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Signet Jewelers Ltd. (SIG)

Q3 2019 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning. My name is Sharon, and I will be your conference operator today. At this time, I would like to welcome everyone to the Signet Fiscal Third Quarter 2019 Earnings Call. All lines have been placed on mute to prevent any background noise. After the speaker's remarks there will be a question-and-answer session. [Operator Instructions] Thank you.

Randi Abada, you may begin your conference.

Randi Abada
Senior Vice President-Corporate Finance Strategy & Investor Relations, Signet Jewelers Ltd.

Thank you. Good morning, and welcome to our third quarter earnings conference call. On the call today are Signet's CEO, Gina Drosos; and CFO, Michele Santana.

During today's presentation, we will 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 and quarterly reports on Form 10-Q.

Except as required by law, we undertake no obligation to revise or publicly update forward-looking statements in light of new information or future events. During the call, we'll discuss certain non-GAAP financial measures. For a discussion of the non-GAAP financial measures as well as reconciliations of the non-GAAP financial measures to

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the most directly comparable GAAP measures, investors should review the press release we posted on our website.

I'll now turn the call over to Gina.

Virginia C. Drosos

Chief Executive Officer & Director, Signet Jewelers Ltd.

Thank you, Randi. Good morning, everyone and thank you for joining today's call. To begin, I'd like to thank all of our team members for their support of our customers this quarter and their ongoing efforts to deliver on the important holiday season. In my remarks today, I'll begin with a brief overview of current trends we are seeing in the marketplace and third quarter results and then move onto an update on our holiday plans and the Path to Brilliance transformation plan. I'll wrap-up my comments with a brief overview of our full year fiscal 2019 guidance.

As Signet has moved through fiscal 2019, our sales trends have continued to stabilize enabled by transformation initiatives to drive demand with clear strategic priorities, greater accountability, efficiency and operational discipline. Early investments in our eCommerce capabilities are positively impacting our financial results with strong double-digit growth in eCommerce sales across our core banners year-to-date.

Our brick-and-mortar sales performance is also improving but it is not yet at the levels that we want to be, which has impacted the flow through of sales growth to our earnings this year. Thus far in the fourth quarter, we are seeing a more competitive environment as department stores continue to invest in the category and consumers are highly responsive to value.

As a result, we are planning for some additional promotional activity in the fourth quarter to support our holiday sales. This issue together with the channel mix I just discussed is expected to be a headwind to gross margin in the fourth quarter. Our revised guidance we issued this morning reflects the trends we are seeing.

Our new Customer First banner positionings and merchandising efforts along with real estate optimization and cost reduction actions are key to unlocking the full potential of our stores and achieving greater operating leverage as we move through our transformation journey.

The third quarter is a smaller quarter for Signet with no major holidays. Our focus this quarter has been on bringing our fourth quarter plans to life and continuing work on longer-term transformation initiatives to invest in growth under our three strategic pillars of Customer First, OmniChannel and Culture of Agility and Efficiency.

Before I discuss these in detail, I will provide some highlights of our third quarter performance.

We delivered same-store sales growth and EPS above our non-GAAP guidance in the third quarter while reinvesting in advertising as we prepare for the holiday season and the launch of our new banner positionings. Here are some highlights of our third quarter performance.

Total company same-store sales were up 1.6% with North America up 2.1%. These results included an accounting adjustment which Michele will further discuss in her remarks that shifted the timing of service plan revenue recognition. This adjustment negatively impacted total same-store sales by 50 basis points and North America same-store sales by 55 basis points.

With respect to our banners, Zales and Piercing Pagoda reflected continuing sales momentum. Kay returned to same-store sales growth, and Jared was flat with the prior year quarter. International same-store sales were down

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3.1% as our UK business continue to be impacted by a challenging macroeconomic environment with weak consumer sentiment.

eCommerce was a strong contributor to growth across all our banners, representing 10.5% of total sales in the quarter, up from 7% in the prior year. Our ongoing efforts to enhance our digital content infrastructure and customer experience resulted in strong double-digit eCommerce growth in the quarter across our core North America and UK banners.

James Allen grew 13.6%, a sequential slowdown, which we expect to continue over the next few quarters as we work through the implementation of sales tax in additional states. Overall, we are confident in the long-term outlook for James Allen and are continuing to leverage their digital innovation capabilities across our banner websites.

We continued to invest in newness in the third quarter through ongoing efforts to refresh core assortment in bridal and fashion while further differentiating each banner with a larger percentage of unique items.

Incremental clearance sales across banners continued in the quarter as part of our strategic effort to make room for new collections ahead of the key holiday season but at lower levels than in the second quarter.

In North America, both our bridal and fashion categories were up in the quarter on a same-store sales basis driven by increased new product sales and incremental clearance sales.

In bridal, we saw strong performance in Disney Enchanted, Love's Destiny and Vera Wang at Zales, Neil Lane at Kay and in solitaires across banners. In fashion, strong results continued in gold, particularly chains and bracelets with diamond earnings and pendants also performing well.

North America watch sales increased while beads declined due to the strategic decision to exit our owned bead brands at Kay and Zales as well as softness in non-owned bead brands at Jared.

In the UK higher sales of prestige watches were offset by lower sales in diamond jewelry and fashion watches. Given the backdrop of a challenging consumer environment, we are seeing increases in promotional activity in the UK marketplace.

Now I will discuss some of the Signet Path to Brilliance transformation plan priorities we began to implement as part of our three-year plan. Beginning with Customer First. As I have discussed previously, an important aspect of our transformation plan is clearly differentiating our banner positionings for Kay, Zales and Jared to align with their unique target customer and value proposition.

We have started to make progress in modernizing and differentiating the brand equities, while making all the brands more relevant to their unique target audiences.

