


# Signet Jewelers Limited

## Fiscal 2018 Second Quarter Earnings Conference Call

## August 24, 2017

## CORPORATE PARTICIPANTS

**James Grant,** *Vice President, Investor Relations*

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**Michele Santana,** *Chief Financial Officer*

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**Simeon Siegel,** *Nomura Instinet*

**Oliver Chen,** *Cowen & Company*

**Ike Boruchow,** *Wells Fargo*

**Paul Lejuez,** *Citi*

**Brian Tunick,** *Royal Bank of Canada*

**Scott Krasik,** *Buckingham Research*

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## PRESENTATION

**Operator:**

Ladies and gentlemen, thank you for standing by. Welcome to Signet Jewelers Limited Q2 Fiscal Earnings Conference Call. During the call, all participants will be in a listen-only mode. After the presentation we will conduct a question and answer session. Instructions will be provided at that time. If at any time during the conference you need to reach an operator, please press the star followed by zero. Please note that this call is being recorded today, August 24, 2017 at 8:30 AM Eastern time.

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

**James Grant:**

Good morning and welcome to our Second Quarter Earnings Conference Call. On our call today are Signet CEO Gina Drosos, and CFO Michele Santana. The presentation deck we will be referencing is available under the Investors section of our website signetjewelers.com.



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During today's presentation we will in places 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 Gina.

**Virginia Drosos:**

Thank you, James. Good morning and thank you for joining today's call. It's great to be here today on my first earnings call as CEO of Signet and announcing encouraging second quarter earnings and a transformative acquisition.

Before I get into details about today's announcements, I want to first acknowledge the tremendous career and contributions of my predecessor Mark Light, who retired last month. I've been in touch with Mark and spoke to him this week. His health is progressing well and he's very appreciative of all the support and your well wishes.

Now I'd like to share some background, my initial observations, my immediate priorities and why I am excited about Signet's future. As many of you know, I had the privilege to serve as an independent director on Signet's board for five years, including as a member of the Customer Experience subcommittee and the Respect in the Workplace Committee. I know firsthand that Signet is a great company with a strong foundation and many opportunities to accelerate its strategy and enhance its competitive advantage in a rapidly changing retail environment. As a director I have worked closely with Signet's leadership team. I've helped shape the recently refreshed Vision 2020 strategy which I'm pleased to see is beginning to deliver results. As you might also know, my career successes to this point are built on consumer inspired strategies and innovation, changing category paradigms and developing an agile, entrepreneurial and efficient approach to business operations. Often, less is more and focus has been an important driver of my success with P&G and Assurex Health.

Over the last month, since my appointment, I have been studying various aspects of our business to start identifying Signet's highest return focus areas. I have also been getting to know, listening to and learning from our talented and hardworking team members, both in the field and in our corporate centers. Our team has incredible passion, dedication and expertise for guiding our mission. We deliver outstanding value to the thousands of customers that choose us to help them celebrate the most memorable moments in their lives. It is a humbling role and one that we never lose sight of.

Doing this well and improving every day is how Signet became the world's largest diamond jewelry retailer. For a consumer-facing company like ours, this is a key factor in how we will grow our business going forward. It is also clear that we still have work to do to better understand how our consumers want to shop and interact with us, how their jewelry desires are changing and how we can wow and delight them by meeting their demands more quickly and whenever and wherever they desire.

The retail jewelry shopping experience hasn't transformed in decades and we can leverage our interactions and data analytics to leapfrog our consumer insights and with that deliver breakthrough innovation in products, assortment, experience, engagement and education.

Next I'd like to highlight our focus on omnichannel strategy. Our encouraging second quarter performance is a good indication that our OmniChannel strategy is starting to deliver and that we should intensify and accelerate our efforts to innovate and transform. Already, more than two-thirds of our



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consumers start their jewelry shopping journey online and bring photos with them to our stores. We can build on their desire to browse and learn by creating more interest, engagement and points of connection through a seamlessly integrated OmniChannel experience. For example, new visualization technologies in store can exponentially multiply access to over 100,000 diamonds in every store via connection to our Virtual Vault and try on technology. Customers can pick up online merchandise in stores to engage our team of jewelry experts or have products delivered to their home to try on and evaluate. We see the acquisition of R2Net and the implementation of its digital capabilities as an important step toward achieving this goal.

This brings me to building a culture of agility and efficiency. I spent 25 years growing, acquiring and scaling brands in the most agile division of a very large company, and then spent four years leading a dynamic and very fast growing technology-enabled company. I know firsthand what having an entrepreneur's mindset and efficiency mentality with focus on fewer more important priorities and leadership at every level can do to transform a company and culture. Signet has work to do in this area and we will reward our change agents and entrepreneurs throughout our company. By doing this, we can better unlock our outstanding talent to innovate in all areas of our business. We will test more fresh, new ideas faster, products, trends and shopping experiences. Signet has taken decisive steps to manage operating costs and deliver efficiencies across the supply chain, but we still have significant opportunities to become a more productive organization. We are committed to driving profitable market share growth, but we also need to be pragmatic in the environment in which we operate, one that is currently defined by heavy promotional spending.

Against this backdrop, it is critical that we deliver on the top line while managing our operating expenses tightly to defend our margin. We will examine all aspects of our business to drive productivity gains and cost savings across the organization and we will share more details on our plans in the upcoming months.

