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GCO - Q3 2018 Genesco Inc Earnings Call

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CORPORATE PARTICIPANTS

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

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

CONFERENCE CALL PARTICIPANTS

Erinn Elisabeth Murphy *Piper Jaffray Companies, Research Division - MD and Senior Research Analyst*

Janine M. Stichter *Jefferies LLC, Research Division - Equity Associate*

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

Laurent Andre Vasilescu *Macquarie Research - Consumer Analyst*

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

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

Scott David Krasik *The Buckingham Research Group Incorporated - Analyst*

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

PRESENTATION

Operator

Good day, everyone, and welcome to the Genesco Third 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 Bob Dennis, Genesco's Chairman, President and Chief Executive Officer. Please go ahead, sir.

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

Thank you. Good morning, and thank you for being with us. I am joined today by our Chief Financial Officer, Mimi Vaughn.

The third quarter, as we expected, was a tale of 2 businesses. Journeys built on its momentum following the emergence from its recent fashion shift and posted a solid comp gain. Meanwhile, Lids, after a challenging second quarter, faced a variety of additional challenges that meaningfully pressured its performance. As we have seen throughout the year, the dramatic consumer shift in shopping away from stores to digital continued once again in Q3, although we did see bright spots in both store traffic and store purchases during Back-to-School in more than one of our concepts.

In total, consolidated comparable sales increased 1%, with stores down 2% and direct up 24%. EPS of $1.02 was a few cents above our internal estimates, but down year-over-year, due to the pressures at Lids, losses resulting from the onetime conversion of our Little Burgundy Canadian business to the Journeys' platform and challenges in our Licensed Brands wholesale business. In addition, EPS would have been higher by a few cents if not for the impact of Hurricane Maria on our businesses in Puerto Rico.

In a few minutes, Mimi will discuss the specifics of Q3 results in more detail, but I'm first going to walk through the high points and then the headwinds of the quarter. And then I'm going to give some color on Black Friday and November trends and talk about how we are thinking about guidance for the remainder of the year before turning it over to her.

And then before I get into operating performance, let me briefly address the goodwill impairment that we announced this morning. Mimi will give more color on this, but I wanted to stress that is a move driven entirely by our current market value and accounting standards and does not reflect any change in our assessment of Lids' strategic position and long-term promise.

So now on to our operating performance. We had expected it to be a difficult quarter, given low levels of mall traffic, the more pronounced shift in shopping to online and the challenges facing Lids. Therefore, we were pleased to see the strength in our teen, young adult fashion footwear businesses on both sides of the Atlantic.

Both Journeys and Schuh carried strong Back-to-School momentum from August into September. During Back-to-School, robust customer traffic in the stores driven by must-have product propelled positive traffic increases year-over-year, and store comps were positive in addition to e-commerce comps being extremely strong for both concepts. However, unseasonably warm weather impeded sales of seasonal product for both chains throughout October until cooler weather arrived for Journeys in the U.S. at the end of the month. So for Journeys, comps improved on a sequential basis and accelerated nicely to positive 4% in Q3.

Customers responded favorably in stores and online to the new product we brought in over the past year in increasing quantities, especially the retro athletic and progressive athletic footwear. Our current assortment is performing well and to our expectations.

Importantly, comps got even more positive as we moved into Q4. Journeys has a much more balanced assortment now than in the previous fashion cycle, and we expect to get a boost from colder weather footwear we sell this time of the year as well. We are enthusiastic about the recent results achieved in both stores and online and the trajectory of the Journeys business as we start the busiest month of the year. As they have many times before, Journeys has navigated through another major fashion shift. And so congrats to Jim Estepa, Mario Gallione and the rest of the Journeys team.

In the U.K., Schuh maintained its consecutive positive comp streak as the business benefited from strong athletic trends and product advantages. It was another solid quarter, with comps up 4%. The quarter started out well at Back-to-School, but comps slowed in October as the warm weather discouraged demand for colder weather product. Temperatures remained warm in November, and Q4 was off to a slow start until throngs of U.K. Black Friday shoppers drove comps into nicely positive territory. And we heard yesterday that Schuh has been awarded the Drapers Best Place to Work award. And so congrats to the Schuh team.

Meanwhile, Johnston & Murphy delivered solid results even while contending with a 1% comp decline. Total sales were up thanks to new store openings and higher wholesale sales as J&M product sold through well at our retail accounts. As anticipated, results have improved as we've gotten into Q4 and anniversaried the lull in consumer spending around the election last year. With the colder weather, sales have really taken off, and fourth quarter comps to date are in solidly positive territory.

Shifting to Lids. Following a difficult Q2, results became even more challenged in Q3 due to a confluence of factors across the major league sports. The MLB lineup, while it was a strong combination of Yankees, Dodgers, Astros and Cubs, did not match last year's lineup, which included very strong games from the Cubs and the Toronto Blue Jays. And overall, baseball for the quarter was down. In addition, NCAA sales were down due to less favorable performance by key schools.

But finally and most importantly, the well-publicized challenges facing the NFL have meaningfully dampened demand for NFL licensed merchandise during the heart of football season. This NFL impact was the single biggest factor weighing on Q3 sales.