You will see a reflection of the diversity of our customer base in this work which underpins Signet's mission to celebrate life and express love for all people and occasions.

Kay's new campaign, Long Live Love positions Kay as the champion of modern love and gratitude, encouraging customers to cherish their meaningful relationships. Jared's Dare to be Devoted positioning encourages customers to celebrate life's greatest devotions with premium jewelry as unique as their love.

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And Zales' positioning focuses on beautiful style and self-expression with a bold energetic brand personality. These new positionings have recently been launched in the marketplace for holiday with new holistic marketing plans across linear TV, digital and social using data science to make the campaigns more personalized.

Holiday advertisements are 90% new this season with the remainder comprised of key performers from last year that have been updated to highlight our new merchandise. We have a balanced mix of gifting and promotional spots as well as messaging, highlighting specific collections for each banner including Vera Wang, Disney Enchanted and Neil Lane.

Our holiday plans also include new and enhanced media integration events for each banner. In addition to creative, we have continued to work on optimizing the quality and targeting of our advertising spend, including improved message timing and banner differentiation.

Turning to product, we have also made progress on refocusing our product assortment, increasing newness and product differentiation by banner through refreshing the core, adding new collections that are exclusive to each banner and continuously enhancing collections with our partners such as Vera Wang.

Trends in jewelry this season include yellow and rose gold color, diamond encrusted Cuban links and fancy stones. Key items at Kay for holiday includes the new Love + Be Loved collection and new Neil Lane designs including fancy stones.

Zales features an updated Vera Wang Kindred Heart collection, new design in Vera Wang Bridal and an expansion of Disney Enchanted. Jared is featuring higher carat weight and fancy cut diamonds, new Le Vian collections, the diamond fashion Eternity collection and [ph] scattered fashion (10:43) product designs.

All banners will have new in-house developed designs focused on the jewelry trends we have identified. In summary, we've launched the beginning stages of our Customer First new banner positioning work and differentiated product assortment in the marketplace this holiday. This work will continue to come to life through more initiatives in fiscal 2020 and beyond.

Turning to OmniChannel, we aim to build a best-in-class mobile experience and drive digital innovation as we progress on our Path to Brilliance. We continue to see encouraging results across our banners driven by higher-quality imagery, improved content, and faster speeds. Here are a few highlights of our OmniChannel initiatives.

We have launched R2Net Segoma 360-degree visualization of 1,000 top-selling designs at Kay and Jared.com with further expansion to come during the fourth quarter.

We are seeing positive results from the enhanced [ph] Design Your Ring (11:50) configurators launched at Kay earlier in the year and most recently at Zales in the third quarter.

Relevance and navigation continue to be a key focus of our content efforts, supported by increasing the number of tests and faster rollout in mobile. In the third quarter, we fully deployed a successfully tested initiative to enhance customer on-site search results at Kay and Jared resulting in significant increases in add to cart as well as improved conversion rates. This enhancement is now in pilot at Zales. We also conducted mobile navigation tests across banner sites during the quarter, returning positive results as we transitioned to a more curated, easier-to-shop category selections.

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Ahead of the critical high-traffic holiday season, we have improved mobile page load speeds and continued to make improvements to our digital infrastructure to enhance the user experience. We have also improved user experience with more customers being served a personalized page on arrival at our websites. Speed of checkout enhancements including social sign-on and the ability to save credit cards are significantly reducing the number of steps customers must take to complete the checkout process. Both of these improvements drive higher conversion.

Moving on to Culture of Agility and Efficiency. A key component of our 3-year transformation plan is to drive out costs customers do not see or care about, in order to lower our cost base and provide funds for reinvestment in growth drivers and enhanced profitability. We are on track to achieve our net cost savings goal with approximately two-thirds of our fiscal 2019 target achieved year-to-date.

Our plan to close more than 200 stores in fiscal 2019 is on track and we are also on track with our goal of achieving at least 30% sales transference. New store openings remained disciplined, focusing on off-mall locations in desirable markets. Our first James Allen concept store and showroom recently launched in Washington D.C., featuring advances in digital technology and a millennial-inspired shopping experience. This store is an opportunity to test new concepts and incorporate innovation in new store design plans for all of our banners.

We continue to enhance training for team members across the company including new leadership training for managers, as well as enhanced training for all store staff to prepare for holiday. Our training teams developed a 4-hour interactive payment program training for all Kay and Jared store employees to increase understanding of all of our payment plan options. We expect this investment in training to improve both employee engagement and the consumer experience with our payment programs over time.

Turning to our guidance. For fiscal 2019 we now expect same-store sales of flat to up 1% and non-GAAP EPS of $4.15 to $4.40. Our revised full year sales and earnings guidance reflects incremental promotional efforts planned in the fourth quarter, as well as incremental headwinds for the timing adjustment related to our service plan revenue, a more challenging outlook for our UK business, slower near-term growth at James Allen and continuing unfavorable banner and channel mix effects. Michele will discuss the guidance in detail in her remarks.

To wrap-up my comments, we are highly focused on delivering on our plans for the fourth quarter. With the key weeks of the holiday season still ahead of us, the initiatives we are implementing in the fourth quarter will serve as a foundation for our future efforts as we move along our transformation journey.

As we move forward with our three-year plan, our priority is to improve our financial performance through higher sales growth, real estate optimization and cost efficiencies, while continuing to make investments to achieve higher growth and profitability.

With that, I'll pass the call to Michele for more details on our financial results.

Michele Santana

Chief Financial Officer, Signet Jewelers Ltd.

Thanks, Gina, and good morning, everyone. I'll begin with a review of our third quarter results and then move on to our updated fiscal 2019 guidance and our outlook for the fourth quarter.