In order to quickly adapt to the changing marketplace, we will keep building our culture of inclusion and embracing a rich diversity of ideas and experiences to further drive success and innovation while bringing in fresh, new ideas from both inside and outside the industry. We will be an employer of choice and a leader in training, engagement, development and diversity.

With that, I will now tell you more about our transformational decision to acquire R2Net and how it will help us accelerate our Customer-First OmniChannel strategy.

Moving to Slide 4, we are thrilled to add jamesallen.com, a fast growing online jewelry retailer to our rich brand portfolio. James Allen has grown sales more than 2.5-fold in the last two years and has a very attractive average transaction value and know-how how to sell diamonds online. Projected Fiscal 2018 revenue is greater than $200 million. James Allen also has very strong millennial appeal which is a key growth demographic for us. In addition, R2Net owns Segoma Imaging Technologies; together they offer a robust suite of innovative technologies to deliver a next-generation digital shopping experience for jewelry.

This transaction will accelerate the execution of our OmniChannel strategy by quickly ramping up our digital innovation capabilities to more seamlessly integrate our digital and physical retail platforms. Signet has been partnering with R2Net for the past decade on our Jared business, since 2007, including our Jared Design-A-Ring web platform. Our companies work well together and we believe this existing relationship will help ensure a smooth implementation process.

As part of the acquisition we are also bringing a very talented group of employees onboard our winning team. In addition to his role as president of James Allen Jewelers, R2Net co-founder and CEO Oded Edelman will become chief digital innovation advisor of Signet where he will report directly to me and assume the responsibility for driving the digital innovation strategy across all Signet brands, and as a sign



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of commitment to the long-term vision of Signet and R2Net, Oded and the other R2Net founders will invest a significant portion of their transaction proceeds in Signet shares. This acquisition marks and important step for Signet as we build scalable digital capabilities for our OmniChannel transformation.

Now, moving to key takeaways of the second quarter on Slide 5, we delivered same store sales growth of 1.4%, earnings per share of $1.33 and operating profit margin expansion of 100 basis points. Fashion and branded Bridal jewelry led the category growth helped by a stronger response to Bridal promotions while Kay Jewelers, Peoples and Piercing Pagoda led banner growth. Our encouraging results were underpinned by e-commerce platform improvements and a strong Mother's Day which led to key learnings around effective marketing through simpler and more targeted messaging.

While the industry remained highly promotional, we tightly managed our cost base which helped Signet deliver top line growth, EPS growth and operating margin expansion during the quarter.

Moving to Slide 6, while I'm only a few weeks in, I'd also like to briefly update you on a number of critical initiatives that the Management team has been leading and that I've dived into quickly, starting with OmniChannel. We've been working hard since the beginning of the year to stabilize the issues we had on our e-commerce sites and to improve the overall customer experience. During the quarter we made a number of enhancements, including improvements to user experience, traffic driving search engine optimization and digital marketing capabilities and enabling greater integration of digital technology in stores. This is reflected in our e-commerce sales increase of 18.1%. Just about 10 days ago, we delivered a major upgrade to all of the Zales division websites. The new Hybrus (phon) technology has immediate search and user experience benefits, and also enables easier future improvements. This launch was executed successfully and conversion rates are already trending in a strong positive direction. We will continue to focus on enhancing our OmniChannel platforms and look forward to implementing R2Net to give us a leading e-commerce brand and accelerate our digital innovation capabilities.

Moving to the strategic decision to outsource our credit portfolio. During the second quarter we announced the sale of the prime portion of our credit portfolio and outsourced servicing of our secondary book to de-risk our balance sheet and streamline our focus on our core business. I am highly committed to this decision and to ensuring excellent execution and maximizing value for our shareholders.

Since the announcement, we've made significant progress on the transition and are on-track to complete this first phase in October, well before Holiday.

We also launched our lease purchase program in partnership with Progressive Leasing ahead of schedule, and we have been training our store teams to leverage this important tool. Our intention continues to be full outsourcing of all of our credit programs. We are actively engaged with a number of interested parties on Phase 2 and are examining a range of alternatives. Michele will provide more details on credit in just a minute.

Finally, I'm encouraged by the team's plans for the Holiday season. We will continue to shift our marketing dollars toward digital, resulting in more targeted efforts with higher ROI and consumer engagement, and building on Mother's Day learnings we will have simpler promotional messages with greater integration across marketing channels. We will be launching new products, important line extensions, and particularly in the fashion and gifting categories.

In summary, we believe we are well positioned for the upcoming holiday season which, together with the momentum we gained in Q2 gives us confidence in our ability to deliver our financial targets.

With that, I'll turn it over to Michele to discuss our second quarter results and Fiscal 2018 guidance in detail.



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**Michele Santana:**

Thank you, Gina. Turning to Slide 7, for the second quarter Signet's total sales were $1.4 billion, 1.9% year-over-year or 2.8% on a constant currency basis. Comp sales increased 1.4% compared to a decline of 2.3% in the prior year's second quarter and compares to a two-year comp hurdle rate of 1.9%. Of our comp sales increase, about 380 basis points of favorability was attributed to the performance and later timing of Mother's Day which shifted to the second quarter. Key events that contributed to this encouraging comp performance were solid Mother's Day results and a successful July Bridal event. Overall, total comp sales increases were driven primarily by higher average transaction value across all store banners. We also experienced increases in the number of transactions in Kay, Zales and Peoples, while the U.K. saw a double-digit percentage decrease in transactions.

