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GCO - Q2 2018 Genesco Inc Earnings Call

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PRESENTATION

Operator

Good day, everyone, and welcome to the Genesco Second Quarter Fiscal 2018 Conference Call. Just a reminder, today's call is being recorded.

Participants on the call expect to make forward-looking statements. These statements reflect the participants' expectations as of today, but actual results could be different. Genesco refers you to this morning's earnings release and to the company's SEC filings, including the most recent 10-Q filing, for some of the factors that could cause differences from the expectations reflected in the forward-looking statements made during the call today.

Participants also expect to refer to certain adjusted financial measures during the call. All non-GAAP financial measures referred to in the prepared remarks are reconciled to their GAAP counterparts in the attachments to this morning's press release and in schedules available on the company's homepage under Investor Relations.

I will now turn the call over to Mr. Bob Dennis, Genesco's Chairman, President and Chief Executive Officer. Please go ahead, sir.

Robert J. Dennis - *Genesco Inc. - Chairman, President & CEO*

Good morning, and thank you for being with us. I'm joined today by our Chief Financial Officer, Mimi Vaughn. The second quarter proved to be a bit more challenging than we expected, with positive momentum from Journeys, offset by increasing headwinds at Lids. In addition, the consumer shift in shopping away from stores to digital continued at a faster pace and, thus, with a more pronounced impact on our results than we anticipated.

Consolidated comparable sales were flat towards the low end of our guidance range, with stores down 2% and direct up 30%, which included strong double-digit comps in almost every business. The flat comp pressured profitability in what is typically our lowest volume quarter as our teen customer gets out of school and customers in general turn their attention to summer activities rather than shopping. The "buy now, wear now" mindset for our teen shoppers has also shifted back-to-school later, which means out of July and the end of the second quarter and into August and September.

Adjusted EPS came in at a loss of $0.10, a little below our forecast. $0.02 of this loss was due to a change in accounting for a Software-as-a-Service system implementation, which wouldn't have impacted the quarter's bottom line under the old accounting treatment. Mimi will provide a bridge to last year's results in a moment, but let me first walk through the highlights and the headwinds of our second quarter performance.

To start, we were pleased with the positive sales trends in our teen and young adult fashion footwear businesses on both sides of the Atlantic. Journeys' comps improved significantly on a sequential basis, turning positive, compared with down 5% in the first quarter. The Journeys team has adjusted its assortment in response to the intense fashion shift that emerged at this time last year. The new product is outperforming our expectations and in the second quarter more than offset the decline in the core brands that previously had been driving the business.

Importantly, Journeys' comps have gotten even more positive as we moved into Q3 in the heart of back-to-school. August was the fifth consecutive month of positive comp sales and the strongest to date. What was most exciting about August was the positive traffic trend in our stores, with traffic up year-over-year.

With most of back-to-school behind us, we are enthusiastic about the results we have seen both in stores and online and the trajectory of the Journeys business. We believe we are well positioned from a merchandise standpoint to build on this top line momentum during the upcoming holiday season and into next spring. In short, while there are still uncertainties in this retail environment, it feels very much like Jim Estepa and the Journeys team have again successfully navigated their way through another major fashion shift. Congratulations to the team.

Across the pond, Schuh posted another positive comp as the business benefits from the work the team has done to secure the latest must-have fashion athletic product. Schuh emerged from its most recent fashion rotation late last year, a little ahead of Journeys, and with building momentum delivered a 10% comp in Q1. Q2 comps were 3%, but would have been stronger had it not been for some temporary headwinds related to some delayed vendor shipments. The good news is, like Journeys, Schuh's momentum has accelerated during back-to-school both online and in stores.

Shifting to Lids. After a positive start to the year, comps became more challenged in each successive month of Q2, driven by a sustained drop in store traffic, particularly in our hat stores. Unfortunately, the trends we saw in the second quarter have gotten worse than the third and have meaningfully changed our outlook for the back half of the year for Lids.

Meanwhile, like Lids, Johnston & Murphy was challenged by weak store traffic. However, comps improved over the first quarter and moved closer to positive territory despite these difficult trends. And we anticipate results will continue to get better as the year progresses, driven by higher prices on select products.

The quarter's results were also impacted by the continued consumer shift in shopping away from stores and to online. Although our online business has been growing a lot in recent years, we called out in Q1 a market shift in this direction relative to store comps, and this pattern continued into Q2. And while we are pleased by the growth of our e-commerce sales and the returns we are seeing from the digital and omni-channel investments we have made, the lack of store sales hurts profitability in this channel with a largely fixed expense base and contributed to deleverage across our businesses.