For the third quarter, total sales were $1.2 billion, up 3% year-over-year on a reported basis and up 3.3% on a constant currency basis. Same-store sales growth was 1.6% in the quarter, which includes an unfavorable impact

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on total same-store sales of 50 basis points or $6 million related to an accounting adjustment due to the timing of revenue recognized under our service plans. The impact of this adjustment on North America same-store sales was 55 basis points.

Revenue from the sale of lifetime extended service plan is recognized based on the underlying customer behavior regarding use of the plan. Our actual plans experience reflects trends in which customers, who have purchased the plan, are having their jewelry serviced later in the coverage period.

As part of our typical quarterly processes, we've reviewed our claims experience and determined that we were seeing sufficient movement in trends to merit a revision to the timing of revenue recognition.

As a result, we are now recognizing 55% of the revenue from service plans in the first two years of the coverage period versus 58% previously. However, by year five we are still recognizing more than 75% of revenue, which is consistent with the revenue recognition pattern we previously applied.

The total recognition period, which is a maximum of 17 years, has not changed. While this revision was identified as part of our normally quarterly processes, it is an infrequent adjustment. We anticipate the change in revenue recognition rate will continue to have an unfavorable year-over-year impact on our revenues same-store sales and operating profit, until we lap this adjustment at the end of the second quarter of 2020.

Inclusive of the impact of the service plan revenue timing adjustment, our third quarter same-store sales were sequentially in line with second quarter results against an easier prior year comparison. A key driver of this sequential trend is a 115 basis points swing and the impact of the changes, and timing of promotions, with an unfavorable 75-basis point impact in the third quarter, versus a 40-basis point favorable impact in the second quarter.

Incremental clearance sales were a smaller contributor to sales in the third quarter at 165 basis points versus 240 basis points in the second quarter. Additionally, James Allen and UK performance slowed sequentially for reasons Gina discussed in her remarks. The third quarter is also our smallest dollar quarter of the year, and as a result, revenue drivers can have a larger impact on growth rates in this quarter versus other quarters.

Items which did not impact same-store sales, but impacted total revenue dollars included the following four items.

First, the adoption of the new recognition accounting standard which contributed $27 million in sales. Second, a calendar shift of weeks in the quarter following our 53rd-week fiscal year which was an unfavorable impact of $9.5 million. Third, an unfavorable impact of store closures of $26.5 million partially offset by new store openings. And fourth, foreign exchange unfavorability of $3.5 million.

Moving on to margins, the gross margin rate was 31.1% in the quarter up 330 basis points year-over-year. Transformation cost savings and lower store occupancy cost due to closed stores offset unfavorable mix including higher clearance sales.

Additional factors that impacted the gross margin rate include the following five items: first gross margin benefited by 350 basis points as we no longer recognize bad debt expense or late charge income due to the completion of our credit outsourcing.

Second, the decision to cease offering credit insurance midyear in fiscal 2018 unfavorably impacted the third quarter margin rate by 40 basis points. Third the impact of the addition of James Allen which carries a lower gross

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margin rate unfavorably impacted the rate by 30 basis points. Fourth, an unfavorable 30 basis points impact related to the timing shift of revenue on service plans.

And lastly, a positive impact of 20 basis points related to the adoption of the new record recognition standard including higher revenue sharing payments associated with the prime credit outsourcing arrangement.

SG&A expense was 34.4% of sales in the quarter compared to 32.5% in the prior year quarter. Total SG&A dollars were up by $34 million over the prior year quarter.

The primary drivers of increased SG&A were the following three factors which were somewhat offset by transformation cost savings. First, $36 million in credit outsourcing cost partially offset by $10 million in savings related to in-house credit operations for a net increase of $26 million. Second, $16 million in higher advertising. And third, $5 million in higher incentive compensation.

Other operating income declined by $72 million as expected compared to prior year due primarily to a loss of interest income as a result of the outsourcing of credit.

Our GAAP operating loss of $49 million included the impact of $9.5 million in restructuring charges related to store closure cost, severance and professional fees associated with our transformation plan and $0.4 million in transaction costs related to credit outsourcing.

On a non-GAAP basis excluding charges, the operating loss was $38.9 million. As we mentioned in our press release, the primary year-over-year drivers of the decline in operating income were a $46 million unfavorable impact from the outsourcing of credit, as well as unfavorable banner mix, unfavorable impact of the timing shift on revenue recognized on service plans. Planned investments in advertising and higher incentive compensation partially offset by transformation cost savings.

GAAP EPS was a loss of $0.74 and a non-GAAP EPS was a loss of $1.06. Non-GAAP EPS reflected a tax rate benefit of 5.7% versus our guidance of 8% to 10%, which was a negative $0.03 impact versus the midpoint of the tax rate guidance. The lower tax rate is primarily driven by pre-tax earnings jurisdictional mix.

And now I would like to briefly touch on our payment plan performance. As you are aware, we experienced some operational issues with respect to our transition to an outsourced model, which began in late October of 2018. We have largely mitigated the operational issues associated with this transition with many metrics performing in line with pre-outsourcing trends in the third quarter.

Prior to the outsourcing, we were experiencing declines in application volumes. Current application volume trends are now back in line with pre-outsourcing trends with declines in applications driven by traffic trends, real estate portfolio mix and eCommerce sales mix.

In the third quarter, the North America payment plan participation rate was 53.3% versus the prior year quarter of 55.2%, a decline of 190 basis points. The participation rate decline was primarily driven by lower application volumes. We remain focused on driving traffic to our stores and optimizing performance within the payment structure including both credit and leasing options.

However, we do expect application volumes to remain a headwind in the upcoming quarters. Also, as a reminder, our payment plan participation rate is typically lower on an absolute basis in the fourth quarter versus earlier

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quarters in the fiscal year as the fourth quarter is a larger dollar sales quarter with a higher mix of gifting transactions.