By category, fashion jewelry led the sales performance, closely followed by Bridal, while watches declined with the exception of our prestige watches in the U.K. that had strong sales performance.

From a channel perspective, e-commerce led the growth with an 18.1% increase over prior year while both mall and off-mall stores delivered sales growth.

Through the first half of the year we have learned that agility in our approach to balancing sales and profit is particularly significant in today's consumer environment. Signet is committed to strengthening its consumer relevance and market share, and will continue to balance incremental promotions to drive top line with expense reductions to offset margin rate decline.

Our wins in the second quarter relating to our promotional messaging that consumers responded very strong to, combined with wins related to our ongoing e-commerce initiatives support our full year guidance outlook.

Now I'll move to the income statement. On Slide 8, our gross margin was $457.9 million or 32.7% of sales. This represented a 120 basis point decline over the last year period and principally due to a strategic increase in promotional activity resulting in a lower merchandise margin rate. However, gross margin dollars increased slightly due to the higher sales volume. In addition, leverage on store occupancy costs of 30 basis points was offset by lower recovery rates associated with Signet's jewelry trade-in program.

SG&A expense was $409 million or 29.2% of sales. Total SG&A declined by $6.7 million or 1.6% over prior year and leveraged 110 basis points. Included in SG&A were costs related to the CEO's separation and R2Net acquisition of $4.7 million which unfavorably impacted the leverage ratio or SG&A rate by 30 basis points.

During the quarter we remained very disciplined and focused on cost reductions to offset the promotional impact on our gross margin rate noted above. Cost reductions were primarily realized in payroll and payroll related benefits in both stores and Corporate as well as other select Corporate expenses.

In the second quarter, Signet recognized a $14.8 million net gain related to the pending sale of our prime portion of receivables to ADS which is expected to close in October. The $14.8 million includes a non-cash gain of $20.7 million related to the reversal of the allowance associated with these receivables partially offset by $5.9 million of credit transaction costs related to legal, advisory and other expenses. I'll further discuss the impact of the credit transaction on Signet's financial in a few moments.

Other operating income was $71.9 million. The $1.2 million increase was due to the Sterling division's higher interest income earned from higher outstanding receivable balances; however, the rate of increase



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was tempered by a greater mix of reduced rate plans. All of this led to operating margin expansion of 100 basis points, 70 basis points of which was attributable to the net credit transaction impact just described as well as CEO separation and acquisition costs.

Diluted earnings per share was $1.33 compared to $1.06 in the same quarter last year. As a result of the imminent credit transaction proceeds, we purchased 8.1 million shares or nearly 12% of Signet shares in the second quarter at an average price of $56.91. This accelerated buyback was motivated by the share price and the ability to fund the buyback using our revolving credit facility combined with our confidence in the transaction closing in October. This acceleration of share repurchases drove $0.07 of earnings per share in the quarter. In addition, $0.08 of earnings per share in the quarter were driving by a combination of a net non-cash gain associated with the credit transaction and related costs partially offset by costs related to the CEO separation and R2Net acquisition. The Mother's Day shift into Q2 also favorably benefited EPS by $0.15.

At the end of the quarter there was $650.6 million remaining under Signet's share repurchase authorization following an incremental authorization of $600 million during the second quarter.

Turning to working capital and free cash flow, a few comments. Net inventory ended the period at $2.3 billion, down 5.6% year-over-year. This was primarily driven by our continued focus on working capital across the business. In particular, we continue to manage Zales stores with less inventory per store to improve prominence and presentation of key collections. Generally, we are delivering less breadth and more depth in key categories which is driving overall inventory productivity.

Effective working capital management led to a solid free cash flow generation through the first half of the year. Free cash flow for the year to date period was $304 million, up $96 million compared to the same period last year. Changes to accounts receivable also favorably affected free cash flow.

Before we turn to our receivable metrics, a couple of other quick highlights. We ended the quarter with $303 million of borrowings outstanding on a revolving credit facility. As previously discussed, we funded the acceleration of share repurchases through our revolver. The weighted average cost of borrowing on the revolver was 2.4% through the first half of the year.

With that, we'll move to our credit portfolio on Slide 10. I'll walk through our second quarter metrics and then spend some time discussing the impact of Phase 1 credit outsourcing for Q2 and beyond. As you know, we are still managing our full credit portfolio until the closing of the transaction which are expected in October, at which time our prime receivables will be sold to ADS. Therefore, in the first table on the slide you will see the key metrics for the full portfolio including prime and non-prime receivables. In the second table, we have provided you with our credit portfolio split between prime receivables held for sale and the residual or non-prime receivables.

Starting with the first table, our second quarter in-house credit sales in the Sterling division were $536 million, an increase of 1.3% over the prior year. In-house credit participation was 61.7%, down 140 basis points due to lower application volume of approximately 11%. The average monthly payment collection rate for the second quarter was 10.3% compared to 10.8% last year. This decline was principally due to increased usage of extended payment credit plans resulting in lower required scheduled payments when expressed as a rate. The collection rate decline combined with slightly higher credit sales resulted in an increase in our gross accounts receivable of $47 million or 2.7% over the prior year. Interest income from finance charges, which makes up virtually all the other operating income on our income statement was flat at $70 million to last year. Net bad debt expense was approximately $58 million or $3 million higher than last year, and when taken together with finance income generated an operating profit of $12 million. This net combination was down $3 million to last year.