All this, coupled with the lack of a strong headwear trend to drive shoppers into our hat stores, led to double-digit store traffic declines and a comp of negative 6%, which was worse than we anticipated. On a positive note, Lids' e-commerce sales continued to run up strong double digit, but this was more than offset by negative store comps.

The fourth quarter is off to a significantly tougher start, driven by many of the same issues plus some new challenges and even harder MLB comparisons, as Cubs merchandise sold through strongly after the World Series win and was a huge gift-giving purchase in last year's Black Friday weekend. Moreover, price discounting has become intense and promotional activity has escalated, especially online, as competitors moved to address inventories in response to the industry-wide sales weakness.

To summarize Q4 so far for the company overall, comps through Cyber Monday accelerated nicely over Q3 for our footwear businesses, but against the tough Cubs comparisons and with additional challenges led to negative November comps offset much but not all of the footwear gains.

For the Black Friday weekend starting on Thursday through Cyber Monday, we were very pleased with the results in the U.K. but mixed on results in the U.S. Comps in total were up, thanks to online, which achieved impressive increases in bookings of almost 70% and were in general led by divisions with the greatest promotional activity. We anticipate a promotional holiday for our licensed sports businesses but are cautiously optimistic that the market will show more restraint in the footwear category, at least in the U.S.

With respect to our full year outlook, you'll recall that we established a wider-than-normal range for EPS on our last call. And this was in response to the several variables that were limiting our visibility. At a macro level, they were whether the overall decline in mall traffic would continue at the more pronounced levels we have been seeing and whether the sales shift out of stores and into digital that is dilutive to earnings would continue at the rapid pace we have witnessed so far this year. And then specific to Genesco, it was the upside and the downside scenarios for our 2 biggest businesses, Journeys and Lids.

In Q3, Journeys' performance was better than expected, but Lids was worse. So the pieces were different, but came about where we thought they would be. Going forward, we are more optimistic about Journeys' prospect in Q4 than we were 3 months ago. However, this is outweighed by significantly more caution for Lids. We find it necessary to adopt an even more conservative outlook for Lids based on the current trends that are running below our expectations.

While we anticipated a number of headwinds, including Cubs and the lack of a major fashion driver in headwear, the additional challenges are: dampened demand for NFL licensed merchandise, which is typically a big gift-giving item in Q4 and then the ensuing promotional activity in the category that has already begun; and two, disruption from the NHL vendor transition, which has been less than smooth for our Canadian businesses. Therefore, we now expect adjusted EPS in the range of $3.05 to $3.35, below our previous guidance range. Something close to the middle of this range reflects our best belief of where we might come out, with upside and downside on either end given what a big quarter Q4 is for us. While we are very disappointed to be lowering guidance, we will take the actions necessary to end the year in a very clean inventory position.

Mimi will walk through the guidance in more detail. And so with that, let me turn the call over to her to go through the financials.

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

Thanks, Bob. Good morning. As usual, we have posted more detailed information in our CFO commentary that you can access online at our website.

Even with higher sales and a positive comp, Q3 EPS was down due to gross margin pressure across several businesses, the deleverage from negative store comps and higher expenses from our omnichannel initiative. In addition, I'll describe the factors that caused Lids, Little Burgundy and Licensed Brands to be down in the quarter, while other divisions were flat to up.

In Q3, consolidated revenue increased 1% to $717 million. Consolidated comps were up 1%, consolidated store comps were down 2% and consolidated direct comps were up 24%, a large gap that is similar to what we have been seeing thus far this year. However, store comps were stronger in Journeys and Schuh, driven by compelling fashion trend. The strength of these store sales was not as obvious in our consolidated results because of the decline in store sales in our other businesses.

Traffic was up almost 15% on our website. Mobile drove a lot of the direct sales increase, but with higher conversion orders on desktop and tablet devices were up too. Direct as a percent of total retail sales was 10%, up almost 200 basis points over last year, demonstrating the substantial progress we have made driving e-commerce sales.

Positive overall comps at Journeys and Schuh were offset in part by negative comps at Lids and J&M. Journeys' comps showed significant improvement from positive 1% in Q2 to positive 4% in Q3. The business performed well across the board, highlighted by year-over-year increases in traffic, in conversion and average ticket size, which was driven by higher-priced fashion athletic product.

Both footwear units and ASPs increased at Journeys. Fashion athletic products also drove higher conversion in Schuh's plus 4% comp, while strong increase in units more than offset lower ASPs from product mix differences. With limited interest in fall products until the weather got colder, Q3 store traffic was difficult for Johnston & Murphy, but better conversion and ticket size offset this to some extent, and comp was a negative 1%. Higher prices on select products at retail drove the better average ticket size and did not affect conversions.

Bob described the declines in MLB, NCAA and NFL and the lack of a strong headwear trend for Lids. As a result, Q3 store traffic was off double digits, and conversion was down too, leading to a negative 6% comp. Given the widespread challenges for Lids across leagues, both hat stores and Locker Room stores posted decline. On a positive note, dollars per transaction were actually better.

Now the gross margin. Q3 consolidated gross margin decreased 60 basis points to 49.4% with increased shipping and warehousing costs from higher e-commerce sales accounting for almost half of this decline.