So moving on to cash flow. Year-to-date adjusted free cash flow excluding the proceeds from the credit transaction was negative $225 million, reflecting lower operating income and investment in inventory. The third quarter is typically our highest inventory level seasonally and also reflects our strategy to accept low price owned bead brands and increased investment in bridal and certain fashion collections. We do expect to reduce inventory levels in the fourth quarter, although not below prior year-end levels. Inventory was somewhat offset by higher payables in the quarter. Capital expenditures declined by $73 million year-to-date as we lowered our store count.

Moving onto guidance, we are raising our fiscal 2019 same-store sales guidance to reflect the performance in the third quarter and our latest view of the fourth quarter. Our fiscal 2019 total revenue guidance is $6.26 billion to $6.31 billion and we now expect same-store sales to be flat to up 1% for the year.

Now embedded in our fiscal 2019 same-store sales guidance is a negative 20 basis points related to the timing shift of the service plan revenue that I had discussed earlier. Our net cost savings guidance remains unchanged at $85 million to $100 million in fiscal 2019 and $200 million to $225 million over three years.

With respect to credit outsourcing, our guidance assumes an unfavorable year-over-year operating profit impact related to credit outsourcing of $152 million to $156 million for fiscal 2019. For fiscal 2020, we continue to expect year-over-year impact on operating income ranging from 0 to a benefit of $5 million.

Our narrowed fiscal 2019 non-GAAP EPS guidance range of $4.15 to $4.40 is inclusive of an updated normalized tax rate assumption of 3% to 4%.

Our guidance also embeds $485 million in share repurchases, which was completed in the second quarter as well as an updated view of year-over-year increases in incentive compensation of approximately $41 million versus $50 million previously. Our GAAP EPS guidance of a loss of $7.40 to $7.07 includes impairment and restructuring charges as well as a loss on the sale of non-prime receivables.

For the fourth quarter, we expect total sales of $2.17 billion to $2.22 billion. Same-store sales are down 1.5% to up 1%, and a non-GAAP EPS of $4.35 to $4.59. Fourth quarter revenue dollars, operating income and EPS will be impacted by the lack of an additional week in the current quarter versus fiscal year 2018, which had a 53rd week.

Our fourth quarter same-store sales outlook incorporates a negative 30 basis points related to the timing shift of service plan revenue. Additional factors impacting our fourth quarter same-store sales outlook are a 40-basis point estimated positive impact of a Zales and Peoples' promotion event that ran in the third quarter last year moving to the fourth quarter this year, promotional environment headwinds in the U.S. and UK, and some continued impact of sales tax implementation at James Allen.

Additionally, we are modeling that the current trends and lower credit application volumes continue in the fourth quarter. Importantly, as Gina discussed earlier, we continue to expect unfavorable channel and banner mix effects on operating profit performance in the fourth quarter.

With respect to gross margin, we expect our gross margin rate to improve on a year-over-year basis in the fourth quarter. Gross margin rate in the fourth quarter will continue to be positively impacted as we no longer recognize bad debt expense and will also reflect promotional environment and mix headwinds.

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SG&A in the fourth quarter is expected to be higher year-over-year reflecting higher advertising and incentive compensation, as well as higher credit costs due to the transition to a fully outsourced model. Also note that the year-over-year increases in incentive compensation are more heavily weighted in the fourth quarter given the level of revenue and profit generation.

We estimate the total year-over-year credit outsourcing impact on operating income to be modest in the fourth quarter with benefits of no longer recognizing bad debt expense and higher revenue share offset by higher SG&A and a lower finance income. As a reminder, we lapped the prime credit outsourcing at the end of the third quarter.

Our non-GAAP EPS guidance of $4.35 to $4.59 excludes expected restructuring charges of $30 million to $35 million related to our Path to Brilliance plan and embeds a normalized tax rate of 3% to 4%. GAAP EPS guidance inclusive of these charges is $3.02 to $3.33.

Moving on to leverage, we continue to expect to exceed the high end of our 3 to 3.5 times target leverage ratio in fiscal 2019, as we begin our transformation, but expect to be back within that range before the end of the three-year transformation plan. As a reminder, approximately $400 million of our debt is unsecured notes with fixed rate through 2024 which will not be subject to rising interest rates.

To close out my comments as Gina mentioned earlier, we are very focused on delivering our fourth quarter results with December being the largest month of the quarter and our fiscal year.

And we'll continue to build on the progress we have made to date under our Signet Path to Brilliance transformation. Also as a reminder we will be issuing our holiday sales results in a press release on January 17 and will not be hosting a conference call.

We plan to provide our outlook for fiscal 2020 when we report our full year results in March.

And with that we are now ready to start our Q&A session.

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QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] Your first question comes from the line of Rick Patel with Needham & Company. Your line is open.

Stephen Lengel
Analyst, Needham & Co. LLC

Q

Hi, this is Steve Lengel on for Rick Patel. Thank you for taking my question.

Virginia C. Drosos
Chief Executive Officer & Director, Signet Jewelers Ltd.

A

Hi Steve.

Michele Santana
Chief Financial Officer, Signet Jewelers Ltd.

A

Hi.

Virginia C. Drosos
Chief Executive Officer & Director, Signet Jewelers Ltd.

A

Good morning.

Stephen Lengel
Analyst, Needham & Co. LLC

Q

Good morning. Can you talk about gross margins for the underlying jewelry business? When you exclude the impact of credit in James Allen, how did margins perform and what is the outlook? Thank you.

Michele Santana
Chief Financial Officer, Signet Jewelers Ltd.

A

Yeah. So I think what we talked in terms of the prepared remarks what the drivers were in terms of the gross margin rate for the third quarter.

And then also in the prepared remarks, we gave you some commentary on how to think about the gross margin rate for the fourth quarter, part of those comments we did call out that James Allen which does have a lower gross margin rate, does have an unfavorable impact in terms of our gross margin.