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So this net reduction, when compared to prior year, is primarily related to lower finance charges associated with the aforementioned increase and reduced rate extended term payment plans which are targeted to higher FICO profile customers as compared to our average plan. At the end of the second quarter, reduced rate extended payment term plans represented about 22% of the portfolio compared to 9% in the prior year.

Moving to the bottom portion of the slide, at the end of the second quarter, $1.056 billion of receivables representing the portion of the in-house financed portfolio that will be sold to ADS were reclassified as held for sale. Related to this classification, the allowance for bad debt associated with this portfolio was reversed in the second quarter, resulting in a non-cash gain of $21 million. The residual gross receivables totaled approximately $736 million at the end of the second quarter. The related allowance in Q2 for this residual part of the portfolio was $114 million or 15% of gross receivables.

For comparative purposes, had the portfolio been bifurcated in the same manner in the prior year, the residual receivables would have totaled $744 million with an allowance of $110 million or 15% of gross receivables in the second quarter last year.

Turning our attention to Slide 11, I'd like to outline the key financial impacts and considerations beyond Q2 from the Phase 1 of our outsourcing. As a reminder, Phase 1 includes the sale of our prime portion of accounts receivable to ADS at par value and the conversion to Genesis Financial as our servicing provider for the remainder of the receivables.

Starting with one-time costs and gains associated with the transaction in the left-hand box, as I mentioned earlier we recognized a pre-tax non-cash gain of $21 million during the second quarter due to the reclassification of our prime receivables as assets held for sale. We also incurred $5.9 million in transaction costs during the quarter. For the full year, we expect total transactions costs to be approximately $35 million.

Moving to Q3 upon the close of the transaction: One, we expect to receive estimated proceeds of $1 billion of which $600 million will be used to repay our ABS facility. As we said during the initial announcement of our credit outsourcing, we earmarked the remainder of the proceeds or $400 million for share repurchases. Based on the compelling share price and availability on our revolver, we accelerated this intent and repurchased the $400 million of shares in the second quarter. As such, the residual $400 million of transaction proceeds will be utilized to repay the short-term loan associated with the financing of the R2Net acquisition with further residual proceeds used to repay the revolver borrowings.

In addition, in the Q3 period we will also recognize what is called a beneficial interest gain, initially a non-cash P&L gain, that we estimate will be $10 million pre-tax. The beneficial interest effectively represents a receivable for the present value of expected future profit sharing payments related to the receivables sold to ADS. This asset will then be reduced in the future via payments received from ADS.

Post closing of the transaction that we expect to occur in October, other ongoing considerations that will impact our operating profit will include the following, of which I'll also provide the financial impact to Q4.

We expect approximately a $22 million decline in our EBIT in the fourth quarter. This decline will be driven by the combination of the following: The elimination of a net contribution associated with the prime portfolio which is finance charge plus our late fees less our bad debt expense. The net combination of these is expected to unfavorably impact EBIT by $28 million. This will be partially offset by recurring SG&A savings associated with the elimination of our in-house credit operations net of servicing costs associated with Genesis Financial plus the ADS net economic profit sharing. The net SG&A savings is estimated to be favorable to EBIT by $6 million.



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The estimated $0.50 accretion in EPS related to the $400 million of share repurchases executed in the second quarter will more than offset the decline in earnings associated with the impact that I just outlined. In addition, interest expense savings of $4 million related to the ADS facility will favorably benefit net income.

Finally, as I mentioned on the previous slide, post the sale, our allowance metrics will move unfavorably given the sale of our highest quality receivables. Our allowance will become smaller in dollars but our allowance as a percentage of a smaller receivable base will look less favorable when compared to the rates associated with our historical total receivables. I wanted to be sure to explain this dynamic in advance.

Finally, as mentioned in the transaction, it is expected to close in late October, ahead of the Holiday season, and is also expected to have no material impact on our net sales. Signet will continue to fund the sales associated with the non-prime receivables until Phase 2 is complete.

We have updated our financial annual guidance to include all aspects of these impacts, which brings me to my final slide. We are reiterating our Fiscal 2018 same store sales guidance and earnings per share as well as updating components to our annual EPS guidance to reflect the impact of the strategic outsourcing of credit, CEO separation costs and the anticipated transaction costs associated with the R2Net acquisition announced today.

Lessons learned in Q2 have caused us to pivot from our previously communicated views in how we achieve our bottom line. As Gina and I have both suggested earlier in the call, we recognize the need to be agile in the current environment with promotional messaging while still being accountable to drive earnings. As a result, we expect to be incrementally more promotional in the back half of the year which will likely result in a slight deleverage of our gross margin rate. Now, with that said, we have identified incremental cost reductions in SG&A that will enable us to leverage SG&A to offset the gross margin rate impact.

So, back to the slide, starting with our guidance of $7.00 to $7.40 and walking down, you will see the net impact estimated from outsourcing of credit is dilutive to EPS by approximately $0.16. Again, this includes the effect from a partial elimination of bad debt expense, late fees and finance income, SG&A savings, servicing costs, net profit sharing and interest expense savings.

Net transaction costs are estimated to be dilutive to EPS by approximately $0.05 associated with the credit transaction. This includes estimated transaction costs associated with legal, advisors and implementation expenses partially offset by the second quarter non-cash gain recognized and the estimated beneficial interest gain to be recognized in Q3.

CEO separation costs are dilutive to EPS by $0.03.