Journeys' gross margin decreased 60 basis points from this and from lower IMOs on the newer fashion athletic product. Markdowns were roughly equal to last year's level demonstrating the health of Journeys' inventory.

Gross margin at Schuh was close to last year, down 10 basis points.

At J&M, gross margin was up 40 basis points benefiting from the retail price increases.

Lids' gross margin decreased 110 basis points due to the softness in sales and the systematic actions we took to keep inventories clean. We worked diligently to this end, and both the quantity and level of markdowns were greater in the quarter as a result.

Knowing with the vendor changeovers we would need to clear NBA and NHL product, we had built lower gross product margins in for these categories into our expectations. While these efforts were successful, markdowns related to soft sales took us to a level beyond our expectations.

Finally, challenges at retail drove much lower Licensed Brands' gross margin as well.

Now to SG&A. Total SG&A expense as a percent of sales increased 70 basis points to 45% with deleverage on rents and selling salaries from negative store comps and higher levels of digital and other marketing spend to stimulate sales and drive traffic to our sites and to our stores. While we've stepped up rent reduction efforts and this will pay nice dividends going forward, the impact is not yet showing up in our results. We've also talked about pressure from ongoing state and municipal minimum wage increases, and we saw this impact in both Journeys and Lids this quarter, which caused us to deleverage selling salaries.

In addition, we added store hours to a lesser extent as needed to manage the workload created from our direct business, like e-commerce, shipments out of stores and e-com returns.

Q3's net result was adjusted operating income of $31.3 million versus $40.9 million last year. Adjusted operating margin decreased 140 basis points to 4.4%.

Lids, Little Burgundy and Licensed Brands were down year-over-year. While we've discussed Lids and Licensed Brands, Little Burgundy, the branded retail business we acquired a couple of years ago in Canada, experienced losses related to the onetime conversion onto the Journeys system. Without this loss, Journeys Group profitability would have been flat. Prior to this conversion, Little Burgundy has exceeded our expectations since its acquisition, and post integration is back on track with much stronger top line performance.

We had expected EPS to be down in Q3 and actual adjusted EPS of $1.02, which compares to $1.28 last year, came in a few cents above our estimate and would have been higher without the impact of Hurricane Maria in Puerto Rico.

One final callout on the quarter. We recognized a goodwill impairment in the Lids Sports Group segment. In accordance with GAAP requirements, driven primarily by the sustained decline in our stock price this year, which has taken our market value below book value, we assess the value of goodwill as of the end of the quarter and determined that recognizing the impairment was required based on the applicable accounting standard. This is a noncash item and does not present any covenant or borrowing capacity issues under our bank credit facility. Most importantly, it does not reflect any change in our confidence in Lids' strategic position or longer-term prospects, despite the headwinds it is experiencing now.

Turning now to the balance sheet. Inventory is clean. Q3 total inventory was down 3% on a sales increase of 1%. Journeys' inventory was up 4% on a sales increase of 6%. Lids' inventory was down 11% on a sales decrease of 9%, as we took the actions necessary to address the sales shortfall. We are below plan for the year currently and hit our goal of being below last year's level this quarter. And we expect inventory to be below last year's levels at year-end as well.

Capital expenditures for Q3 were $37 million, which is higher than usual due to the Journeys distribution center expansion, 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. We have improved the gap to last year's earnings in each of the last 2 quarters and expect to do so again in Q4 with the momentum in our footwear businesses in spite of the lower guidance. When the consumer has a reason to buy, we are able to capitalize on that opportunity as we did at Back-to-School and intend to do again over the holidays.

For the year, we anticipate total sales will be flat to up a little over 1% with consolidated comps, including direct, to be roughly flat ranging from down 1% to up 1%. By the end of the year, we plan to have opened 76 new stores, more than half of these in Journeys Kidz in Canada and the U.K. The rest are mostly fill-in opportunities for our more mature concepts in strong malls where we haven't previously been able to get the right rent deal. We plan to close over 150 stores for a square footage decrease again this year, although we will keep a store open with a short lease term if the rent deal is attractive, as Bob will explain, and 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 70 to 80 basis points for the company in total for the year with more pressure in Q4 than previously anticipated. Gross margin compression from the new assortments should level off for Journeys in the fourth quarter when we anniversary the heaviest markdowns Journeys took to clear product due to the fashion shift. Lids will be more promotional in Q4 to address soft sales to be competitive in the marketplace and to keep inventories clean. Schuh will be more promotional as well.

With the low comp and higher mix of e-com sales, we expect SG&A expenses will delever in the 80 to 100 basis point range. We expect foreign exchange will benefit earnings by $0.02 per share assuming exchange rates stay where they currently are, but given the uncertainty with Brexit, this could become a headwind.

So this all results in an operating margin percent that will be below last year's level, and our fiscal tax rate is estimated at 34.3%. We now estimate adjusted earnings per share for fiscal '18 to range from $3.05 to $3.35, down from a range of $3.35 to $3.65. CapEx will be in the $130 million to $135 million range, down from our original forecast as we have tightened spending in the back half. This includes the major expansion of the Journeys DC, which causes the elevated level of CapEx this year. We expect to have borrowings related primarily to this incremental CapEx and rent payments occurring in the 53rd week outstanding at the end of the year. We estimate depreciation and amortization at $78 million.