Looking at the second half of the year, we are encouraged by our back-to-school performance at Journeys and Schuh and their prospects for holiday. At the same time, we find it necessary to adopt a much more conservative outlook for Lids based on the fact that current trends are running a good deal below our expectations and will now make it even more difficult to lap the tough comparisons we faced from last year's Cubs World Series win starting in October.

Therefore, we now expect fiscal '18 adjusted earnings per share to range between $3.35 and $3.65. This is admittedly a wider range than we usually give, reflecting the many variables in the retail environment that have made a narrow range a challenge for the last several quarters and that make it even more of a challenge for the remainder of the year. And what are these variables? At the macro level, one challenge is whether the overall decline in mall traffic will continue at the more pronounced levels we have been seeing. Another is whether the sales shift out of stores and into digital that is dilutive to earnings will continue at the rapid pace we have witnessed so far this year.

There are also upside and downside scenarios for our individual businesses. At Journeys, for example, we are bought to improve against some of the missed opportunities in Q4 last year. Last fall, we saw a very slow start to the boots season, while at the same time, we were managing through the more major fashion shift. And as a result, we trimmed our order book to prudently protect our downside. However, the boots season finally came late, and we likely missed some sales as we ran out of product. It was the right decision, but in the end, hampered the business. This year, we've bought to take advantage of the opportunity we missed last year, adjusted to reflect this year's fashion trends. And while our current fall line is more balanced and a little less weather-dependent, whether we fully realize the Q4 opportunities still depends on winter weather and boots sell-through. Another wildcard is how promotional competitors may be in this space.

At Lids, we have seen a recent slowdown in our hat business. While we have initiatives underway to combat this trend, this decreases visibility on the back half. And we have planned a tough comp with last year's Cubs championship, but there is a meaningful difference between a possible Dodgers-Yankees World Series versus, for example, a National-Indians World Series this fall. So once again, there are very real upside and downside scenarios which justify our broader guidance range, and we do regard our guidance as a range.

There is a history with investors of simply focusing on the top end. Something close to the middle reflects our best belief of where we might come out, with the top end representing more upside and the lower end a tougher scenario, either of which we view as a genuine possibility. While we are disappointed about lowering guidance, we are focused on planning both offense and defense aggressively for the balance of the year and beyond. Our overarching strategy serving distinct segments of the consumer market in leadership roles that out-position competition will allow us to navigate successfully the disruption in our sector caused by digital commerce and the reshaping of the mall landscape and to emerge on the other side with strong concepts that serve consumers well. Our strong commitment to our omni-channel strategy requires resetting our store fixed expense base while growing e-commerce and omni-channel even more.

We have plans in place to address these headwinds and opportunities. And in a few minutes, I will review in more detail the urgent actions we are taking to: first, reduce our real estate risk, rent and other expenses as part of this resetting; two, enhance our in-store experience and to drive traffic to our stores; three, build further our omni-channel and digital capabilities; four, strengthen the equity of our retail brands; and five, manage capital spending carefully as we move into the new year.

But before I go through all that, let me turn the call over to Mimi to go over the financials and guidance in greater detail.

Mimi Eckel Vaughn - *Genesco Inc. - Senior VP of Finance & CFO*

Thank you, Bob. Good morning. As a reminder, we have posted more detailed information online in our CFO commentary.

For Q2, consolidated revenue decreased 1% to $617 million. Without the sale in December of the SureGrip business and the impact of foreign exchange, primarily the pound devaluing against the dollar, revenue would have been flat.

Consolidated comps in Q2 were flat, consolidated store comps were down 2% and consolidated direct comps were up 30%, a large gap similar to what we saw in Q1. While traffic was down in our stores, it was up on our website, and mobile drove much of the increase in direct sales. Direct as a percent of total retail sales was up 10%, up more than 200 basis points over last year.

Positive comps at Journeys and Schuh were offset by negative comps at Lids and J&M. Journeys' comps made a dramatic improvement from negative 5% in Q1 to positive 1% in Q2 as the new part of the assortment grew at a fast-enough rate to overtake the decline in the legacy part of the assortment. Traffic improved and average ticket increased as Journeys sold higher-priced fashion athletic products through the summer and beginning of back-to-school. Fashion athletic products also drove Schuh's plus 3% comp, which would have been higher without a supply chain disruption of one of its top-selling vendors.

Team win and loss record, mall traffic and the absence of a strong headwear trend all affected Lids' sales in Q2. Comps were negatively impacted by hot market teams with unfavorable playoff results for us in the NBA and the NHL. While the Golden State win drove additional sales, the increase didn't come close to matching the large gain from the Cavaliers last year. And a Penguin three-peat for the Stanley Cup did not add sales either. Even with better conversion and higher transaction size in stores and strong positive digital sales, Lids had a negative 2% comp in total, with hat stores posting the most challenging results.

