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Signet Jewelers Ltd. (SIG)

Q4 2020 Earnings Call

CORPORATE PARTICIPANTS

Virginia C. Drosos

Chief Executive Officer & Director

Joan Holstein Hilson

Chief Financial Officer

OTHER PARTICIPANTS

Lorraine Hutchinson

BofA Securities, Inc.

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Tracy Kogan

Citigroup Global Markets, Inc.

MANAGEMENT DISCUSSION SECTION

GAAP AND NON-GAAP FINANCIAL MEASURES

- During the call, Signet will discuss certain financial measures not presented in accordance with generally accepted accounting principles, otherwise known as non-GAAP measures
- These non-GAAP measures include operating income, effective tax rate, and EPS
- For future discussion of the non-GAAP financial measures, as well as reconciliations of the non-GAAP financial measures to the most directly comparable GAAP measures, investors should review the news release posted on Signet's website at www.signetjewelers.com/investors

Virginia C. Drosos

Chief Executive Officer & Director

BUSINESS HIGHLIGHTS

Opening Remarks

- Before I discuss our fourth quarter and FY2020 performance, I would like to address the COVID-19 outbreak
- On behalf of the Signet Board of Directors, executive team, and all of our Signet team members, our hearts and prayers go out to all who have been impacted by the COVID-19 global pandemic
- We greatly appreciate all who are caring for those in need, especially the many healthcare professionals on the frontlines

- I'm also thankful to our team members who are demonstrating remarkable compassion, commitment, and courage during this crisis
- In this rapidly evolving environment, we have been making decisions in real-time, prioritizing the health and safety of our team members and customers, and taking bold actions to ensure the long-term sustainability of our business

Transformation

- With that in the forefront of our minds, it's difficult to transition to a discussion of fourth quarter business results
- However, we believe it's important to share how the business performed prior to seeing impact from the COVID-19 pandemic, the actions we have taken since, and how we're positioning our company for when the nation begins to emerge from this crisis
- The environment we're operating in today underscores the importance of Signet's transformation into a more agile and efficient organization
- As you've seen from our announcement earlier this week, we have moved quickly and aggressively to strengthen Signet's financial flexibility

Discretionary Spend

- We are focused on substantially reducing discretionary spend in areas that our customers do not see or care about, as well as driving marketing efficiencies through enhanced digital presence and targeting using advanced data and analytics
- Additionally, given the temporary closure of our stores, we are implementing reduced work hours, furloughs, and reduced compensation across store and support center teams
- As part of this, our top leaders and I have taken a voluntary 50% base salary reduction, and other leaders have taken significant reductions too
 - Half of this will be replaced with equity grants
- The Board of Directors has reduced its retainer fees by 50% and agreed to be compensated entirely in the company's common shares

Emergency Relief Fund

- Many of us have also contributed a portion of our bonuses to an emergency relief fund established to help our colleagues in need
- Our Signet team is in this together, and I have confidence we will emerge as an even stronger united team and company
- Since we do not have visibility into the duration of this crisis and the related economic impact, in addition to expense reductions, we are temporarily suspending our cash dividend and have elected to pay the May quarterly dividend on the preference shares in kind rather than in cash
- We also aggressively reduced planned CapExs

Digital Investments

- Within this lower spend, we are prioritizing digital investments and our flexible fulfillment initiative
- Recall that over the past two years, we successfully transitioned our banners to the hybrid eCommerce platform, enabling much faster speed, curated search, and product visualization using high-quality imaging

- We also made important investments in our mobile experience and custom configurators to allow customers to personalize and even design their own jewelry
- All of this improves the experience of our online purchaser as well as the browser, who starts their journey online and will eventually purchase in one of our brick-and-mortar stores
- To achieve immediate eCommerce impact, we are focused on enhancing search and browse, easier checkout, and even more advanced custom design capabilities to create an optimized and frictionless shopping experience for customers

Flexible Fulfillment Initiative

- We are also continuing to implement our flexible fulfillment initiative, which unlocks store-level inventory, allows us to optimize across our network through a single view, improves our product assortment by store, and enhances the customer experience with buy online, pick up in store available this holiday
- Very importantly, we believe we are effectively managing through the present disruption
- At the same time, we are working to accelerate our transformation through acutely focused investments to build Signet's future