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

Now I'll turn the call back over to Bob.

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

Thanks, Mimi. Before we move to Q&A, I want to provide an update on the important strategic initiatives we are executing. They are key to meeting the challenges in this changing retail environment and are aimed at both enhancing our profitability in the short term and strengthening our strategic positioning for the longer term. As a reminder, these initiatives are: first, reducing our real estate risk and rent expense; next, enhancing our in-store experience and driving traffic to our stores; third, building further our omnichannel and digital capabilities; fourth, strengthening the equity of our retail brands; and finally, managing capital spending carefully as we move into the new year.

So beginning with reducing real estate risk and managing rent expense, our store portfolio is in very good shape. In the U.S., around 35% of our doors are in A malls, 45% in B malls, 15% in C malls and the balance in street and other locations. So we have the least amount of exposure in the more challenged malls. And so with this backdrop, I want to address the issue of closing stores and the suggestion by many investors is that retailers like us should accelerate their pace of closings.

First, we don't believe that by closing stores, we transfer sales to other locations like some big-box retailers that are more destination driven. It is more likely we lose the sale to a competitor. We do believe sales transfer to our other stores in a situation where the whole mall closes. On top of this, the vast majority of our stores are profitable. So closing them wouldn't increase earnings, it would decrease them. I think what the Street sometimes doesn't appreciate or doesn't realize is that our 4-wall contribution in C stores is in the mid-teens, as high on a percentage basis as our A and B locations due to more favorable rent deals. And the average lease life in C malls is 3 years, and we're renewing usually for only 1 or 2 years upon expiration, most frequently with further rent decreases. So bottom line, we are making money in C locations, but we can exit in the short term if these malls deteriorate.

We've talked about the good success we're having with renewals and rent reductions, which have been a huge focus for us. We went out and visited with our major landlord partners and we understand each other's challenges, which is helping both of us reach solutions that we can both live with. To give an update, we have negotiated nearly 200 renewals this year-to-date and achieved in total a 16% reduction in cash rent or 9% on a straight-line basis. In renewal negotiations when rent does not adjust to meet our ROI requirements, we will close the store. But thus far, our landlord partners have worked with us.

With 250 to 300 leases expiring annually plus short-term renewal rollovers and store closings, we have the opportunity to favorably adjust the rent structure for almost 50% of our fleet over the next few years. An integral part of this strategy is to maintain flexibility, and with an average current lease life of 4 years, which continues to shorten, we are accomplishing that.

So next, we're enhancing our in-store experience and doing all we can to drive traffic to brick-and-mortar locations. We view our stores as strategic assets and critically important to delivering the omnichannel experience. The 2 most important dimensions here are our store employees and our store environment. So we continue to invest in both to ensure that we are providing a compelling and differentiated in-store experience for the millions of customers who cross our lease lines every year.

When Aston Market researched about what makes the Journeys store experience unique, customers are quick to call out our employees. Second only to fashion, our people are their favorite thing about our stores. Journeys employees are fashion ambassadors, who we encourage to be themselves, unique in how they dress and how they interact with shoppers. They provide an outstanding full-service shopping experience giving customers advice as a fashion authority and making the in-store interactions memorable and fun.

Employees tell us Journeys is a great place to work, measured by a record number of applicants for holiday hiring. We invest continually in employee engagement and training, currently with some of the best training programs we've ever offered. Our employee engagement surveys give us insight in how we can strengthen the already powerful Journeys culture and build on the strategic advantage.

Over at Lids, we're testing a new store design in a handful of locations. The updated look and feel features cleaner product presentation, narrower assortments with more of a showcase orientation and a larger emphasis on interactive experiences, such as custom embroidery. It's still very early, and we'll need to analyze the results over a longer period of time, but the first indications are encouraging, highlighted by increased traffic and higher dollars per transaction with the embroidery add-on.

J&M recently debuted its newest flagship store on the corner of Madison Avenue and 52nd Street. The team is very excited about this site, as it sits in the heart of an emerging men's shopping district in Midtown Manhattan surrounded by terrific co-tenants and only 2 blocks from where J&M operated a successful flagship store for many years. This store showcases the latest design format with upgraded presentation materials and enhanced display functionality to better support both our footwear offering and expanded apparel categories. We'd love you to stop by this store if you are in that area.

And further on stores, it is apparent that the growing number of online returns are becoming a pain point for e-tailers evidenced by recent alliances formed with brick-and-mortar partners for the drop-off of returns. Consumers have been voicing their preference for these more convenient return options. So one advantage of having a large store footprint is that much of the U.S. population lives within a few miles of our Journeys and Lids stores. For example, most of the online sales that end up being returned at Journeys or brought to a physical store rather than being shipped back, providing us with an opportunity to convert the return into a sale once these customers are in our stores, something we are successfully doing more than 50% of the time thanks for the good work of our compelling store associates.

And then finally, we have proven abilities to drive traffic into our stores and onto our websites and to give you some examples for the Q4 critical holiday selling period, we're investing in targeted digital campaigns and more catalog drops for Journeys. We will increase the number of e-mail campaigns by sending almost 70 million more messages and increasing the number of catalogs dropped by 30%, which means several million more books. These actions are even more pressing for Lids and include an almost 25% increase in media spend, focused largely in the areas of social, paid search and affiliate marketing.