Outside of that we don't get into talking in terms of jewelry or category gross margin rates.

Stephen Lengel
Analyst, Needham & Co. LLC

Q

Okay. Thank you. Can you also talk about the tax rate beyond this year? We understand it was supposed to be reset a little bit higher than this year's rate. But given credit outsourcing and other things going on, is there any way to provide a rough ballpark of how we could – how we can model that next year?

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Michele Santana
Chief Financial Officer, Signet Jewelers Ltd.
A

Yeah. So what I'd tell you and as I said when we do deliver our full year results in March that's when we'll really provide you the guidance and the outlook for 2020.

But going back to previous comments that we have made as it relates to our tax rate post our fiscal 2019 we've said that we expect that tax rate to move closer to the U.S. corporate tax rate of 21%.

Stephen Lengel
Analyst, Needham & Co. LLC
Q

Okay. Thank you very much.

Michele Santana
Chief Financial Officer, Signet Jewelers Ltd.
A

You're welcome.

Operator: Next question comes from the line of Oliver Chen with Cowen and Company. Your line is open.

Oliver Chen
Analyst, Cowen and Company, LLC
Q

Hi. Thank you. Regarding promotions and balancing promotions versus traffic, what would you say is the biggest opportunity in terms of the banners and the promotional levels over time?

And how do you expect this environment to evolve into next year? Kay was also impressive in terms of the sequential improvement. Would love your thoughts on what you're most encouraged about at Kay as well.

Virginia C. Drosos
Chief Executive Officer & Director, Signet Jewelers Ltd.
A

Hi, Oliver. So I'll take your questions in order. As you know we've been trying to moderate discounting while we've been improving our product offering, our marketing and our value equation across all of our banners.

But the Q4 is always a competitive quarter and we're seeing our competition especially department stores with increased discounting and layering of discounts. And so it's our desire to make sure that we stay competitive in the quarter and drive top line sales.

Now what I think is really moving in our favor is the repositioning of our brand banners to create more differentiation and help customers understand what we stand for, to build that trust relationship.

Secondly, really increasing the new product that we're bringing and building the brands that we have within our banners, strong Neil Lane focus in Kay, for example, strong Vera Wang in Disney focus within Zales is important in that mix. And then I think over time just making sure that we're getting the right targeting of our advertising and our media for gifting and for bridal within the mix.

Oliver Chen
Analyst, Cowen and Company, LLC
Q

Thank you. That's helpful. And then on the Kay side...

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Virginia C. Drosos
Chief Executive Officer & Director, Signet Jewelers Ltd.
A

Yes.

Oliver Chen
Analyst, Cowen and Company, LLC
Q

...what are some of the key factors that you're excited about? And would also love your thoughts on mobile given the tremendous traffic trends we're seeing in mobile at large. And what do you think your organization needs – James Allen is really ahead of the curve and you've done a really good job synergizing with those capabilities.

Virginia C. Drosos
Chief Executive Officer & Director, Signet Jewelers Ltd.
A

So we're encouraged by the stabilization in Kay. We'd attribute that to several things. One is of course coming out of the operational issues that we experienced with credit last year. We've done a lot of work over the course of this year to really improve those processes and get the right kind of training in place for our store associates. Beyond that we are encouraged by early signs on some of the new items that we've put into Kay. Some beautiful designs on the Love + Be Loved collection.

I mentioned some of the exciting things that we're bringing also on Neil Lane. So I think product is definitely playing a role in that. And then we have some of the highest scoring advertising that we've had for any of our brands on Kay this holiday season. And so we're feeling good about the messaging and how we focus that messaging. Even tonight you'll see some good NFL integrations coming on Kay.

We've really done some great work on leveraging our media spend in a more targeted and more differentiated way across our banners. But it will take some time. I think – this is a major transition – transformation that we're making. And so it's going to take some time to get all of the different levers right. But we've at least gotten some of those foundational ones in place for the fourth quarter and we'll continue to be agile about how we learn about that going forward.

In terms of mobile, that's been a key driver of our eCommerce trends. We saw some very strong results on eCommerce again in the third quarter which we're pleased about. We've been focused all year long on mobile as the key effort there. Faster load times, more curated shopping experience, more personalized pages. And we always are clear that we think that the combination of a strong eCommerce experience with our store footprint creates a competitive advantage of OmniChannel because we know that customers have an integrated shopping journey. They're back and forth between mobile and an in-store experience before they make their purchases especially in the bridal category.

But James Allen is exciting. I'll be attending our grand opening of our first store there tomorrow. It really is an incubator for us where we'll be testing a number of different digital innovation initiatives. And we'll continue the focus that we've had on being able to roll-out our James Allen technologies across our other banners because that's been a big positive for us in this fiscal year.

Oliver Chen
Analyst, Cowen and Company, LLC
Q

Thank you very much. Happy holidays.

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Operator: Your next question...

Virginia C. Drosos
Chief Executive Officer & Director, Signet Jewelers Ltd.

A

Thanks. Happy holidays.

Operator: And your next question comes from Brian Tunick with RBC. Your line is open.

Brian Jay Tunick
Analyst, RBC Capital Markets LLC

Q

Great, thanks and good morning. Was curious about the credit participation rate and the lower credit application trends and how much of an impact that had on your year-to-date or this quarter's comp trends. And just wondering, what are some proactive initiatives you can take to try to positively impact those metrics?

And then my second question would be on all the exciting OmniChannel initiatives you've been talking about, is there any review or updated view I guess, of the portfolio regarding the different banners? And maybe some idea of what you think the ideal store base should look like? And/or if you want to talk about maybe how store closings or lease obligations look for the next year or two. Thank you very much.

Michele Santana
Chief Financial Officer, Signet Jewelers Ltd.