Key Strategies

- We've made progress over the past two years on our Path to Brilliance transformation and are galvanized around three key strategies: number one, Customer First; number two, Omni-channel; and number three, building a culture of agility and efficiency
- Our results in Q4 demonstrate that these strategies are working
- So while there is considerable disruption today, we believe we have built a strong foundation and the resiliency and capabilities to emerge as a stronger company with enhanced competitive advantage

Q4 and FY2020 Results

SAME-STORE SALES GROWTH, OPERATING INCOME AND FCF

- Now turning to our fourth quarter and FY2020 results as well as color on our performance entering FY2021, our fourth quarter results were better than anticipated, and we ended the year strong, with our best overall holiday business performance in four years
- Our team delivered fourth quarter same-store sales growth of 2.3% and generated double-digit growth in eCommerce
- We delivered 0.6% same-store sales growth for the FY and exceeded our cost savings target for the year, achieving an expense reduction of approximately \$100mm
 - All of this drove strong non-GAAP operating income, up 16%, and FCF of \$419mm for the FY

FY2021

- The momentum we experienced during the holiday season continued as we entered FY2021
- We had a strong Valentine's Day selling season with customers reacting favorably to our product newness, customer experience innovations, and our always-on approach to marketing
- March performance to-date reflects the increased impact of the COVID-19 pandemic, which led us to close all of our retail store locations earlier this week
 - In a time like this, we all know that celebrating those you love is important
- To effectively serve our customers, our team is being agile and innovative

- Given our size and scale, there are things we are doing right now to drive relevance and deliver our company mission to help customers celebrate life and express love

Providing our Expertise

- Here are three themes we are actively focused on to put innovation into action and meet our customers where they are
- First, providing our expertise
- Our customers often want advice before making their final decision
- Across all of our banners, our level of personal service, especially today, is one of our strongest differentiators
- So we're leveraging the expertise of our digitally native banner, jamesallen.com, to rapidly advance our online selling assistance tools across all of our banners
- We've enhanced our live chat capability and trained hundreds of our customer care and in-store jewelry experts, who are now working from home to provide their expertise virtually

Omni-Channel

- Secondly, bringing the best of our stores to our customers with Omni-channel
- We are hosting virtual special events, including for Mother's Day, hosting video chats, and empowering our team members to be social ambassadors
- We have also rapidly added to our online inventory from store stock to be ready to meet all customer needs

Customer Value

- And third, giving customers an excellent value
- We know that given current and future economic uncertainty, our customers are even more value-conscious
- We believe our excellent vendor relationships, sourcing capability and scale allow us to make sure we are providing high-quality jewelry at a great value
- All in all, the team is working to support our customers' desire to celebrate love, especially now online
- Our team members across the country are delivering our mission in new and innovative ways

CLOSING REMARKS

- In closing, our team delivered strong results in Q4 and FY2020
- As we navigate the current uncertainty, we are leveraging the strong foundation we have built over the past two years of our Path to Brilliance transformation
- Importantly, we have acted immediately to build additional financial flexibility during this disruption
- We also believe that our transformation strategies are working, and we are acutely focused on the key priorities that will most enable our future growth

Joan Holstein Hilson

Chief Financial Officer

FINANCIAL HIGHLIGHTS

Opening Remarks

- In my remarks, I'll first cover the highlights of our fourth quarter and FY2020 financial results, move on to the actions we are taking to conserve cash while our stores are closed due to COVID-19, and then conclude with a discussion of our credit facilities
- The cumulative progress we have made is evident in our strong holiday quarter and full-year FY2020 financial results

Same-Store Sales, Operating Profit, SG&A and Gross Margin

- Fourth quarter same-store sales grew 2.3%, with double-digit growth in eCommerce as well as brick-and-mortar same-store sales growth
- Non-GAAP operating profit grew 12% in the quarter, driven by higher gross margin as well as lower SG&A expense on a dollar and percentage of sales basis
- Fourth quarter gross margin and SG&A each benefited from strong transformation cost savings
- SG&A in the quarter also benefited from lower advertising spend that delivered higher impressions and lower staff costs, inclusive of a smaller store base
 - These SG&A benefits were somewhat offset by higher incentive compensation y-over-y as a result of positive sales and profit performance