Finally, store traffic was difficult for Johnston & Murphy, but better conversion and ticket size offset this to some extent, and comp was a negative 1%.

Gross margin for Q2 decreased 60 basis points to 49.7%, with increased shipping and warehousing costs, primarily from higher e-commerce sales, accounting for half of the decline.

Journeys' gross margin decreased 110 basis points due largely to lower IMOs on the newer fashion athletic products. Markdowns were just under last year's level as a percent of sales, demonstrating the health of Journeys' inventory.

Lids' gross margin decreased 80 basis points, 50 of which was due to higher shipping costs principally from higher e-com sales. While the total decrease was less than Q1, we had expected gross margin to improve in Q2, given the actions we were taking with shallower markdowns earlier in the season. Increased promotional activity as we work diligently to keep inventories clean contributed to the lower gross margin in the quarter as well.

J&M's gross margin decreased 160 basis points due to higher -- increased 160 basis points due to higher IMOs and a mix shift towards retail sales, which generate higher gross margins than wholesale sales. Schuh's gross margin improved 40 basis points and benefited from product mix.

Now to SG&A. Total SG&A expense as a percent of sales increased 160 basis points to 50%, with significant deleverage due to the negative store comp in our lowest-volume quarter when expenses are the most fixed. All divisions deleveraged selling salaries and all divisions deleveraged rent expense, except for Lids, which has made the most progress thus far with rent reductions, although in recent months, Journeys has stepped up its rent effort significantly, which will pay dividends going forward. We had higher levels of digital and other marketing spend to stimulate sales as well.

In prior quarters, we have highlighted how effectively our system for measuring store traffic and conversion has been to allow us to better match staffing with customer traffic. This has enabled us to hold selling salaries flat in spite of minimum and living wage pressure and overtime requirements. As we anniversary these improvements, these wage pressures will become more of a challenge, as we began to see in Q2.

Q2's net result was an adjusted operating loss of $1.7 million versus earnings of $12.1 million last year and year-over-year declines for all of our divisions. Adjusted operating margin decreased 220 basis points to negative 0.3%. We had expected it would be difficult to make a profit in Q2, given that we were still cycling out of the Journeys fashion rotation.

Actual adjusted EPS of minus $0.10, which compares to $0.34 last year, came in a few cents below our estimates due to somewhat lower sales and lower gross margins than planned. In addition, $0.02 of this loss was due to a change in accounting for a Software-as-a-Service systems implementation.

Turning now to the balance sheet. Q2 total inventory was up 1% on a sales decrease of 1%. Journeys' inventory was up 2% on a sales increase of 3%. In an effort to accelerate the fashion shifts by changing the merchandise offering, Journeys brought in more new product earlier than usual at the beginning of the year, and these amounts are now normalizing. In addition, Journeys is systematically working down the legacy part of its inventory by carefully managing receipts. And we don't anticipate needing a higher level of markdowns for this product as a result.

Lids' inventory was up 1% on a sales decrease of 5%. Lids' inventory is higher than a year ago, but we are taking the action necessary to address the sales shortfall. We are below plan for the year currently and still expect to be below last year's level by the third quarter in spite of the challenges to the top line.

Capital expenditures for Q2 were $37 million, and depreciation and amortization was $19 million. Finally, we repurchased no shares during the quarter. $24 million remains under the current $100 million repurchase authorization.

Turning now to guidance for fiscal '18. While we now expect a more challenging year, we have seen that when the consumer has a reason to buy, we are able to turn their needs into sales, which presents opportunity for us with the rest of back-to-school and holiday. As we get into the second half with the Journeys' improvement, our year-over-year comparison should get better.

We anticipate total sales will be flat to up a little over 1% with consolidated comps, including direct, to be roughly flat, but ranging from down 1% to up 1%. Bob has given color on upside and downside comp scenarios already.

We plan to open about 80 new stores, over half of these in Journeys Kidz Canada and the U.K. The rest will be mostly fill-in opportunities for our more mature concept in strong malls where we haven't previously been able to get the right rent deal. We plan to close over 100 stores per square footage decrease once again this year. Although we will keep a store open with short lease term if the rent deal is attractive, so this number may change. The stores that we open will be far more productive than the ones that we close.

We expect gross margin to be down 50 to 60 basis points in total for the company for the year, with the greatest pressure at the back half coming in the third quarter. Gross margin compression from the new assortments should continue at roughly the same pace for Journeys in the third quarter, but should lessen in the fourth when we anniversary the heaviest markdowns Journeys took to clear products due to the fashion shift.