Transaction costs associated with the R2Net acquisition are estimated to be dilutive to EPS by approximately $0.10. These costs include legal, advisor, accounting and financing. Our guidance does not include any impact related to R2Net operations post closing. We'll update guidance for sales and EPS related to this announcement upon closing of the acquisition.

Finally, our guidance reflects the favorability to earnings per share of $0.50 related to the accelerated share repurchases completed in the second quarter. Our effective tax rate will be closer to the lower end of our previous guided range at 24%. Our weighted average share count will drop materially by the year end due to the Q2 share repurchases of 8.1 million shares.

Cap ex and square footage guidance remain virtually unchanged.



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Lastly, as you consider how to model the third and fourth quarters, I wanted to offer these directional comments about same store sales and EPS. Our same store sales in Q4 will show notable sequential improvement over Q3 driven by, one, Q3 is our smallest quarter and there is no key gift-giving holiday within; two, Q4 will have an easier comp anniversary and will benefit from the deployment of several initiatives during the Holiday season that we have already seen early successes in the second quarter. And as you know, Q4 will be a much larger contribution to full year earnings per share versus Q3 as it represents about 40% of our annual operating income.

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

**Virginia Drosos:**

Thanks, Michele. Before we take your questions, I'd like to reiterate a few points. First, I am honored to lead Signet at this exciting moment in our winning history; a time when we will leverage our strengths in new ways, develop new muscles and build our capabilities and culture at an accelerated and energizing pace. We have many great assets to enable our future success. We have a hardworking, talented and passionate team. We have the discipline and operational expertise that sets the gold standard in the industry. We have recognizable and trusted brands that are part of consumers' most meaningful life moments. But let me be crystal clear; we also have a number of challenges that we need to decisively address. We operate in a retail environment that is more dynamic and demanding than it has ever been. Leading requires us to act faster, smarter and more efficiently. I will not lose sight of this.

We will focus on clear strategic priorities that will help us gain momentum and lead growth once again. I will strive to build a stronger, more agile and more innovative Signet every day. By leveraging our strengths and keeping a laser focus on what's needed to deliver growth and profitability, I have great confidence that we will achieve sustained success and create strong value for our consumers, employees and shareholders.

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 pound sign. Please hold for a brief moment while we compile the Q&A roster.

Your first question comes from the line of Simeon Siegel with Nomura Instinet. Your line is now open.

**Simeon Siegel:**

Thanks. good morning guys and welcome, Gina. Gina, you bring an informed but new perspective to the leadership team. Any updates on your view on store counts and thoughts on the preferred store fleet size and maybe e-comm penetration, especially given that you just bought an e-tailer. So, if you could disaggregate color between the main nameplate concepts and then the regionals, that would be great. Thanks.

**Virginia Drosos:**

Sure. Thanks very much for your question and warm welcome. We've been aggressively managing our real estate portfolio. Year-to-date we've closed 98 stores and opened 53 for a new down of 45. This is focused on regionals and underperforming mall stores. We have a highly analytical point of view on this,



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now looking at ROIC every quarter, on these stores. But we do view our retail footprint as a competitive advantage and believe that we can do a much better job connecting our in-store and our online experiences. That's important because while jewelry customers begin their shopping journey online, 9 out of 10 jewelry shoppers want a store experience before they buy. So, going forward we'll continue to take advantage of lease optionality to exit unprofitable stores, strategically open fewer new stores with strong potential sales and ROIC and much better connection between the online and bricks and mortar parts of our business. R2Net I think will play a strong role in helping us to build digital innovation capabilities to do this.

**Simeon Siegel:**

Great, thanks. Then, Michele, if I can, I think you mentioned, you spoke about the interest expense. Any way to think about the interest income for the back half? I know you had said it wouldn't be material to the statements but just to clarify does guidance and the balance sheet now reflect contractual accounting for the non-prime book? Thanks.

**Michele Santana:**

Sure, Simeon. A couple of things. Yes, I did mention an interest expense savings but also in my prepared remarks I talked about the interest income at least associated. I don't know if you're talking about the finance charge income or if you're talking about some other type of interest income, but if you go back through the prepared remarks that's included, all factored into the guidance.

In terms of your question on a contractual basis, let me give some additional color there. We expect that when we do convert, when we close the transaction in October, that we will convert to contractual as we move to Genesis. However, for Q3 reporting, our delinquency will be done as a final time on recency basis and the reason for that, Simeon, is due to the cycle billing times and the conversion date that's happening later in October. Beginning with our last seven billing cycles, which we have a total of 25 cycles in October, all accounts going forward will be aged and managed purely on a contractual basis. So you'll see when we report Q4 that we will be moved to contractual. So, hopefully that helps.

**Simeon Siegel:**

Perfect. Thanks a lot, guys. Best of luck for the rest of the year.

**Virginia Drosos:**

Thanks, Simeon.

**Operator:**

Your next question comes from the line of Oliver Chen with Cowen & Company. Your line is now open.

**Oliver Chen:**

Thank you. Your comments are really helpful. We are curious about your comments around the promotional environment and what's happening with the industry at large and your thoughts on mom and pops. It sounds like you're very agile in thinking about this but will the comparisons ease and context on how the environment is evolving relative to your strategies? Then on the R2Net deal, could you just help us understand which features are you most excited about to help accelerate your own OmniChannel capabilities? Would be curious about that and generally speaking how the timing would work and what we



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should think about. One of the topics you brought up a lot was speed, and it could be in relation to that or supply chain; curious about that as well. Thank you.