Operating Profit, Interest Expense and EPS

- GAAP operating profit includes a charge of \$33mm related to the company cash contribution portion of the settlement of a previously disclosed shareholder litigation, which will be described in our Form 10-K filing
- The settlement is \$240mm with approximately \$205mm expected to be paid with proceeds from insurance policies the company has in place
 - The settlement is subject to court approval
- Interest expense declined 29% y-over-y in the quarter as a result of lower debt balances as well as the benefit of lower interest rates post our September 2019 refinancing
- Fourth quarter non-GAAP EPS was \$3.67 compared to prior-year non-GAAP EPS of \$3.96, as the benefit of higher operating profit and lower interest expense was more than offset by a higher tax rate

Full Year FY2020 Results

SAME-STORE SALES, REVENUES, OPERATING PROFIT, MARGIN AND SG&A

- For the full year FY2020, same-store sales grew 0.6%, with double-digit growth at James Allen and Piercing Pagoda. eCommerce grew 10% y-over-y and accounted for 12.2% of sales, up from 10.9% in the prior year, and more than doubling as a percentage of sales over the last three years
- FY2020 revenues declined 1.8%, driven by a smaller store base
- FY2020 non-GAAP operating profit grew 16% to 5.2%, with gross margin expansion and SG&A leverage delivering non-GAAP operating margin improvement of 80BPS
- Operating profit performance was driven by transformation cost savings, lower staff costs inclusive of closed stores, somewhat offset by slightly higher advertising and higher levels of clearance

COST SAVINGS AND FCF

- We delivered \$100mm in net cost savings in FY2020, with a portion of the gross savings reinvested in technology and innovation initiatives to drive growth
- Gross savings were primarily driven by procurement, workforce optimization, and lower corporate costs
- Our cost savings efforts have achieved \$185mm in savings in the first two years of our Path to Brilliance transformation plan
- We expect to continue to have a strong focus on cost savings in FY2021
- However, given uncertainties around COVID-19, we will not be providing a cost savings outlook for year three of the transformation at this time
- Higher operating profit together with improved working capital management resulted in FCF of \$419mm, up \$300mm y-over-y on an adjusted basis, which excludes the non-prime credit proceeds in the prior year

Operating Expense and CapEx Reductions

- Now I'll discuss the actions we are taking to navigate the current environment and the unknown duration of the impact of COVID-19
- We are taking immediate actions to increase financial flexibility through operating expense and CapEx reductions
- As Gina mentioned, the Board of Directors has elected to suspend our common dividend and pay the May quarterly dividend on the preference shares in kind
- With respect to operating expenses, we substantially reduced our marketing spend while continuing targeted digital campaigns to support eCommerce operations as well as actively addressing all discretionary corporate spend

Voluntary Reductions and Equity Grants

- Our executives and Board of Directors have taken voluntary reductions in compensation
- Half of the forgone base salary will be replaced with equity grants
- We are also implementing actions across store and support center teams
- We have reduced planned CapExs by more than 50% vs. prior year and are prioritizing initiatives that continue to support our eCommerce channel

Inventory Management

- Additionally, inventory management remains a strategic priority for the company
- We have developed strong inventory management disciplines over the last year, which we believe will enable us to manage our inventory in a more agile way across channels
- These capabilities include store allocation tools that were piloted in Q4 last year, leveraging artificial intelligence for just-in-time loose diamond replenishment, and life cycle management
- We've also embarked on a full review of our inventory-related store policies
- Thanks to the strong relationships we have with our vendor partners, we have significantly reduced merchandise receipts, while maintaining flexibility to ensure appropriate levels of newness to support holiday later this year

Real Estate Portfolio

- With respect to our real estate portfolio, we expect to further reduce our store footprint as we continue to optimize our physical presence to a smaller, higher growth potential store base that delivers a fully connected Omni-channel journey
- We are reducing our presence in declining malls, while planning to selectively reposition certain stores to our small locations
- However, due to the potential longer-term impact of COVID-19, we will be closely analyzing the health of every location in our fleet and evaluating where we believe the market potential has been impaired

Liquidity

- Turning to liquidity
- As previously announced, we refinanced our credit facility in September of 2019
- Our debt now consists of an asset-based credit facility and senior unsecured notes, both of which are due in 2024
- We have no scheduled principal payments under these facilities until they mature in 2024
- In order to strengthen our financial flexibility, we accessed an additional \$900mm on our asset-based facility on March 19
 - As of the date of this drawdown, we had more than \$1.2B in cash on hand and an additional \$292mm available on this facility
- The asset-based revolving credit facility is subject to a fixed charge coverage ratio if availability under the facility falls below 10% of the borrowing base or \$100mm, whichever is higher
- The most recently reported borrowing base under this facility is approximately \$1.4B
- Additionally, the senior unsecured notes due in 2024 are not subject to financial covenants