Lids will continue to feel margin pressure into the third quarter, in particular as we finish clearing product for the NBA and NHL vendor transitions, but this should improve in the fourth quarter. Schuh's gross margin should improve in the third quarter and flatten out in the fourth.

With the low comp and higher mix of e-com sales, we expect SG&A expenses will delever in the 50 to 80 basis point range. We expect foreign exchange will benefit earnings by about $0.03 per share, assuming exchange rates stay where they currently are, but given the uncertainty with Brexit, this could become more of a headwind. This all results in an operating margin percent that will be below last year's level, and our fiscal '18 tax rate is estimated at 35.2%.

We now estimate earnings per share for fiscal '18 to range from $3.35 to $3.65, down from a range of $3.90 to $4.05. Earnings will be entirely back half weighted, given the trajectory of the Journeys' recovery.

Importantly, while we don't give guidance by quarter, all of the upside in the back half over last year will be in the fourth quarter as we expect earnings to be down in the third quarter. We are planning capital expenditures in the $135 million to $140 million range, down a little from our original forecast, but including a major investment to expand the Journeys distribution center, which causes a more elevated level of CapEx than usual.

While we have a higher balance than last year currently drawn under our credit facility, by year-end, we expect to have only borrowings related to the incremental CapEx and payments occurring in the 53rd week. Depreciation and amortization is estimated at $80 million.

Lastly, we are assuming average shares outstanding of 19.3 million for fiscal '18. This guidance assumes no additional stock buybacks, but we can use repurchase availability opportunistically going forward.

Now I'll turn back to Bob.

Robert J. Dennis - *Genesco Inc. - Chairman, President & CEO*

Thanks, Mimi. I'll now review in more detail the important actions we are taking across our operating companies that are key to meeting our challenges. I will discuss the 5 initiatives I mentioned earlier.

Starting with reducing real estate risk and managing rent expense. With forecasted record retail store closures, the state of mall traffic and the rent deleverage we have experienced, we have stepped up efforts significantly on this critical front.

As a starting point, our store portfolio is in very good shape. In the U.S., about 35% of our doors are in A malls, 45% in B malls and 15% in C malls and the balance in the Street and other locations. Importantly, our store 4-wall contribution in C locations is in the mid-teens and as high on a percentage basis as our A and B locations due to more favorable rent terms. An average lease life in the C malls is 3 years, and we are reviewing many of these locations for only 1 or 2 years upon expiration to preserve flexibility, often with further rent decreases. So bottom line is we're making money in the C malls and can exit in the short term if the situation in these malls deteriorates.

A lot of the work we need to do is in our A and B centers. If store traffic and comps are going backwards, store rents need to go backwards as well. We have had good success in the renewals we have negotiated this year, with a 20% reduction in cash rent or 12% on a straight-line accounting basis. We are seeing reductions in all tiers of malls, with some of the largest reductions in the least productive ones. With almost 650 leases expiring this fiscal year and close to 1,300 expiring over the next 3 years, we have the opportunity to favorably adjust the rent structure for almost 50% of our fleet. And as I said, an integral part of this strategy is to maintain flexibility. And with an average lease life of 4 years, which continues to shorten, we believe we are accomplishing that. For stores where rents do not adjust to meet our ROI requirements, we will close. But thus far, in the better malls, our landlord partners have worked with us.

Second, enhancing our in-store experience and driving traffic. With the millions of customers that cross our lease lines each year, we have substantially more interaction with customers in our stores than we do online. One advantage to having a large store footprint is that the vast majority of the U.S. population lives within a few miles of our Journeys and Lids stores. This is a benefit since, first of all, 30% of customer purchases are in cash. Furthermore, stores play a key role in delivering our omni-channel experience.

So for example, most of Journeys' online sales that end up being returned are brought back to a physical store rather than being shipped back to us. Once these customers are in our stores, we have the opportunity to convert them to a sale and are successful doing that more than 50% of the time. This all makes our store fleet a strategic asset. And we have continued to invest in our physical store fronts, including over 500 major and minor remodels over the last 3 years to improve the shopping environment and evolve our brand image.

Another example of driving traffic is the embroidery and customization initiative at Lids, which is an interactive in-store offering that allows customers to personalize their purchases with their own names, additional images and even players' signatures. This differentiates the Lids experience and gives customers a reason to come into the store. We are adding close to 70 embroidery machines in the next few months to bring the total number of Lids stores with embroidery to over 1,000 and adding trainers and employee training hours to aid in the execution of this exciting initiative.