A

Yes. So maybe I'll start with the first part of the question on the credit, and then Gina you can take the second part of the question. So in relation to the participation rate, as we said on our call that we did see a decline of 190 basis points, what I would say, Brian, is we are very pleased in the fact that one, we are able to offer the full spectrum of the payment plans that we've been talking about, that really do meet the variety of our customer needs.

We also spend a lot of time in the quarter that we noted on the call related to doing training with our store associates that I think was hugely received. And we just need to continue to build [ph] muscle (41:06) as it relates to the payment plans that we offer. When we think about the decline that we saw in the participation rate, I had also mentioned that the primary driver behind that was really the lower in-store application volumes, pretty consistent with the decline that we had solved pre-conversion. And we also had called out – we do expect some continuing headwinds as it relates to the application volumes associated with declining traffic trends in the store, as well as a shift between eCommerce and off-mall channels. Do you want to take the second part?

Virginia C. Drosos
Chief Executive Officer & Director, Signet Jewelers Ltd.

A

Yes. And I think on real estate, we continue to look at this as an OmniChannel customer experience, so optimizing our real estate store footprint at the same time we're really building up our mobile experience digitally. We have already announced that we're on track to close more than 200 stores in fiscal 2019. That comes on top of over 200 stores last year. So this has been a significant optimization effort. The closures that we have coming will be primarily mall-based, skewed to lower traffic C and D malls, and continuing to focus on exiting our regional banners. And the majority of those store closings will occur late in this fiscal year post holiday.

Brian Jay Tunick
Analyst, RBC Capital Markets LLC

Q

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And how about a prescriptive of the next few years from a store brand perspective. Or even for next year could we expect a similar amount of store closings?

Virginia C. Drosos
Chief Executive Officer & Director, Signet Jewelers Ltd.
A

We haven't guided to the store closings in fiscal 2020 yet. But definitely as part of Path to Brilliance, we remain very agile and focused on optimizing our OmniChannel experience, which means always taking a look at our real estate portfolio, making sure we think we've got the right number of stores in the right places, and testing new store footprints and experiences as well.

And that's one of the benefits that I mentioned of the James Allen is our ability to think about the future store experience that we think is right for our jewelry customers. We did say when we guided Path to Brilliance originally that we expect for our store count to be lower by the end of our three-year transformation than we will be in fiscal 2019.

Brian Jay Tunick
Analyst, RBC Capital Markets LLC
Q

All right. Super, thanks and good luck for the holiday.

Virginia C. Drosos
Chief Executive Officer & Director, Signet Jewelers Ltd.
A

Thank you.

Operator: Your next question comes from Simeon Siegel with Nomura-Instinet. Your line is open.

Simeon Avram Siegel
Analyst, Nomura/Instinet
Q

Hey Guys. Good morning and happy holidays. Gina, just given the comments on the promotional environment can you contextualize your view on AUR for 4Q and into next year?

I guess maybe touching on so you had the past two quarters of clearance you talked about 4Q promotions but then maybe any thoughts on De Beers pricing. And then you on the flipside mentioned bringing in premium diamonds.

So maybe just reflecting on that and maybe the path to stabilizing AUR, and then Michele, just recognizing the moving pieces within the credit and then the savings from Path to Brilliance just can you help us think through what SG&A dollars should grow in 4Q? And then any color you want to share into next year? Thanks.

Virginia C. Drosos
Chief Executive Officer & Director, Signet Jewelers Ltd.
A

Yeah. Hi Simeon thanks. So let me start with why transaction value is up in the third quarter despite clearance.

So number one, our average transaction value in North America was up about 4.5%. And this reflects the impacts of both our banner and our product mix.

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Beads were a large number of low-priced transactions in the prior year and our strategic decision to exit our owned brands beads provides a lift to our average transaction value when beads become a smaller percentage of that mix.

I also mentioned that we're seeing trends and strong sales in gold across our lines as we're replacing beads with gold as the key fashion category and up-weighting our diamond offerings in our stores, larger carat weights, more fancy stones. That has an impact. And bridal sales were up in the quarter. So the combination of those two things gave us a higher ATV in the quarter.

I'd also comment that as we talked about the unfavorable impacts that we see in the fourth quarter, one of those is revenue recognition on our ESP, another is our UK performance that's a bit weaker driven by a tough macro consumer environment there, slower growth on James Allen and the North America's competitive environment is meaningful but it's less than half of the revision that we're talking about.

So hopefully that gives you some context.

Michele Santana
Chief Financial Officer, Signet Jewelers Ltd.
A

The only thing I'll add on to that, Simeon, and then I'll answer your SG&A question. I think as part of your question you had asked about the De Beers action.

And it really – the very low quality of diamonds that are subject to that – to those pricing actions. It's just not material to our part of the assortment. And then in terms of I think what you were looking for was maybe some additional direction on SG&A in Q4 if I understood the question. So...

Simeon Avram Siegel
Analyst, Nomura/Instinet
Q

Yeah please.

Michele Santana
Chief Financial Officer, Signet Jewelers Ltd.
A

...we do expect SG&A to be higher year-over-year in the fourth quarter. We expect to see higher year-over-year advertising. Consistent with what we've been discussing this past year. We do expect to see higher year-over-year incentive compensation expense with more of that annual increase in incentive comp that is booked in Q4 just given the level of revenue and profit generation that occurs in the fourth quarter it's more heavily weighted there.

That also does incorporate the impact of cost related to our – to the non-prime credit outsourcing. And I think if you go back in the release you can also see how we've guided that impact in total for Q4.

And then the last thing I would call out as you think about SG&A is again some of those higher costs that we're talking about will be partly offset by transformation cost savings, as well as the lack of a 53rd week this year.