Non-Prime Credit Offering

- Now I would like to briefly discuss our non-prime credit offering
- In June of 2018, we entered into a five-year agreement under which CarVal Investors and Castlake LP would purchase 70% and 30%, respectively, of our non-prime receivables related to our private label credit offering
 - These non-prime sales currently represent approximately 7% of Signet annual sales in the prior year
- As we disclosed in our December Form 10-Q, the net yield on these receivables has fallen below the minimum yield under the agreement, which gave the investors the right to terminate the agreement as of December 31, 2019

CarVal's Termination

- As you will see in our 10-K filing, on March 23, 2020, CarVal provided notice to the company that it was terminating the agreement effective the same day
- In the notice of termination, CarVal stated that it is willing to provide a 30-day purchase facility at substantially the same terms as the terminated agreement, but for a fixed term of 30 days from March 23, 2020
- Signet is in discussions with CarVal regarding such transition agreement
- Castlake has informed Signet that subject to their reservation of right to terminate, they do not currently intend to terminate their agreement

- On March 25, 2020, Castlake and Signet entered into a nonbinding memorandum of understanding regarding the parties' shared interest in a potential definitive agreement, whereby Castlake would purchase 100% of the funding obligations on the forward flow and add-on purchases on a go-forward basis
- Importantly, our servicing arrangement with our partner, Genesis Financial, remains in place
- We believe that CarVal's termination will not have a material adverse impact on our Signet's financial condition, and we'll provide an update on our partner arrangements when these discussions are completed

CLOSING REMARKS

- Finally, I'd like to mention that we will not be providing fiscal or first quarter 2021 guidance due to the current uncertainty in the market
- Be assured that our leadership team and team members at every level of our organization are resolutely focused on generating cash to maintain financial flexibility in this fluid environment

QUESTION AND ANSWER SECTION

Lorraine Hutchinson

BofA Securities, Inc.

Q

Thanks for the update on the credit business. So non-prime is 7% of your sales. Can you talk about the breakout of the rest of the sales between prime, and then also the other financing, the rent-to-own financing that you've offered?

Joan Holstein Hilson

Chief Financial Officer

A

Thanks for the question, Lorraine. We haven't disclosed the breakout of those. But what I can tell you is that the leasing aspect of our business is something that's been growing over the past year, and our customer has responded to that. One of the things that we are looking forward to doing is moving to offering that online at some point in the coming year.

Lorraine Hutchinson

BofA Securities, Inc.

Q

Okay. And then any help on how the terms will change now that CarVal is stepping out and Castlake is taking over the rest of the portfolio, how we should be thinking about the discount that they're paying for the receivables on a go-forward basis?

Joan Holstein Hilson

Chief Financial Officer

A

Lorraine, as I mentioned that we are in process of negotiating that MoU with – we have a memorandum of understanding with Castlake at this time, but we haven't disclosed the MDR rate. The arrangement with CarVal for the next 30 days is substantially under the same terms of the existing agreement.

Lorraine Hutchinson

BofA Securities, Inc.

Q

Okay. And then if we look at the prime offering, have you heard at all from your partners there on any changes to their appetite to finance jewelry purchases?

Joan Holstein Hilson

Chief Financial Officer

A

Lorraine, not at this time. Our relationship and partnership with our other providers are very strong, and we look forward to working with them throughout this crisis and once we emerge.

Tracy Kogan

Citigroup Global Markets, Inc.

Q

I had two questions. The first is on the mall vs. non-mall stores. I was wondering what the performance was this past quarter between those different groups of stores. And then if you could, just remind us at year end after your closings where you stood with mall vs. non-mall?

And then just on the Castlake agreement, do you expect the customer – will this all be seamless to the customer? I know you've had some issues before rolling out when you had the new deals, so I just wanted to understand if the customer would feel any difference.

Joan Holstein Hilson

Chief Financial Officer

A

Thanks for the questions, Tracy. With respect to the service provider, as I mentioned, Genesis is continuing and we have a very strong relationship with them. We expect this transition to be with little to no disruption, and our customers should not experience any real noticeable change.