Touching on just a few examples with the near-term action to drive traffic to our stores and websites with the critical holiday selling period. We are investing in targeted digital advertising campaigns and more catalog ops for Journeys. We will increase the number of e-mail campaigns by 20%, which means sending hundreds of millions of additional messages. And we will also increase the number of catalogs mailed by 40%, which means dropping several million more books with an initiative that has demonstrated positive ROI.

These actions are even more pressing for Lids and include a 60% increase in digital ad spending, largely in the areas of paid search, increased e-mails to a subscriber list that is 50% larger due to greater collection efforts through the Lids loyalty Access Pass, the Lids app and in-store initiatives, and focused digital offers to Lids' most loyal customers through Access Pass and the app. Lids has specific efforts aimed at driving traffic to stores as well such as local inventory ads, in-store only events and offers such as free customization and bounce-back coupons.

So third topic, building out omni-channel and digital capabilities. One of the most important features of the current Journeys distribution center expansion is significantly more capacity for e-commerce shipments to accommodate the explosive growth we'd seen online. Some of our initiatives were not just e-commerce specific, but are designed to facilitate interaction across channels, like the new order management system we are implementing right now at Lids. This will enhance "buy online, pick up in-store" capabilities, which is also a key focus of Journeys and Johnston & Murphy in fiscal '19.

Fourth, increasing the use of social media to strengthen the equity of our retail brands. Social media is one of the most effective ways for brand building today, especially with teens and young adults. So we have been featuring influencers in our catalogs and websites at Journeys to leverage their social circles to generate awareness of the Journeys retail brand and are currently launching an ambassador program at Lids to do the same thing. We are especially focused on initiatives that strengthen customer relationships and loyalty. We launched a revised loyalty program at Lids last quarter to capitalize on purchases across multiple sports and are currently evaluating options for loyalty at Journeys too.

Finally, I'll mention a fifth initiative, which will come into play largely in the new fiscal year, moderating CapEx spending. At this point, the vast majority of the capital expenditures planned for fiscal '18 is committed, including the Journeys DC expansion, but we are doing what we can to tighten up on spending as we finish the year. Looking at fiscal '19, CapEx will come down meaningfully. Spending will be limited to a small number of new store openings in only the best locations with home-run opportunities. We will continue to invest to update our store fleet and image, but selectively and in places and at levels which we know we will earn our target rate of return.

Last, we will continue to fund IT and other projects to build further our digital and omni-channel capabilities. We are working hard to strike the right balance between protecting near-term profitability in the current environment and executing the long-range plans that will see our concepts emerge from the ongoing retail and transformation and even stronger strategic positions. While we had a challenging first half of the year, we are encouraged for the back half and, in particular, by the incredible progress the Journeys team has made navigating this most recent fashion shift.

With the exceptional talent and experience of the team and very strong culture, we are confident Journeys will continue its long run of extraordinary success. We are also confident in the Lids organization, guided by its strong and able leadership team and that they will successfully make its way through the current challenges.

Moreover, I would like to thank everyone in each division across our organization for your hard work and perseverance in these challenging times. My confidence in the future rests on you, the experienced, committed and highly capable people we have in each of our companies. Your creativity and hard work is what will ensure that we will prevail. Thanks again, and keep up the good work.

And finally, to all of our employees battling the devastating flooding in Texas, our thoughts have been and will continue to be with you.

And with that, operator, we're ready for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Pam Quintiliano with SunTrust.

Pamela Nagler Quintiliano - *SunTrust Robinson Humphrey, Inc., Research Division - MD*

Bob, when you talked about guidance and all the unknowns within the broad range, when we think about the high end and the low end of the guidance, just what are you assuming for the competitive promotional environment out there? Obviously, it's very messy. Just how should we think about how you're planning for the holiday season? And then just quickly, you mentioned broadly 30% of customers transact in cash. How does that differ between Journeys and Lids?

Robert J. Dennis - *Genesco Inc. - Chairman, President & CEO*

Sure. That was 2 questions, but okay. On the first one, look, the range is what it is. So if it's a more promotional environment, Pam, that pulls us down to the lower end of the range. We actually haven't really seen Journeys struggling that much with the promotional environment. We called it out because we know a number of the other mall retailers are in a tough inventory position with their comp trends. So we're alert to the fact that, that could pick up. But right now, in terms of the product that is hot and working well for us, we're not seeing a huge promotional pressure as of yet. And in terms of cash, both Journeys and Lids are -- have that kind of cash profile. I think they're pretty similar.

Mimi Eckel Vaughn - *Genesco Inc. - Senior VP of Finance & CFO*

Yes, they're pretty similar.

Robert J. Dennis - *Genesco Inc. - Chairman, President & CEO*

So about the same.