**Virginia Drosos:**

Thanks, Oliver. Let me start and then Michele, you can jump in with more details. First on the promotional activity, we've discussed our strategy to appropriately balance sales and margin, and you heard in our Q2 discussion that we're willing in this environment to build profitable market share with higher levels of promotional spending offset by cost savings.

**Michele Light:**

Yes. Oliver, if I could just add a couple of points to that and then we'll circle back to your R2Net questions. As we said on the call, we are planning to be incrementally more promotional and with that we expect that we will slightly deleverage our gross margin rate, and as you know that is a change from how we previously communicated our position before. But given the promotional environment and the competition we see in the marketplace and the fact that we are going to go after market share we absolutely believe it's the right thing to do, but equally important is ensuring that we remain agile and flexible and being able to go after cost reduction to support a lower gross margin reign and ultimately drive the bottom line.

**Virginia Drosos:**

Then on your question regarding R2Net, I'm really very excited about the technology they bring and the way I think about it is a pool of existing technology and a really robust R&D pipeline of future technology. If I talk a little bit about the existing technology, there are four critical pieces that I'd call out. One is diamond imaging cameras. They've developed an in-house capability to create real diamond images in 360 degree HD with a 40 times super zoom on any device. So it looks great in the mobile app as well as online. It can look great in our stores, and they are continually updating and improving these cameras. So I think that's something that we would look to reapply in the reasonably near term.

The second is the 3D imaging technology, and this is a rendering system which provides interactive videos of any diamond within a ring. So when a shopper is online looking, they can look at the over 100,000 different diamonds that are online and place that actually virtually into any setting to get a very clear idea of what that ring will look like. It's unlike anything else that's available on the Internet today. That links up in my opinion with a ring try-on app so that—and you can download this in the App Store. Not sure if you've been online but it's really terrific technology, and you can put an image of a selected ring to visualize how it would actually look on your hand, not someone else's hand, a model's hand, but literally how any ring would look on your hand.

Then the fourth one I'll call out which is something that we've been talking about already at Signet, but I think R2net can help accelerate our capabilities, is customer service and 24/7 chat. They have a great capability 24/7 that allows customer service team members to be more like jewelry consultants and in real-time they can work with a customer online, point out flaws in a diamond that might be being considered, show comparisons of other diamonds. Really terrific technology.

So, what we'll do is, you know, first we need to close the deal, obviously. We're thinking that will happen sometime late September, and then as we begin to implement technology we'll certainly do that with an eye toward which of these we think could bring the biggest benefit to some of our existing Signet brands without disrupting anything to do with our e-commerce capabilities for Holiday.

**Oliver Chen:**



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Thank you. Virginia, just one last question. When you think about the individual banners between Jared and Zale, there's different aspects from the consumer selling experience versus product execution. Could you just dive a little bit deeper into where you see those opportunities specific to the banners? Because it feels like they're slightly different.

**Virginia Drosos:**

You're exactly right. They are slightly different. Zales, for example, has a somewhat different customer than Kay and different from Jared, and I think we have a great opportunity to improve and differentiate our assortment. For example, in Zale, we want to look at higher price point fashion offerings than we've had traditionally in the past. For Jared, we're looking at more branded merchandise and ways to really help Jared elevate its point of view. We see the key competitor, if you will, for Jared as regional independents, and so how do we position Jared to be able to reach to a higher income and discerning consumers. Then Kay, the same. We've done very well with Bridal brands and so we're looking at how we extend off of those brand names into more Bridal offerings but also into fashion.

Understanding the consumer and who's shopping at each of our banners is an important first step that we've been working on and from that we'll be differentiating our assortment a bit more than we have in the past.

**Oliver Chen:**

Thanks. Congrats on the deal. Best regards.

**Virginia Drosos:**

Thank you.

**Operator:**

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

**Ike Boruchow:**

Hi. Good morning everyone. Congrats on the nice improvement you're seeing in the business. I guess, Michele, you mentioned gross margin will be down a little bit in 2H, and correct me if I heard this wrong, but you're planning to offset that with some cost initiatives that you've identified. Can you maybe talk to the specifics there, and are these initiatives brand new to the business, meaning will those cost savings wrap around to the first half of next fiscal year?

**Michele Santana:**

Sure, Ike. Yes, the plan that we have is that given the environment as we talked about, and importantly some of the lessons that we learned from Mother's Day on how we drove our promotional messaging which was much more streamline, we will look to offset that through further cost savings on SG&A. Some of these cost savings are continuing benefits of what we've done in the first half of the year. So, if you look in the first half of the year, SG&A kind of excluding the CEO separation and the acquisition costs associated with R2Net are down about $20 million. Some of those benefits will continue to the back half of the year such as our Corporate payroll, store payroll savings. We're also pushing in deeper into certain areas where we see further opportunities and select Corporate expenses. In addition, we're also making smart reductions in advertising. Part of that is shifting advertising to higher ROI media. For instance,



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shifting away from some of the traditional media into the social media, which is also very efficient in terms of dollars. It's also supported by recent research we've done in which we know that people need fewer visits to stores so our marketing is going to reflect that. For instance, years ago the Bridal journey required seven store visits on average, but today it's down to about four as a result of digital. So we're kind of leaning into that. So even though we are going to be diving deeper and reducing SG&A, we also at the same time are preserving or improving the customer experience through smarter allocation of our resources.