Virginia C. Drosos

Chief Executive Officer & Director

A

And then hi, Tracy, it's Gina. Just to address your first question on mall vs. non-mall, as we've discussed in previous calls, we continue to see stronger performance in our off-mall location vs. malls. We did see in Q4 that our Signet banners continued to perform and drive traffic ahead of other retailers based on ShopperTrak data. So we believe our always-on marketing approach is working to drive a higher level of traffic, but still a traffic decline in malls and less traffic there than on malls (sic) [off malls].

The good news in the holiday season was that thanks to our terrific team and also having great merchandise on hand, we had much stronger closure. And so therefore, we saw transactions up in both mall and off-mall locations.

Tracy Kogan

Citigroup Global Markets, Inc.

Q

And then what was the split between mall and off-mall at year end?

Virginia C. Drosos

Chief Executive Officer & Director

A

If you think about Kay as an example, Kay has roughly 290 off-mall – there's a different breakout of off-mall, Tracy. But when you think about it, there's like 500 off-mall between outlet, hometown, out of 1,200 stores, which is the largest – Kay is the largest composition of off-mall in the fleet.

Joan Holstein Hilson

Chief Financial Officer

A

Other than Jared, of course, which is fully in off-mall locations.

Virginia C. Drosos

Chief Executive Officer & Director

A

Yes.

Ike Boruchow

Wells Fargo Securities LLC

Q

My first question is – I know there's no guidance, but maybe just at a high level, Gina or Joan, could you talk about the eCommerce performance that you're seeing? I'm just kind of curious how eComm is holding up during a time when we know that stores are generally closed across the country, just directionally, how we should think about that channel? Is there growth? Is it slowing down? Is it accelerating? Just again, any color would be kind of helpful.

Virginia C. Drosos

Chief Executive Officer & Director

A

Sure. Hi, Ike. Thanks for calling in today. We've seen continued growth in our eComm business. If I just kind of go back to Q4 for a minute, we were up 15%, and we've been steadily growing our share of sales in eComm, so now up to almost 14% of sales. And you'll remember just even a few years ago, it was only around 5%. So we've been continuing to add to that customer experience.

What we're doing now is really trying to bring the best of our stores to that eCommerce environment. So I mentioned in my script some of the new tools that we're putting for virtual selling. And just as a great example, as Jared ramped that up this week, in the first couple of hours, we had 37 customers served by five jewelry consultants in different parts of the country working from home and the report was really good.

So we think we'll have new tools coming online that will be helpful. We're also making sure we have great value online right now. So we're seeing some strengths in our eComm business at this time, but I think the jury's out, of course, on where all this will head. But we are prepared based on everything we've been doing over the last couple of years and introducing new capabilities as we go.

Ike Boruchow

Wells Fargo Securities LLC

Q

Got it. For Joan, just curious on the balance sheet. When I'm looking at the ending balance sheet for Q4, your accrued expenses jumped up by about \$200mm. Can you just talk to us about what's going on there? It just seems a little odd relative to the prior years of how that line item would move. Just in that accrued expense line, what exactly is kind of going on right now?

Joan Holstein Hilson

Chief Financial Officer

A

Ike, I can work through the detail of that. But generally speaking, as we look at the timing and just the close of the year-end, it's really about timing of specific payments at the end of the year and where the year cut off.

Ike Boruchow

Wells Fargo Securities LLC

Q

Okay. And then my last one again for you, Joan. Correct me if I'm wrong, but I think that you guys have a 2.5 times levered debt covenant, debt to EBITDA. If retail's going to remain under heavy pressure for a prolonged period of time, I know you guys don't know, we don't know, nobody knows. But if that's going to take place, it looks like you guys might end up tripping that. And I guess I'm just trying to understand how are you thinking about that possibility, what does that exactly mean. Just how do we think about – how to think about potential trip to the debt covenant on the balance sheet?

Joan Holstein Hilson

Chief Financial Officer

A

Yeah. As I mentioned in my remarks, our credit affiliate's subject to a fixed coverage ratio if the availability under the facility falls below the 10% of the borrowing base or the \$100mm, whichever is higher. And the unsecured notes are not subject to financial covenants. So at this point, we're not in that position. So the fixed coverage ratio only applies if the facility falls below 10%.

Virginia C. Drosos

Chief Executive Officer & Director

CLOSING REMARKS

- Again, on behalf of our whole team here at Signet, our hearts and prayers are with all those who are impacted by this COVID-19 pandemic and especially our investor base, many of you in New York, which is a tough time right now
- So we appreciate you calling in today and being part of this with us. Take care, everyone, and stay safe

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