Operator

Our next question comes from Jay Sole with Morgan Stanley.

Jay Daniel Sole - *Morgan Stanley, Research Division - Executive Director*

Bob, can we dig in to the Lids hat story a little bit? Obviously, Mimi called out wins and losses and some tough compares and some traffic issues. Is there an element of maybe just sports have become a little bit less popular, people aren't wearing the sports hats as much, they've shifted to something else in fashion? So is there -- because most of the stuff that was called out are sort of temporary. It's going to probably reverse just based on wins and losses are unpredictable. But is there anything bigger going on that you could call out?

Robert J. Dennis - *Genesco Inc. - Chairman, President & CEO*

It's a great question, Jay. And so we know that the comp in the second quarter suffered by what we call a hot market offset, and Mimi called it out. So Cleveland was such a bigger event than Golden State because Golden State, in a way, is a repeat. So that's a piece of it. From a fashion standpoint, we've gone through a trend where what is affectionately called the dad hat, which I don't take offense to, has been very popular. But that's getting a little long in the tooth, so we don't really have a strong fashion trend that's driving things. And then, obviously, the win-loss record and sort of the hot market challenge going forward with the Cubs is substantial. And our ability to mitigate that will depend, as I called it out, a Dodgers-Yankees or frankly a Dodgers-Houston World Series would be good, but I can come up with some combinations that are less good. In terms of a generalized propensity to not buy as many hats, it's very hard to get underneath that. And we are working hard to get underneath that and try to understand whether that is part of the underlying trend. What I can tell you is that there isn't a section of the store that is suffering more than the other. We're getting less traffic, and they're buying across the assortment in roughly the same percentage. So it's not like we have a style in the store or a sports in the store that is especially tanking. We do have to be -- we are a little -- and this is not a hat issue, but as we rotate out of the NBA jersey and the NHL jersey, we're deliberately intentionally lean there so that we can accommodate that change. Mimi, anything you would add?

Mimi Eckel Vaughn - *Genesco Inc. - Senior VP of Finance & CFO*

I think one of the things, Jay, is that we are pleased by the very strong growth that we have seen online, and we are doing a lot of hat selling online. Our traffic has been up. Our conversion has been very strong online. So we think perhaps part of this is that consumers are just diversifying how they're thinking about shopping both in stores and online, and that may account for a portion of the pressure in the stores as well.

Operator

Our next question comes from Steve Marotta with CL King & Associates.

Steven Louis Marotta - *CL King & Associates, Inc., Research Division - Senior VP of Equity Research & Senior Research Analyst*

Mimi, you mentioned e-commerce penetration. I think you said 10%. A, is that right? And b, isn't it larger on an annual basis? And I just want to ask one more question about the Dodgers-Yankees. Bob, you mentioned that's good. Does that mean you would expect it to lap positively against the Cubs or just less bad?

Robert J. Dennis - *Genesco Inc. - Chairman, President & CEO*

No, everything we do is trying to be less bad. There is no good substitute for the Cubs.

Mimi Eckel Vaughn - *Genesco Inc. - Senior VP of Finance & CFO*

And as far as e-commerce penetration, Steve, yes, for the quarter, it was 10%, but we see the strongest e-commerce penetration in the fourth quarter. And so I think the important call-out is that we were running 200 basis points up over last year. And so we ended last year for the year at a little under 10%. And if we track to the same level, we should be around the 12%.

Robert J. Dennis - *Genesco Inc. - Chairman, President & CEO*

Yes, 12% or 13%. Unfortunately, the percentage is going up mostly because of the increases we're getting in e-com, but the negative comps in the stores are also changing that percentage. So it's going up a lot. And I just want to be clear because I know there's some confusion in this. We talked about how the conversion, the move from stores to e-com is dilutive to our earnings. That is not to say that the e-com business is unprofitable. The 4-wall on the e-com sits in the same neighborhood as our stores. The problem is when the sales go down in the stores, it is against a highly fixed cost base, especially in the first 3 quarters. When sales go up in e-com, we add variables expense. And so Mimi called out on the gross margin line the additional shipping charge that occurs, which is incremental. So if you just take another percentage of our sales out of stores and into e-com, leaving total sales constant, it does hurt profitability. But we are very pleased with the profitability of the e-com business as its own business.

Mimi Eckel Vaughn - *Genesco Inc. - Senior VP of Finance & CFO*

Yes. And part of it is that we run e-com to be profitable. We have shipping threshold across all of our businesses. We don't have free returns. We are...

Robert J. Dennis - *Genesco Inc. - Chairman, President & CEO*

We do. We have free returns to the store.