**Ike Boruchow:**

Got it. No, that's very, very helpful. Then just a follow-up on Phase 2. Maybe Michele, can you talk about your thoughts on potential timing as well any other types of options or alternatives that you may be considering internally?

**Michele Santana:**

Yes. Let me give you a little bit more color on Phase 2. I guess broadly some of the timing around that, very much what we previously said at the time we had announced our phased approach remains in play in terms of our objective. We are actively engaged, as Gina had mentioned on the call, in discussions with multiple interested parties and very committed to fully outsourcing the credit portfolio in a timely manner, but keep in mind, Ike, we're also very focused on ensuring that we close the Phase 1 transaction in October before the Holiday season, so we are kind of running a parallel path.

What I would say and what we've stated previously is that we expect Phase 2 to be completed at some point in FY19 but we're going to continue to push forward on that path.

**Ike Boruchow:**

Got it. Thanks so much.

**Michele Santana:**

Thanks.

**Operator:**

Your next question comes from the line of Paul Lejuez with Citi. Your line is now open.

**Paul Lejuez:**

Hey, thanks guys. Have you thought about whether or not you're going to cross-market James Allen with your existing brands? That's the first question. Then just I think there's bigger picture. You focused more on OmniChannel. Any early thoughts on the required cap ex investments as you think about next year? Also, if you could maybe touch on what we should be thinking about in terms of EBIT margin as you move more of your business online as online continues to outperform stores. Thanks.

**Virginia Drosos:**

Sure. Just starting with your question on James Allen, our initial view is to run that as a largely independent division and keep jamesallen.com as the very strong, fast growing e-commerce brand that it is now, and then look to reapply technologies to kay.com, zale.com, jared.com and also in stores. We will also over time look at whether a showroom type concept would make sense on James Allen to create



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some in store excitement around that brand as well, but I think we need to really get into more of an implementation phase before we get concrete ideas on that, but that's at least the early thinking on that piece.

**Michele Santana:**

Maybe, Paul, just in terms of your question, I believe one was on cap ex related to the acquisition to elevated levels going forward. I mean I would say I wouldn't anticipate any material elevation in our capital expenditures. I think how we'll look at is there is a pool of dollars for capital expenditures and we'll allocate that based on priority and ROI.

Then in terms of EBIT margin as we—shifting OmniChannel e-commerce for stores, our e-commerce margin is pretty healthy, and keep in mind we don't have the related store expense, so although we do have shipping costs associated with the e-commerce, we're not having that store occupancy expense so it really isn't a drag on our margin for us.

**Paul Lejuez:**

Thanks. Can you add anything on your store closings? What sort of recapture rate you see on the sales as you're closing stores?

**Virginia Drosos:**

Yes. I'll take that one. We typically see around 30% recapture rate and that has a lot of upside in it. It's not a bad number now but we think, especially with some of our new Clienteling system that we've rolled out to the field, we have an opportunity to increase that up over 50%, and so that's a real focus area for us. I'd like to add one more point on what Michele was saying about EBIT. James Allen has a significantly higher transaction value than any of our other websites and that gives us a great learning lab for how we can increase the purchase on line for the rest of our website and that in and of itself would be an improvement in EBIT for us.

**Paul Lejuez:**

Thanks. Good luck guys.

**Operator:**

Your next question comes from the line of Brian Tunick with RBC. Your line is now open.

**Brian Tunick:**

Thanks. Good morning. Gina, I was curious, I guess, first maybe your view on the softness in the jewelry category overall. What are you seeing there maybe any differently? Obviously, you're making a big acquisition on the millennial front today. Just curious what you think is going on the last year and a half in the jewelry category and maybe what could help resuscitate it? Then maybe, Michele, on capital allocations, could you maybe update us on your views of where the balance sheet and leverage ratios will come in at the end of the year given this accelerated buy back, the credit sales, today's deal and maybe how your prioritizing capital allocation as we go into next year? Thanks very much.

**Virginia Drosos:**



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Sure. I think that the jewelry sector headwinds are really a combination of overall retail headwinds and the very rapid change in how consumers are choosing to shop. Then secondly a more sector specific issue around a lack of excitement and innovation. Those are two things where Signet is well positioned to strengthen our capabilities and to lead. I will say that after four years of declining growth, we have recently started to see a re-acceleration of the jewelry industry, low single digit growth year-on-year in the last year and we've done a lot of consumer research and we know that consumers of all ages, including millennials, tell us that jewelry is among the top three gifts that they like to receive and that diamond rings will continue to be how they choose to commemorate their engagements.

I think there is significant resiliency in the jewelry industry across generations. As we can bring more exciting innovation, more visualization, more ability to be able to shop online for a purchase that traditionally people have thought you have to touch and feel and see in store, when we can magnify that diamond 40 times, turn it around 360 degrees and give people a great view of that online combined with 24/7 chat with diamond experts, I think we'll be able to lead a change in jewelry industry growth rates.

**Michele Santana:**

Brian, in terms of your question on capital allocation priorities. A few thoughts there. The business has very strong cash flow generating capabilities and so we absolutely remain committed to one, preserving our financial strength and our flexibility to support growth and also maximize our shareholder return. This also though includes strategic investments, like the acquisition that we just announced today of James Allen and balancing that through returning capital to our stockholders through dividends and/or share repurchases. I'd say there's really no change in terms of those priorities that we have previously communicated. When you think about the end of the year leverage ratio what I'd probably point you to, we will probably be maybe low-end three times, maybe slightly under that.

