a very good second half and fourth quarter.

Operator:

Your next question comes from the line of Dorothy Lakner from Topeka Capital Markets. Your line is open.

Dorothy Lakner:

Thanks. Good morning everyone. Just wanted to follow-up on some of those things Mark that you were just talking about. I wonder if you could provide a little bit more color on this new technology, Clienteling kind of technology and when the training is going to occur, so when we should start to see some benefits. Obviously for holiday but just wondered on the timing. Then, also just the timing of the Vera Wang fashion introductions, the diamonds and pearls. Then just on Ever Us, obviously a big success story for you all. Wondering if you're seeing any changes in the customer base for that. I know you'd seen a broader customer acceptance for that product than you'd expected, sort of different types of clients than you expected. I wondered if that's changed any as we go into the rest of this year.

Mark Light:

Thank you, Dorothy. For a little bit more color on the technology I was referring to before, so we have some great partnerships that we're working with, some software technology companies like salesforce and Rosetta that's working with us on this product that we're calling Clienteling. Briefly, just to give you an idea and this thought is that a good jewelry sales consultant has a book and they'll have it and they'll keep it manually now, to understand all their customers, what they bought in the past, what are their key special occasions and their lifetime moments, whether it be birthdays or their loved ones or anniversaries or just graduation gifts and that type of things, and all that has been done manually in the past. We're going to be able now and to have and give our associates real-time information through their iPads so that they could understand what their customers have bought in the past, what birthdays are coming up, help communicate with them more intelligently. We'll also have the ability to turn this technology for CRM. So we think there's just vast opportunities of what we can get incremental benefits and sales from that new technology.

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To your point, we are training up our people in our Jared and our Kay stores and we'll start in August. We'll have a big training conference at our leadership conference in October, and for Jared and for Kay they'll be fully ready for this aspect of this new technology for the fourth quarter and we think there's a good opportunity to increase our sales and get incremental sales with just communicating more effectively with our customers.

As far as Vera Wang and the extension of jewelry, we just think it's a great opportunity. Vera, as I said, is a tremendous designer and she's got such credibility in the bridal area, and she has a great eye so she's been designing some beautiful jewelry, pearl jewelry, pearls and diamond jewelry for our business and so far it's testing well. We don't want to say for certain because we're still in the testing zone, but if the tests continue to be successful, we may see some major extensions of Vera Wang jewelry potentially in our Zales stores for the fourth quarter. But we'll keep you up to speed on that.

As far as Ever Us goes, as you said Dorothy, it is a tremendous success story for us and having an item and a trend that we have created. We just—this has just continued to grow for us and the tests that we're starting to see in necklaces, we see opportunities potentially in other parts of jewelry, different ring styles, are really going well and we don't see a slowdown. As I said in my prepared remarks, from our experience these type of trend changing or beacon type strategies from our experience actually gain momentum because as well as it did for us last year and into this year, it's still a small, small portion of customers out there that just really have an understanding of what Ever Us is all about. So we believe there's still tremendous upside for the Ever Us collection going into the fourth quarter and into the future.

Operator:

Your next question comes from the line of Janet Kloppenburg from JJK Research. Your line is open.

Janet Kloppenburg:

Hi everybody. Congrats on a good quarter. Nice showing.

Michele Santana:

Thanks Janet.

Janet Kloppenburg:

Mark, I was just wondering if you could talk a little bit about your outlook for the fashion jewelry component. It feels like there's a lot of newness that you've created on the bridal side, both Ever Us and Vera, and I'm just wondering if you're finding it more competitive on the fashion side? If you could also help me to understand what's going on in the Jared business a little bit more. I know you're transitioning. Maybe the promotional strategy there and the pricing strategy, but if you could elaborate a little bit, that would help a lot. Thank you.

Mark Light:

Sure. Thank you, Janet. The fashion outlook, the fashion business is a business that we have to stay on top of and it's not—you've got to continually investigate and innovate with new opportunities and new styles like we did with Ever Us, and we have a lot of exciting things in the pipeline. I touched on several of them. One, Pandora, is all about fashion. Pandora jewelry is all about fashion. When you think about Vera Wang designs and what we're going to do is all about fashion. So, we have a lot in the works and then we're testing the pipeline. We're just showing some for competitive reasons, that we're always looking to be innovative and look for new ways of continuing to test new things in fashion.

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You know, Dorothy, you've given me an opportunity to say something broader. For us to continually gain market share in the jewelry industry over the last 5, 10 and 20 years and for us to continue going forward, we as a company have got to constantly be innovative. We've got to consistently have new ideas in our pipeline, not only as it relates to fashion, which is critical, but all facets of our business. So we are continually—that's why we opened a design center and it's why our design center is continually looking for new ways and looking at fashion trends to continually test and look for new ways of innovative ways to sell fashion and gift giving products to our customers. So we believe we have a good, healthy pipeline in fashion.