Mimi Eckel Vaughn - *Genesco Inc. - Senior VP of Finance & CFO*

Free returns to the store, right. We don't have free returns online. We are also not just buying market share at the expense of profitability. We measure carefully the return on the paid search and the catalogs that we are dropping. And we aim to continue to run that business for profitable growth.

Operator

Our next question comes from Erinn Murphy with Piper Jaffray.

Eric Thomas Johnson - *Piper Jaffray Companies, Research Division - Research Analyst*

This is Eric on for Erinn today. Some of your specialty retail athletic peers in Q2, most of them underperformed and lowered their full year expectations pretty meaningfully. I was just curious if that's changed your guys' outlook. Or has your outlook changed year-to-date within the fashion athletic in terms of what you're planning? Outperforming your plans, but in the second half, are you still expecting, I guess, what you were maybe 90 days ago?

Robert J. Dennis - *Genesco Inc. - Chairman, President & CEO*

Yes, I mean, we're tracking. We have said from the start -- first, let me say, Erinn, if you're listening in, we're thinking about you. We know it's tough in Houston, so hopefully, you're toughing it out there.

Mimi Eckel Vaughn - *Genesco Inc. - Senior VP of Finance & CFO*

We hope you get out of your apartment at some point.

Robert J. Dennis - *Genesco Inc. - Chairman, President & CEO*

Yes. But we're on the track of where we said we thought we would be. We described this as a fashion rotation, which has been just part of Journeys' history throughout its life, and that when this one was a little more severe because of how concentrated we were early on. So -- with the last trend. So when you look at the athletic peers, they're in a different situation than we are. We're very focused on fashion athletic. A lot of that is classic. There are some styles that are more progressive that are -- but clearly still in the fashion category. And that's essentially where we are focused. That is a lot of full-priced selling that delivered the comp that we described in back-to-school August. And we believe, as we said on the script that, that is a trend that we can sustain through the end of this year and should be helpful for us even into next spring.

Mimi Eckel Vaughn - *Genesco Inc. - Senior VP of Finance & CFO*

We anticipate the same level of comp we've guided to the same level of comp for Journeys, which means we're tracking on where we thought we would be. Really, the takedown in our guidance is largely attributed to the trends we're seeing in Lids and the turn that we have seen in the last half.

Robert J. Dennis - *Genesco Inc. - Chairman, President & CEO*

Yes, and the shift from -- to digital. That shift to digital is just a dilutive event.

Operator

Our next question comes from Laurent Vasilescu with Macquarie.

Laurent Andre Vasilescu - *Macquarie Research - Consumer Analyst*

Your guidance for the full year on gross margins seems to be down 50 to 60 bps. And then I think you mentioned 3Q gross margins will also be down. Should we assume gross margins to be flat, up or down for the fourth quarter? And then secondly, any high-level thoughts on how you're thinking about the boot category for the back half of the year?

Robert J. Dennis - *Genesco Inc. - Chairman, President & CEO*

I'll do the boot category just very quickly. The only thing we're thinking about the boot category is we're recognizing more and more that it is a "buy it now, wear it now" business. So if you go back a long ways, we used to actually intensify the boot assortment at back-to-school. That makes no sense anymore. The teenager is not investing in their boot buys until it is much closer to the day where they need it. So part of what we're doing in the fourth quarter is we'll be flowing boots differently, and that's created an opportunity to flow more of the hot athletic product deeper into the year than we ordinarily would. And we think all of that should be a positive for the business. On gross margins, Mimi?

Mimi Eckel Vaughn - *Genesco Inc. - Senior VP of Finance & CFO*

Yes. So on gross margins, we were down 60 basis points in the second quarter, which was a good deal better than the first quarter. The first quarter, as we've talked about, had some unusual pressure on a year-over-year basis. Promotions normalized for Lids in the first quarter this year. So in the third quarter, we expect roughly the same gross margin pressure. But in the fourth quarter, we actually should be in the neighborhood of level to last year. Last year, we were doing a lot of promotions in order to clear product and make sure that we ended the year in very clean inventory position as we were moving through the fashion rotation. And so in spite of some of the trade-offs that we're making in IMOs for the new product in Journeys, when we lapped that more promotional activity, we should be about even. And then for Lids, the strength of the Cubs sales, some of the championship product actually is delivered, our gross margins are lower there. So we think that we ought to be close to par on Lids as well for the fourth quarter.

Operator

Our next question comes from Jonathan Komp with Robert W. Baird.