As a result of intensive efforts to collect e-mail addresses for the loyalty access pass with the Lids app and in-store initiatives, Lids' list size should be almost 70% larger by year-end, allowing Lids to touch millions more qualified customers. Specific efforts aimed at driving traffic to Lids stores include local inventory ads, in-store only events and offers such as free customization and bounce back coupons.

And then finally, we are building out our omnichannel and digital capabilities. Since we last spoke, we have continued to invest in these initiatives across all our companies. Schuh is a frontrunner and currently enjoys the most robust capabilities, including collecting -- collect within 1 hour guarantees, second reserve with a 20-minute response time, mobile checkout in stores and the use of a mini-distribution center to extend the cutoff for next day delivery. Most recently, Schuh launched a new web platform that is faster and offers quite a bit more functionality.

For Lids, the implementation of a new order management system brings us closer to complete buy online, pick-up-in-store capabilities. With this new offering, we have seen an increase in customers who want immediate pickup and elect to come into the store instead of having products shipped, reinforcing the need-it now mind-set of the customer and their willingness to make the trip to the store to get it. We have also upgraded Lids' online embroidery to more closely mirror our extensive in-store capabilities, adding another level of customization to the digital shopping experience.

And across all businesses, we put big focus on optimizing the mobile experience, since nearly 80% of traffic to our website now comes in through mobile. Digital has unlocked exciting possibilities that were never before available to our customers and will allow us to differentiate the experience we are able to offer.

Fourth, our focus on social media is paying dividends with increased engagement and increased fan followership. As an example, Journeys has partnered this holiday with Instagram and YouTube influencers to promote the hottest styles in footwear and accessories. This content will come to life across earned and paid media channels in the digital world in places like display ads and in the physical world in places like in-store signage as well as in our influencers' social circles. Similar campaigns are being conducted in our other retail brands.

And finally, we are managing capital spending carefully as we move into the new year. In fiscal '19, CapEx will come down meaningfully and be much closer to depreciation levels. We will have anniversaried the Journeys DC expansion project, spending will be limited to only a few new store openings where the opportunities are compelling and with the shortening lease terms, we should see less renewal capital spending as well.

Let me conclude, as I usually do, by saluting our employees for their hard work, talent and dedication, which we see quarter after quarter, but which we're especially appreciative of in this, the busiest of quarters. And I particularly want to recognize our employees in the areas that were hit so hard by the hurricanes. In Texas, in Florida, and especially in Puerto Rico, many employees who are dealing with devastation in their personal and family lives, have still managed to do what it takes to get our stores back up and running as quickly as possible and to serve customers who needed to replace items they may have lost in the storms. I'm so gratified to witness that level of dedication. But I've also been amazed by the tremendous outpouring of support across the company, including from employees in Canada and the U.K. as well as all the U.S. divisions for their fellow employees, who are affected by the storms. We are truly fortunate, and I'm very proud to have such a great group of colleagues. My thanks to all of you for what you continue to do for each other and for Genesco. Happy holidays to everyone. And we look forward to talking with you next time.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) We will go first to Pamela Quintiliano with SunTrust.

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

So I had -- if I could sneak in 2, because I think one, you're probably not going to answer it. But footwear, the first one, just, how sticky do you think current trends are? So not asking the brands and all that, but just based on what you've seen historically, how many more quarters do you think we could potentially get out of it? And then turning to Lids, there's obviously a lot of moving parts there, a lot beyond your control. It sounds like you're going to be aggressive with the promotions, reflecting what you're seeing from some online competition, you mentioned a lot of the marketing and outreach you're doing. Can you just talk us through what's incrementally new year-over-year for fourth quarter? And if there is anything that you moved around or shifted the timing of reflecting the recent trends that you saw in the marketplace?

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

So on Journeys, Pam, we're very happy with the assortment, as we said in the prepared remarks. We think that we are very good for holiday season. We think we are very good for spring, which were at this point heavily bought for. And then beyond that, I think we will probably give you more visibility on the next call. But we feel like this is looking like what we have seen in the past with Journeys. And as you know, in the past, when we come through a fashion cycle, we get a 2- to 3-year run. And so we're in the early stages of that. And we'll see if that plays out. But we'll give you more color in another few months. On Lids, the big surprise for Lids is really football. The Cubs were a huge event for us last year. And so we knew about that, and it's something we planned for. It's just been very well documented that the NFL has hit speed bumps, and you can measure it by TV viewership or merchandise sales. Other retailers have reported out on this. And so we faced headwinds in the category. And some of it's team-based, most notably with the challenges faced by the Dallas Cowboys. We're very happy they won last night. And last year, they were strong playoff contender, and they're, obviously, a very, very popular team nationwide. But this is really an overall thing. So beyond teams, overall the NFL trend is broadly hurting our sales across all teams in general. And this is something we did not expect to see. We also lack a fashion driver in our headwear business. And so we are working with our vendors to address that. We've had fashion drivers come and go over the past 16 years that I've been in the business, and I don't think there is a reason to not expect another one. We just don't have visibility at the moment. And so we're working with the vendors. We are testing many things to see what might get some grip, but right now we don't have any visibility on that. And then the other thing in the quarter, which we called out is the NHL licenses are in transition and that has led to some supply chain disruption. And so while the impact is de minimis in most of the U.S. markets, it's a pretty major headwind, as you might imagine, in Canada. And again, we believe the vendors are going to be able to support us better than they have and we are hoping that in the future that they sort of iron out the transition, so we're hopeful this is just a one-off. And then finally, for Lids, the other headwind for them has just been the traffic in the malls. It's the most impulse oriented of our businesses, and the reality of the traffic trends in the mall are there for us to work on. And as we noted, what we're doing is taking a lot of initiatives to try and make sure that our core customers, particularly the heavy buyers of headwear, are aware of what's new in the stores, and social media is an important medium for getting that information out. So we're kind of disappointed where things are. We think a lot of it is hopefully temporary. The issue -- the very near-term issue is no one in the industry saw the NFL thing coming and so everybody was bought for a much more robust year. And so with sales off as much as they are, we are already seeing discounting in the market. And so when we thought about what our fourth quarter outlook is, we had to anticipate that there would be margin pressure, especially in that category due to the trends. Mimi, anything?