As far as the Jared business goes, Janet, we have said that we believe, firmly we believe that even though Jared's comps were down the first quarter, their total sales were up and we believe we're gaining profitable market share in the jewelry industry. We believe that firmly because Jared is growing in a healthy, profitable way. That being said, we have made some enhancements and refinements to the Jared model. We've talked about how we've changed some of the selling tactics that we use. We talked about how we are changing some of the assortment that we're having. We're getting more involved in some fashion areas. We're getting more involved with some lower price point fashion products. We're getting more involved with designers like Vera Wang. We've also talked about how we're continually looking for ways to enhance our selling coverage and how we sell to the Jared customer, and that Jared customer we've learned in our segmentation analysis is they are looking for a little bit more promotions. They are looking for some sales every once in a while so we're testing that also. And Janet, we're also testing radio advertising in certain markets because continuity over radio is a strong thing and we're selling products in Jared and engagement rings in Jared 12 months a year, not just in the 12 weeks that we advertise on TV

So we are actually very bullish on our Jared business. We believe that we've got a lot of good things going on at Jared's and they're in a transition stage where we're changing the inventory up a little bit, we're continuing to change the selling tactics that we have, and we're still working on testing some new bounce-back programs and coupons and promotions. So again, we feel very bullish about how Jared is going to perform in the fourth quarter as long as the economy is consistent and operating consistently.

Operator:

Your next question comes from the line of Lindsay Drucker Mann from Goldman Sachs. Your line is open.

Lindsay Drucker Mann:

Thanks. Good morning everyone.

Michele Santana:

Good morning.

Mark Light:

Good morning.

Lindsay Drucker Mann:

I wanted to clarify, Mark, on just quickly a comment you made before about the end to first quarter and the beginning of second quarter. The start to the second quarter, are you saying that the momentum you've seen to start the quarter is consistent with your Q2 guidance, or are you embedding some degree of

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acceleration the way that it feels like you're embedding some degree of acceleration in the back half of the year? That's my first clarification.

Secondly, as you think about the strategic review of the credit book, you talked about basically every kind of scenario that could be determined from this outcome. I was curious, Mark, as you think about what the priorities are for the outcome, is it shareholder returns? Is it unlocking value? And as you think about—now I know that this is your initial strategic review with an outside party but you've been conducting some review internally and you do have this partnership with ADS now, a good quarter under your belt. Is there a scenario you believe where you could have a third party run the credit portfolio and not have to change your current lending practices, or are the two very different? Thanks very much.

Mark Light:

Okay. First, to answer your first question, Lindsay, what I was saying was that April declined—after we announced that it declined and that is was declining as the rest of retail was, and May was at similar levels of that to April. So that was built into our second quarter guidance of being up 1% to 2%. So what we're saying is that our April decline, it's not decelerating, it's not accelerating; it's similar to what's happened in April is what is happening in May. That's what that is. Is that clear for you, Lindsay?

Lindsay Drucker Mann:

So you are looking—in order to get to an up 1% to 2% business would have to accelerate from here.

Mark Light:

Which we believe that—we feel comfortable on our guidance of 1% to 2% that we can deliver that sales guidance for the second quarter.

Michele Santana:

I think with what we've seen, as Mark said, with May being very similar to what we had observed in April and we've incorporated that into the guidance, that it's a very balanced view in terms of balancing both the upside/downside risk to achieve a 1% to 2% comp. We feel good with that comp guidance.

Mark Light:

Your question about our priority as it relates to the credit review—and Lindsay, you're not going to like this answer—but shareholder value and operating profit are both hand-in-hand. So it's about both and when we look at this we're going to look at it holistically. What options do we have? What alternatives do we have that can help potentially enhance the profitability and/or the shareholder value? We believe they go hand-in-hand.

Are there opportunities for third parties? Can there be? That's what the analysis is all about. We're looking to see what are the opportunities out there and we have to take a deeper dive and we need time to make those determinations. But be confident in understanding what we're going to do is make the right decision for our business model, to make the right decision that's right for our shareholders and what's right for the company as a whole and our customers, and we have to take all those elements into our decision-making process. We'll keep you up to speed, Lindsay. We just wanted to announce it to everybody because we did hire Goldman Sachs who has a lot of experience and to do this thorough analysis we will be talking to different types of constituents to get this analysis done and we wanted to make you and everybody else aware that we're doing that now but we will keep you up to speed once we have more information to talk more intelligently with more data.

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Operator:

Thank you. Ladies and gentlemen, we are out of time for our formal Q&A session. I would now like to turn the call back over to Mr. Light.

Mark Light:

Thank you. I'm trying to find my date here. Thank you for taking part in this call. I want to let you all know that our next scheduled call is on August 25th when we will review our second quarter earnings. Thanks again to all of you and good-bye.

Operator:

Thank you. Ladies and gentlemen, that concludes today's conference call. You may now disconnect.

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