Simeon Avram Siegel
Analyst, Nomura/Instinet
Q

Okay. Thanks a lot guys, best of luck for the holiday.

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Michele Santana
Chief Financial Officer, Signet Jewelers Ltd.
A

Sure. Thank you, Simeon.

Virginia C. Drosos
Chief Executive Officer & Director, Signet Jewelers Ltd.
A

Thank you, Simeon.

Operator: Your next question comes from Lorraine Hutchinson with Bank of America. Your line is open.

Lorraine Corrine Hutchinson
Analyst, Bank of America Merrill Lynch
Q

Thanks. Good morning. Could you just provide some more context around the James Allen sales slowdown. What you saw in the states that have implemented the sales tax? And then any initiatives that you have in place to try to bring that business back up to the growth rate that you had initially expected?

Virginia C. Drosos
Chief Executive Officer & Director, Signet Jewelers Ltd.
A

Sure. I'll start on that and Michele...

Michele Santana
Chief Financial Officer, Signet Jewelers Ltd.
A

Sure.

Virginia C. Drosos
Chief Executive Officer & Director, Signet Jewelers Ltd.
A

...you can fill in any details. So during the third quarter we began to implement sales tax in a number of markets. This, of course, comes out of the Wayfair decision and so we're pursuing that on James Allen as we should. And we're testing a variety of customer initiatives and sales growth actions at James Allen as we implement this sales tax collection. We've also been very clearly keeping track of the impact that we think that's having on sales in markets where our competition has also implemented sales tax already and where they haven't, as well as how consumers are thinking about online sales on James Allen or other online retailers relative to brick-and-mortar. So we're taking a very holistic view of it.

And in the third quarter we started collecting sales tax in an additional 24 states, such that by the end of the third quarter, sales tax was being collected in states representing about 50% of our revenues. We'll continue to rollout that sales tax collection over the next couple of quarters and make sure that we are understanding what – which of the initiatives that we're putting in place are having the best customer impact. So we remain positive about the future outlook for James Allen. And we are continuing to leverage all of the digital innovation coming out of James Allen across the rest of our banners as well.

Lorraine Corrine Hutchinson
Analyst, Bank of America Merrill Lynch
Q

Thank you.

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Virginia C. Drosos
Chief Executive Officer & Director, Signet Jewelers Ltd.

A

Sure. Thank you.

Operator: Your next question comes from Ike Boruchow with Wells Fargo. Your line is open.

Ike Boruchow
Analyst, Wells Fargo Securities LLC

Q

Hi. Good morning, everyone. Happy holidays. Two questions. First one on the gross margins for holiday, appreciate, Gina, the information you gave about the competitiveness of the department stores and whatnot. Just kind of curious maybe, Michele, is there any color you can give us on the gross margin line explicitly for Q4? You were really helpful for Q3 bucketing all the impacts. Just some help on how to think about how those promotions maybe impact the gross margin line? And any of the other buckets we should be modeling for Q4?

Michele Santana
Chief Financial Officer, Signet Jewelers Ltd.

A

Yes. So I guess some color in terms of how to think about the gross margin in the fourth quarter. All-in, we do expect the gross margin rate to improve on a year-over-year basis in the fourth quarter. Consideration that we'll be impacting that rate on a positive basis, we'll no longer be recognizing the bad debt expense. That also when we think about our gross margin rate for the fourth quarter with it being up year-over-year does take into consideration the promotional environment that Gina was talking about as well as the banner and channel mix that we do see as being headwinds.

But discontinuation of credit insurance, we've been talking about that for a few quarters. That is fully lapped in Q4. So we don't see any impact year-over-year on the gross margin rate associated with that. The other thing that we've been discussing impacting the gross margin rate is James Allen. So we do expect that to – will continue to have a lower gross margin rate versus our other core banners. But as you would expect the impact on the total gross margin will be smaller in the fourth quarter versus previous quarters as we'll now have fully lapped the acquisition date.

Clearly what I would also add is I wouldn't be looking at the Q4 gross margin rate increase year-over-year to be as high as what we just went through in terms of our Q3 results. Keep in mind, bad debt will not as big of a driver in that rate in Q4 as what we saw in Q3. So hopefully that gives you some additional color.

Ike Boruchow
Analyst, Wells Fargo Securities LLC

Q

Yeah, that helps, and then just two quick follow-ups to that question. Should there be clearance sales benefits to comp in Q4 that we should be thinking about? And then is the promotional commentary is that broad-based? Or since you're mentioning department stores, is that more of a Kay and a Zales consideration relative to Jared?

Michele Santana
Chief Financial Officer, Signet Jewelers Ltd.

A

Yeah. So in terms of clearance, and we're not going to provide the levels but what I would tell you is that there's always some level of clearance that's in our business, including the fourth quarter. We do expect clearance to be higher than last year's fourth quarter. And that's just embedded in the estimate of the sales guidance and the EPS

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guidance that we provided as well as the gross margin commentary that we've just talked about. And promotional environment I'd just think that as broad across the banners.

Ike Boruchow
Analyst, Wells Fargo Securities LLC

Q

Okay. Thanks Michele, I appreciate it.

Michele Santana
Chief Financial Officer, Signet Jewelers Ltd.

A

Sure. You're welcome, Ike.

Operator: Your next question comes from Omar Saad with Evercore ISI. Your line is open.

Omar Saad
Analyst, Evercore Group LLC

Q

Thanks for taking my question. I wanted to follow-up on some of your comments about faster design, more newness product introduction across the different banners. Maybe elaborate on how fast you can get products and designs to market? How you often you can introduce new product collections? And maybe how you're approaching the different banners differently as you build out these capabilities and skill set around it. And any anecdotal signs that these efforts are resonating with the consumer would be really helpful too if there's a greater response to newness. Thanks.