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

No, I think that covers it.

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

Okay.

Operator

We'll take our next question from Erinn Murphy, Piper Jaffray.

Erinn Elisabeth Murphy - *Piper Jaffray Companies, Research Division - MD and Senior Research Analyst*

I guess, I have a couple as well. I mean, first on the operating margin for Journeys, you reported a solid mid-single digit comp, but it's the eighth consecutive quarter, where you've had op margin declines. I think Mimi, you called out there was a little bit of impact from Little Burgundy, so ex that it would have been flat. But, I guess, bigger picture, curious what you need to see though on a top line to see margin expansion for Journeys going forward. Is that possible just given where we are in the fashion cycle? And then, Bob for you, just -- you mentioned that U.K., you're planning to be more promotional at the Schuh division in the fourth quarter. What's really driving that?

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

So Erinn, just to begin to talk about Journeys and what happened in the third quarter, I think if you uncover that 4% comp, first of all, exactly what you've called out, the Little Burgundy conversion is what caused the drag on the Journeys Group profitability. This is a onetime thing. We got them onto our system. We're up and running and feel really positive about their business. So that should not be a factor going forward. When you look at the 4% comp, that is split between a little less than a 3% comp within the stores and a very strong double-digit comp online. And in the quarter, we need about a 3% comp to be able to leverage and we anticipate that in the fourth quarter, in particular, that we will have a chance to do that. We have a much bigger opportunity on sales. There is much more opportunity to leverage the fixed expense, both on rent and to manage selling salaries in a way that in the fourth quarter, we anticipate that Journeys' comp not only will be stronger, but the ability -- the store comp will be stronger, but the ability to drive profitability to the bottom line will be higher there. When the rent reductions that we have been achieving begin to kick in, what needs to happen here is really a resetting of the overall cost base within the store cost structure. So that's what we're working hard on is to bring down rent expense, reset the cost structure by things like, we've recently renegotiated our carrier contract. So overall, shipping expense will be going down for us as well. And all of these actions will put us in a position where we are better able to leverage overall comp within the stores.

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

On Schuh, I don't think I said we were going to have increased promotion in Q4. What we did say is they were year-over-year a little more promotional over Black Friday. We will continue to seek to be a full-priced seller, only taking the markdowns on slow movers until the market forces us to do something different. And so right now, we're in wait-and-see mode. As you know, in the past couple of years, it has gotten more promotional in the U.K., as we reported out. And so we are alert to the fact that if that happens, we need to join the fray. But it is our intent to focus on being a full-price seller until forced to play otherwise. If we play otherwise, we think we learned a great deal about how to promote in order to get maximum gross profit dollars out of a more promotional position. But we're going in as a full-price seller.

Operator

We will take our next question from Steve Marotta with CL King and Associates.

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

Endeavoring to unpack the NFL just a little bit. Could you please discuss the percentage of sales at Lids that was related to the NFL in the second half of last year and then in the first half of this year, which I assume is relatively de minimis, but it would still be a helpful number? And then what you expect it to be in the second half of this year? Again, as a percent of the total Lids sales, what NFL was related to? And because everyone else had 2 questions, my follow-up is what percentage of sales at Lids originated in Canada?

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

Bad behavior is contagious. Steve, on the -- I'm not sure we're going to disclose -- Mimi is looking for some numbers down to the level of -- by quarter. I'll give you some color on it.

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

It's our #1 vendor in the fourth quarter.

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

It's -- no surprises. It's the #1 league for business in the fourth quarter, especially in our Locker Room stores. Over the course of the year, it's in -- NFL sits in the -- somewhere in the 10% to 15% range, but it is heavily weighted to the fourth quarter. And you're right, it's de minimis in the second quarter. And really the only thing that shows up in the first quarter is the Super Bowl. So it really is a third and fourth quarter event. I forgot your other question. Oh, what percentage comes from Canada? Was that in Lids?

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

In the Lids, yes. In Lids, it's about 15% of overall sales come from Canada.

Operator

We'll take our next question from Laurent Vasilescu with Macquarie.