**Brian Tunick:**

Great. Thanks and good luck guys.

**Virginia Drosos:**

Thank you.

**Michele Santana:**

Thank you.

**Operator:**

Your next question comes from the line of Rick Patel with Needham & Company. Your line is now open.

**Rick Patel:**

Good morning. Gina, great to have you on the call and congrats on a strong Q2. Just a couple of questions on the competitive environment. First, are you still seeing a lot of liquidation sales go on from the independents like you did earlier in year, or is that lessening? Then second, a major department competitor is certainly accelerating it's focus on jewelry with pretty good results so far. How should we think about this competitive threat and what lever Signet can pull to offset this pressure?

**Virginia Drosos:**



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First on the liquidation sales, I would say we're seeing fewer from the independents that we had previously but we're seeing stronger promotional spend from department stores. Very price oriented promotional spend. We take a view on this that we are leaders in this business for the long term and so we're very analytical about our promotions, willing to balance those to drive our top line growth but profitable share growth, winning in bridal, getting stronger in fashion. Those are the key things that are most important to us. It certainly is not all about price in our context. So we're working harder to combine our promotions with equity building advertising and other marketing so that we make sure we're building our brands over the long term.

**Rick Patel:**

Could you give us some more color around the new initiatives for Holiday? I'm just curious about what's going to be different from last year from the merchandising perspective in terms of your existing brands and any other new brands you might look to scale that you may have tested over the last few months.

**Virginia Drosos:**

Yes. So I don't want to give away too much from a competitive standpoint, obviously, but we have a number of new fashion brands that we've been working on. Some of those are brands which really speak to the heart and soul of consumer passions, which I think are great and some of which are really trend driven, very on style at the moment, designer oriented brands, building on the stacking trends that we've seen recently in the market. I think they're very strong. We're focused on price points in the gift giving range of $200 and $700. We'll have a very strong offering there. What we're really aiming to do, combining that with a disciplined and smart promotional and marketing spend is to drive traffic into our stores and be very much part of consumer's holiday gift giving.

**Michele Santana:**

If I could pile and add one additional comment as well. When we go through our Holiday period this year, we will have that—our lease-to-own program with Progressive Leasing and when you think about that, currently about 45% of customers who apply for credit today are denied, and so that does represent a great opportunity for the those customers who can't seek credit. As mentioned on the call, we're able to successfully roll that out ahead of schedule and so now it's really just a matter of our store associates kind of building them also related to that.

**Rick Patel:**

Thanks very much. All the best in the back half.

**Michele Santana:**

Thanks.

**Virginia Drosos:**

Great. Thank you.

**Operator:**

Your next question comes from the line of Scott Krasik with Buckingham Research. Your line is now open.



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**Scott Krasik:**

Hi everyone. Thanks. Congrats, Gina. Just wondering—it seemed like the underlying sales trends excluding the Mother's Day shift in the first quarter were maybe down mid-single digits or so. Second quarter that's improved meaningfully. I'm just wondering how you view sort of your underlying trends ex the shift. Maybe how were sales in June and July and how you're thinking about that going forward.

**Virginia Drosos:**

I'll say a couple of things on that and Michele feel free to chime in. We had very strong average transaction value growth across our banners and across our key national banners, led by Kay. Certainly Piercing Pagodas, Zale as well, we also saw transaction increases in the quarter. We're very pleased to see growth on both of those fronts. You're right that ex the Mother's Day we would have been down slightly on a comp basis, but coming out of some momentum that we had behind our Bridal promotion in July, we're feeling very good about our guidance for the back half of the year.

**Michele Santana:**

Yes. Absolutely. I would say we're very much encouraged by our Q2 results. We talked about strong performance going into the quarter and strong performance exiting the quarter with our July promotional event. I did provide some color on the call on how to think about Q3 and Q4.

**Scott Krasik:**

Right. Then so just lastly, an update on maybe the synergies where you are there and then I think you alluded to the next question that you're finding some new savings. Can you just further expand on that?

**Virginia Drosos:**

Sure. We're looking for savings across our company, but just to answer specifically, synergies and related to the Zale acquisition, which is the synergies that we've talked about the most. Zales, and having been on the Board for five years, I continue to be very excited about that acquisition. Very good strategic decision for us and we're very committed to achieving business success. What has gone well on that integration is our operational focus on synergies, so we're on track to deliver the numbers that we've communicated previously. What our big opportunity is to drive further benefit from that acquisition is on the sales growth side. We haven't meaningfully improved our sales productivity and still our Kay average store sales are about 50% higher than a Zales, which again gives us a tremendous opportunity as we improve assortment, as we get our inventory right in the stores, as we update the look of those stores, as we bring technology like we've talked about. A tremendous opportunity to drive sales productivity. While we will reach our synergy targets, I think the integration still has tremendous upside and as we fully embrace the ideas and talents of our Zale division team we'll be able to bring those to life.

**Scott Krasik:**

Thanks. Good luck.

**Operator:**

That's all the time we have for questions today. I will turn the call over to Ms. Drosos.

**Virginia Drosos:**



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Okay. Thank you very much. Our next call will be the release of third quarter earnings on November 21. That's it. Thank you.

**Operator:**

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



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