Jonathan Robert Komp - *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst*

I want to follow up on the guidance for the year. Mimi, I know you held the prior range at the high end for the comps, but you brought the full range down for earnings. So I just -- and I know you called out some of the expense deleverage with the traffic shifts, but I'm wondering if you could be a little more descriptive and maybe incremental costs pressure that you're embedding now. And then also, when you look out to the fourth quarter, I think it's obvious that Journeys will be facing a low margin comparison. It's not entirely obvious that the other concepts will be facing a low comparison. So could you maybe just parse out what you're expecting in the fourth quarter in terms of driving the earnings growth?

Mimi Eckel Vaughn - *Genesco Inc. - Senior VP of Finance & CFO*

Sure. So in terms of the range of the guidance comp -- and you're right, it's -- at the back part of the year, we do such a large amount of business that even a point of comp ends up moving the needle quite a lot. And so the largest change in our guidance is the takedown of that Lids comp. You'll see that we're actually expecting stronger results for Schuh, so that offsets it to some extent. And we're expecting to see on the -- be on the same trajectory on the top line for Journeys. What we do see though is more gross margin pressure. We saw more gross margin pressure overall in Lids in the second quarter. We expect that it will continue in the third quarter. And whereas we thought that gross margin would be flat for the year, we now expect it to be down in the neighborhood of 50 to 60 basis points. And I just talked about the margin pressure. In the fourth quarter, it's the championship product for the Cubs that has delivered. We actually get a lower margin percentage for that versus our regular product mix, and so that will build some more opportunity for favorability on a year-over-year basis in the fourth quarter.

Operator

Our next question comes from Sam Poser with Susquehanna Financial Group.

Samuel Marc Poser - *Susquehanna Financial Group, LLLP, Research Division - Senior Analyst*

I really want to follow up on the store, like on the stores and driving traffic into the stores. And when you spoke about next year, you said you would -- that the store growth would be way down. Could you really -- can we get some detail onto what you're doing to drive traffic into the stores with such a large store base and your discussion that the consumer isn't -- is coming in less?

Robert J. Dennis - *Genesco Inc. - Chairman, President & CEO*

Well, to be clear, at Journeys, the customer is coming in more during back-to-school. The general trend in the mall over the last 3 or 4 years has -- we've been traffic challenged, the mall has, and we have in most of our concepts. For the early stages of that, Sam, we were making it up on conversion because we were getting customers with the greater intent to buy based on having done their window shopping on their couch.

Mimi Eckel Vaughn - *Genesco Inc. - Senior VP of Finance & CFO*

Yes. So in the second quarter, or just to put some numbers against that, we were significantly better than the mall in terms of traffic for Journeys. And then in August, we turned positive in terms of traffic year-over-year.

Robert J. Dennis - *Genesco Inc. - Chairman, President & CEO*

Yes. But the reality is, if you look at the big swing in our store comps between digital and stores, we've got the consumer making the call that they want to do a lot more of their business digitally. We have a store base, and so we need to drive traffic to that stores. We need to get rents aligned with what traffic we do draw in, realistically looking at that as possibly being a pattern that will continue to be a challenge. But then we also have to try and drive the traffic where we think we can, and a lot of that is being done with digital marketing. And as you know, Sam, with catalog, we've had great success with catalog. And we're increasing a lot of that since the kid isn't just wandering to the mall maybe as often as they used to. We're giving them a reason to come. We're using bounce-back coupons, which proved to be very effective to try and increase the frequency with which our core customers revisit the store. And then obviously, what we're doing in terms of the store presentation is we did the research a couple of years ago, and the customer pointed us to some ways in which we could improve the presentation in the store in terms of it was not high CapEx stuff, but important stuff, and we got after it. And so we're making headway in that direction. The guys at Lids are actually testing a new look to see if that works for driving more traffic in. A lot of the work in the Lids area, as you know, is being done with customization. So we've got embroidery as a big push in the hat stores. We're doing customer apparel mostly on jerseys and a number of our big format stores. So all in all, we're doing a lot of things. We think to try and enhance the experience in the store and to attract more people to come to the store. And at the same time, we're playing defense, mindful that even if we do all those things, some of the -- just the structural changes that seem to be going on might be a headwind, and that will call for both the rent -- attacking rents and then looking at the fleet size if rent can't, in fact, adjust to where we think they need to be.

Operator

It appears there are no further questions at this time. Mr. Dennis, I'd like to turn the conference back to you for any additional or closing remarks.

Robert J. Dennis - *Genesco Inc. - Chairman, President & CEO*

Yes. Well, first of all, thank you for joining us on the call. We look forward to talking to you. And again, to all of our employees down in Texas, we're with you. Our hearts are with you. And we're going to try and be as helpful as we can as you all try to recover. Thanks a lot. We'll talk to you in a bit.

Operator

This concludes today's conference. Thank you for your participation. You may now disconnect.