Laurent Andre Vasilescu - *Macquarie Research - Consumer Analyst*

Do you have any high-level thoughts on the number of store openings and closures for next year and by banner? And can you discuss a little bit more in detail any recent traffic patterns you're seeing between A, B, C mall locations?

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

Yes, at high level, the themes are, we will probably close fewer stores than investors might anticipate. And the reason for that is that in our prepared remarks, we described a dynamic that when we go to close a store that is underperforming, a landlord, especially in a C-level mall, will come up with a rent deal that allows us to make money and so we will roll it over for one more year. But as you can imagine, there is a level at which even free rent doesn't ring the bell. And so a mall can decay to the level where we have no choice but to close. And so that's kind of the rough pattern. So that's on closures. On openings, we still have, we believe, important runway in the Journeys Kidz concept. As you know, the Kidz footwear business has gone through a consolidation as Stride Rite closed a lot of their doors. And we're just finding that, that concept resonates. As you can imagine, with kids going to the store is a little more important because they have a sizing issue. And our service model there is very focused on sizing the kids correctly. So that's more of a reason for having a weighting towards a store-based concept. And then beyond that, we have got really opportunities that have shown up heavily in A centers for us to bring in most notably the Journeys concept into malls where we have really never been getting an opportunity, and that's just another measure of what's going on in the world of store consolidation. So we are finding opportunities to not only go into these malls but to go in with the right kind of rent deal to be very productive and very profitable. And so we're taking advantage of those. So that's sort of at 30,000 feet how we're thinking about it. And then on the call in 3 months, we'll give you specific numbers because we will have finished our budget by then. Last thing I'll highlight, which we also mentioned, is we think capital will -- is going to continue to come down because on most of these short-term renewals, we really do what is necessary to keep the store open for another short while, which is more of a maintenance kind of CapEx than necessarily a full store rebuild. And so that is helpful to the cash flow aspects of the business.

Operator

We'll take our next question from...

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

Well, just on the traffic patterns between the different malls, for a while, we were seeing traffic patterns -- first of all, it's down everywhere, although in Back-to-School with Journeys, we saw a nice pop. But if you take averages over the course of the year, all levels of malls are down, and it is a little more pronounced as you go down into the -- deeper into the mall universe, with the Cs being the worst.

Operator

We'll take our next question from Jonathan Komp with Baird.

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

Just want to follow up more on the Lids outlook. In comparing the fourth quarter comps guidance versus what you gave a couple of months ago, it looks like kind of about a 400 basis point reduction. I was just curious, can you clarify is that entirely related to the NFL? I think that implies the NFL down in order of like 20%-ish. So I just wanted to maybe clarify that is the first question.

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

Yes, that's -- you've got -- it is heavily weighted towards the NFL. And that is sort of the order of magnitude of the problem.

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

Yes, I think that's right. There is a little bit in there for hockey, but the preponderance, because the overall NFL product for gift giving and the fact that we are in the season is the strongest part of our business.

Operator

We'll go next to Sam Poser with Susquehanna.

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

I guess, on the Lids group business, last year, Lids had a good year and you bonus-ed -- or maybe it was the year before, when you sold the Team Sports business, you provided an additional incentive comp for the sale of that business. Now...

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

It was 3 years, right?

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

Two years ago. With the write-down of this business now, how does that impact -- how is that impacting -- how are you going to handle incentive comp or the bonus comp there with this because...

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

Sam, you're mixing apples and oranges. The business we sold, none of that goodwill is in this. That goodwill got addressed when we sold the business. So the goodwill we are discussing in the current impairment is all related to Lids retail, not Lids Team Sports.

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

And just to clarify, Sam, that really is an adjustment on the balance sheet. Basically, we look -- we do a market cap test, and you've seen our stock price, it's at levels that are well below historical levels. And when the carrying value of Lids almost equals the market cap of the entire company, what the accounting standard calls for is an adjustment on the balance sheet to the goodwill, which is an intangible asset. So that's really what ended up happening, and we flowed that through the income statement for GAAP purposes. And so it is a noncash issue. It's an adjustment to just account for the overall carrying value given where we are currently -- our stock price is currently trading.

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

And it doesn't enter the bonus equation. It's a separate item.

Operator

We'll go next to Janine Stichter with Jefferies.

Janine M. Stichter - *Jefferies LLC, Research Division - Equity Associate*

I'm just curious if you could talk a little bit more about boots at Journeys. It sounds like they got off to a slow start in October, but you're seeing some better trends now the weather has turned. Just curious kind of what's embedded in your guidance up against some easy compares last year when I think you cut orders and left some money on the table. And also on the IMU pressure from the fashion athletic, can you just give us a sense of how important the fashion athletic business is in 4Q relative to 3Q as boots become a bigger part of the mix versus 3Q?

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

Yes. And so on cold-weather products, you've got it about right. At Journeys -- and by the way, throw in all our businesses that have cold-weather products, Johnston & Murphy and Lids. It was warm through like the last week of October then when it got cold, you could just -- it was like throwing a light switch and all of a sudden we started to sell through nicely. And you remember correctly from last year, it didn't get cold early enough and the whole market got promotional and we joined in. And so to play -- we played an appropriate level of defense and liquidated a bunch of our boots, which only in retrospect when you looked at how the rest of the year played out, we recognized that had we not, we would have had some more boots to sell at full price. But 20/20 is -- hindsight is 20/20, so the team did exactly the right thing. So this year, we feel like we're off to a good start, and we think that when we start to anniversary the period where we didn't have an adequate supply last year that we'll be in very good shape. The IMU pressure from fashion athletic product, that's in our guidance. So it's more important in Q3 than it is in Q4, but it's a factor that we have it in the numbers.