Virginia C. Drosos
Chief Executive Officer & Director, Signet Jewelers Ltd.

A

Sure. So, one of the things that we've really put in place over the last year is enhancement in our in-house design team. I mentioned, I think maybe in our second quarter call that we've brought on a new chief merchant to help lead our efforts both in working externally with vendors, but also in creating our own designs. And we also have created a system where we're very consumer-led on looking first at trends, interpreting those trends, and then developing designs that we think will really capture our customers' hearts and minds regarding that trend.

So a good example on the trends would be the Love + Be Loved collection. It's really well targeted to Kay's banner positioning, which is all about celebrating meaningful relationships. It's a design that represents two lives kind of entwined together. Very sleek modern-looking design developed by our in-house design team and developed in about, say, five months from the initial testing and qualification of that concept through to execution in the marketplace. So this consumer-led approach is allowing us to go a bit faster.

We've also really stepped up our work with our partners. That's why we have such good new product on Vera Wang both in fashion and bridal this holiday season as well as Disney, which has really been a success driver for Zales. So there's product on both bridal and fashion in both of those. And then I think in Jared and those made by the way a lot of sense for Zales given the positioning to a more style-oriented customer.

And then in Jared, we've done a lot of work on our diamond value proposition and really making sure that we have premium high-quality designs, unique designs, certainly capturing the customer trend toward more customization and uniqueness.

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So Jared is really playing in a distinctive place there with a lot of the new product that we've put in. But in general that new product has been higher, more driven by trends, higher level of qualification with customers and faster speed to market from the initial idea through to actually seeing it in-stores.

Omar Saad
Analyst, Evercore Group LLC
Q

That's really helpful. Can you give us a sense maybe of how the mix has shifted for a few years ago to today how much more you account in that kind of newness category? Is that quantifiable?

Virginia C. Drosos
Chief Executive Officer & Director, Signet Jewelers Ltd.
A

Yeah. So it's up from call it in the 20s as a percentage of our sales to now over 30% of our sales given the newness that we've been able to put in and that is as expected based on our customer testing results. We've got some exciting product in our stores now.

Omar Saad
Analyst, Evercore Group LLC
Q

Thanks for your help. Good luck for holidays.

Virginia C. Drosos
Chief Executive Officer & Director, Signet Jewelers Ltd.
A

Thank you.

Operator: Your last question comes from Paul Lejuez from Citigroup. Your line is open.

Paul Lejuez
Analyst, Citigroup Global Markets, Inc.
Q

Hey thanks guys. For a couple of quarters now you mention a benefit to comps from incremental clearance sale. I'm just trying to understand how you use that term incremental? Is that relative to last year? Is it relative to your plan?

Or is it a certain type of promotion that when we use that promotion, it falls into that category of incremental? And also curious if you could talk about what percent of your fourth quarter is already behind us versus what lies ahead? Thanks.

Michele Santana
Chief Financial Officer, Signet Jewelers Ltd.
A

So Paul, maybe I'll start. In terms of your clearance question, it is – when we speak to incremental, it's incremental over last year period.

We talked about this – I think in the [ph] Q3 (57:36) call. But as we think about is those amplified clearance levels which we did say in [ph] Q3 (57:42) was lower than what it was in the second quarter.

It really, it goes back to part of our merchandising strategy that we're working to increase the newness, to refocus our product portfolios, it's all of the bridal, fashion things that Gina has been talking about that we're trying to do with our product assortment.

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We will always have a certain level of clearance in our business. But we did make the decision to add incremental clearance to accelerate our strategy on the newness side and free up store space. Your second question was on.

Paul Lejuez
Analyst, Citigroup Global Markets, Inc.

Q

November as a percent of the...

Michele Santana
Chief Financial Officer, Signet Jewelers Ltd.

A

Oh! Oh! Yes.

Paul Lejuez
Analyst, Citigroup Global Markets, Inc.

Q

...total fourth quarter versus what lies ahead.

Michele Santana
Chief Financial Officer, Signet Jewelers Ltd.

A

Yeah, yes. What I said we don't break it out in terms of percentage. I believe in my prepared remarks I made the comment that December is the largest month of the quarter in the fiscal year. But we don't provide the percent of the month.

Paul Lejuez
Analyst, Citigroup Global Markets, Inc.

Q

Got you. And on that, you said the third quarter impact from clearance sales was less than 2Q what's the plan for 4Q relative to 3Q? Should we expect a lower benefit from clearance sale?

Michele Santana
Chief Financial Officer, Signet Jewelers Ltd.

A

Yeah. So as you would expect we're not quantifying it Yeah. So as you would expect we're not quantifying it because it's all factored into our guidance. It goes back to there's always some level of clearance that we do have in our business.

I did mention earlier I think there was a question on this, that we do expect clearance to be higher than last year's fourth quarter. But as we said, Paul, it's all reflected in our guidance that we provided.

Virginia C. Drosos
Chief Executive Officer & Director, Signet Jewelers Ltd.

A

I think it's also dependent on how customer shopping trends evolved throughout the quarter. We have a great mix of full priced product, as well as clearance product in our stores. And we'll see how customers gravitate.

Paul Lejuez
Analyst, Citigroup Global Markets, Inc.

Q

Are there any particular categories that have been the driver of those clearance sales?

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Virginia C. Drosos
Chief Executive Officer & Director, Signet Jewelers Ltd.
A

No, I wouldn't call out any particular category.

Paul Lejuez
Analyst, Citigroup Global Markets, Inc.
Q

Okay. Thanks guys. Good luck.

Michele Santana
Chief Financial Officer, Signet Jewelers Ltd.
A

Thank you.

Virginia C. Drosos
Chief Executive Officer & Director, Signet Jewelers Ltd.
A

Thank you.

Operator: And this does conclude today's conference call. You may now disconnect.

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