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

Yes, that's right. The fashion athletic product as a percentage of our sales in the fourth quarter is considerably less. Boots are really the big product that sells in the fourth quarter. And typically, our boot IMUs are lower than our athletic in general. And so this year in the fourth quarter, we actually don't anticipate any gross margin pressure. Last year, we were clearing product in order to address the fashion shift. And this year, we've substituted some of that lower IMU for the markdowns we took. So we're actually expecting that we will be in good shape from a gross margin point of view this year in Journeys' 4Q.

Operator

We'll go next to Scott Krasik with Buckingham Research.

Scott David Krasik - *The Buckingham Research Group Incorporated - Analyst*

One for Mimi, one for Bob. So just if you look at the last 10-K rent expense, I think was a little over $270 million, a little over 21% of sales. Is that trending similarly for this year? And then should we just take a 9% reduction to that for next year? Is that the right way to think about it? And then Bob, I know you don't talk about profitability of Lids Locker Room, but just given some of these numbers, specifically the skew to NFL, is proof-of-concept an issue here? And how do you think about that longer term?

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

So yes, Locker Room does run a higher percentage of NFL than does the headwear stores, you're right on that. We are not drawing a line on this event, where suddenly interest in the NFL plummeted and everybody ended up long inventory and had to discount as an indictment of the concept to be honest. I mean, it is one of the risks in the business, and so it's a consideration. But what we are going to be waiting to see is what happens when people have learned -- first of all, what does the NFL do to try and rejigger their business model to get viewership and interest rebooted? And then we are continuing to operate the business and we will be buying it next year to what we think is the right-sized amount of NFL. So we think -- we are hopeful that it is a onetime event that is related to the fact that everyone is just over-inventoried on NFL.

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

Yes. So Scott, in terms of our rent expense, I think the way you have to think about it is that we've got renewal cycles on a portion of our leases that come up every year. And so we've got in the neighborhood of 300 to 350 leases expiring each year depending on our opening schedule. And so more or less you could say that somewhere in the neighborhood of 15% of our portfolio would be renewed each year, and then you can apply that

9% or 10% reduction to that part of the portfolio. And then it compounds, right? Because we will get a set of rent reductions in this year, we'll get a set of rent reductions next year and those sets of reductions will begin to compound and really impact our rent expense line.

Operator

We'll take a follow-up from Jonathan Komp with Baird.

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

I got cut off, so I just wanted to follow up on Lids. And more curious kind of beyond the fourth quarter, how you're thinking about the sustainability of some of the pressures versus opportunity to recapture performance again. So it looks like pretty soft results this year. Just kind of broadly how you're thinking about it?

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

Yes, that requires that we sort of step back and think about what this business is. We know, first of all, that there is a hearty appetite for fans to buy fan gear at stores. And it's driven by a game day. We know that the omnichannel experience for fans is very compelling. When we ramped up the level of buy online, pick up in store that's available to them, they jumped all over it. We know broadly that returns were a pain point and therefore, we fit that need really well. In the headwear space in particular, we still have a very strong position. Just like the Journeys business that has come through a fashion cycle after going through a trough, we are in a fashion trough in Lids headwear. And so we are of the belief that we can recover from that. It's just -- unfortunately, we have no visibility on what that might look like. But just 20 years of the headwear business says that trends show up and people get engaged on a new kind of look. So we're working like crazy with our vendors to figure out what that might be. So we think there is lots of reasons that this business has a reason to exist. And the other thing that's going on, and I'll highlight this for both Journeys and for Lids, there are some pretty clear indications of consolidation continuing to happen in the industry. So yesterday, a regional competitor, who is in a similar space to Journeys, called Shiekh filed for Chapter 11. There is a lot of buzz around the Locker Room space of competitors that are struggling. We think there will be a pretty meaningful rationalization of an over-stored environment, and we will be the beneficiaries of that. So we've invested -- we're the only one in the store world that has a first-class digital presence. And so -- and that's showing up in terms of the huge gains we're seeing in our digital business, which we continue to invest in. So we see a lot of things about Lids' strategic position, its competitive position that are compelling, but we acknowledge that right now, we're in a bit of a hole. So what do you do in that situation? We certainly are not going to invest in a lot of new stores in an environment where we don't have the visibility of fashion on the hat side and competitive dynamics on Locker Room side. So -- but we will be competing to try and take advantage of what we think is a long-term strategic position. To borrow from Wayne Gretzky, we're trying to skate to where the puck is going to be. We don't like where the puck is right now.

Operator

I'd like to turn it back to our presenters for closing remarks.

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

Well, I just appreciate everybody joining the call. Thank you for all the thoughtful questions. Happy holidays to everybody, and we look forward to having a chat early next year.

Operator

That concludes today's conference. We thank you for your participation. You may now disconnect.