THOMSON REUTERS STREETEVENTS

EDITED TRANSCRIPT

GCO - Q1 2018 Genesco Inc Earnings Call

EVENT DATE/TIME: MAY 25, 2017 / 12:30PM GMT

CORPORATE PARTICIPANTS

Mimi Eckel Vaughn *Genesco Inc. - CFO and SVP of Finance*

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

CONFERENCE CALL PARTICIPANTS

Benjamin Bray *Robert W. Baird & Co. Incorporated, Research Division - Junior Analyst*

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

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

Laurent Andre Vasilescu *Macquarie Research - Consumer Analyst*

Mitchel John Kummetz *B. Riley & Co., LLC, Research Division - Senior Analyst*

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

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

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

PRESENTATION

Operator

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

The company expects to make forward-looking statements. These statements reflect the company's 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-K filing, for some of the factors that could cause differences from the expectations reflected in the forward-looking statements made during the call today.

The company also expects 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, CEO and President*

Good morning, everyone, and thank you for being with us. I'm joined today, as usual, by Chief Financial Officer, Mimi Vaughn.

The first quarter top line played out close to how we planned for the company, in terms of total sales with comps down 1% at the low end of the range. And as anticipated, comps experienced wide swings over the course of the quarter. Following a very challenging February in the U.S. due to the IRS delay of income tax refunds, sales trends improved in March until the Easter offset at the end of the month. While the Easter shift benefited April, which was by far the strongest month of the quarter, sales in our U.S. businesses were more challenged than we expected in total for the quarter, offset in large part by stronger sales in the U.K.

Another important variation from our expectations is that sales were more concentrated in digital. While overall comps were down 1%, store comps were down 4% and direct comps were up almost 30%, which included double-digit comps in almost every business. Although we are very pleased with these strong direct comps as a measure of success in the omnichannel investments we have made, the lack of traffic in the mall causes our store fixed expense base to deleverage and hurts profitability.

Adjusted EPS of $0.06 was only a few cents below our internal estimates for the quarter, but well below last year's level. We said on our last call we expected Q1 to be very challenging for earnings, to be substantially less due to negative comps at Journeys from the fashion rotation, gross margin pressure at both Journeys and Lids, deleverage from soft comps and spending at Lids to fund initiatives that pay back later in the year and beyond but will be dilutive to the quarter.

Somewhat lower sales and more SG&A deleverage caused our results to be a little below where we thought they would be. As we'll discuss, we expect that several of the specific factors that made Q1 difficult will improve in the course of the year. But we are lowering our outlook because we now expect it will take a little longer than we first thought to emerge from the fashion rotation at Journeys, and we are assuming a more conservative outlook for sales in our bricks-and-mortar stores given the anemic level of mall traffic we saw in Q1.

Now to go into more detail on the main drivers of Q1 bottom line performance. First, Journeys comps declined 5%. Following 2 consecutive years of record sales and peak profitability and a positive comp in Q1 last year, Journeys' results were challenged by the fashion shift that began right as we approached back-to-school. This was exacerbated by our concentrated deep and narrow position in a smaller number of brands, which had been benefiting the Journeys business for some time.

Journeys made excellent progress adjusting its assortment for the beginning of this year to better reflect current customer demand. The new brands and styles are performing very well and we are pleased with our brand and style diversification, as we have managed through the fashion shift over the past 9 months. However, the declining part of the assortment that is still a good part of our business, decreased even more than we expected and therefore, comps were worse than they thought they would be and these weaker comps contributed to significant expense deleverage.

Second, as expected, Journeys' gross margin was pressured by the mix shift to a greater fashion athletic assortment, as the majority of these newer product carries lower initial margins.

Third, Lids sales momentum was slowed by weak mall traffic to start the quarter caused, in part, by the tax refund delays and Easter offsets, following a strong finish to fiscal '17. Lids low positive comp increase wasn't enough to leverage expenses. The impact was particularly acute in stores since negative store comps were offset by positive digital ones to generate the overall comp increase.

Fourth, Lids gross margin, as expected, was down versus a year ago due to a challenging comparison. You'll recall Lids entered last year extremely clean after the substantial inventory rightsizing actions we undertook the year before. This year, markdowns were at a more normalized level, higher than last year given how clean inventories were then.

And then fifth, we made a number of marketing and digital investments at Lids that increased expenses during the quarter. We believe these investments are generating dramatic sales gains in e-commerce and will generate positive returns over time. But as our annual sales have become increasingly weighted to the second half and, particularly, the fourth quarter, these digital and omnichannel investments are more dilutive in the first part of the year.

While these 5 factors had a meaningful effect on results for the first quarter, we believe the impact from a number of them will decrease as the year advances. Specifically, the pressure on both Lids and Journeys gross margin will lessen, and Journeys comps will improve as we anniversary the negative comps, which began last summer. Mimi will discuss this in greater detail when giving the guidance in detail.

Although Lids profitability is down year-over-year, results for Q1 exceeded our expectations. Building on strong progress made in the turnaround last year, we are investing in digital, social and loyalty programs, among others, to allow the business to compete effectively and deliver on customer's heightened expectations in today's retail world. And in addition, the noticeable slowdown in customer traffic that Johnston & Murphy saw in Q4 that began with the run up to the election was less negative in Q1, but the sustained declines were difficult over to come -- to overcome even with higher conversions.

One bright spot was Schuh, where comps accelerated to double digits for the quarter, driven by consumer demand for the latest must-have fashion athletic product. After experiencing a similar change in fashion like Journeys and then a few challenging quarters last year, Schuh's current product offering translated into the strong comp gain. This, along with improved gross margin, led to meaningful profit improvement for the quarter. On top of this, Schuh was named the footwear multiple retailer of the year by Drapers for 2017 against quite formidable competition. So congratulations to the Schuh team.

The other bright spots were Licensed Brands, which had solid results in Q1, and Little Burgundy, which is posing double-digit comps again this year, and congratulations to both of them.

In summary, we expected a very challenging first quarter and our results were a little below our estimates. Our full year outlook has always been back-half-weighted based on the factors I outlined. However, we are lowering our outlook going forward, due to a couple of the more challenging headwinds we recently experienced.

First, the fashion rotation at Journeys is taking longer to play out than we estimated. As I mentioned, Journeys new brands and styles performed even better than we thought they would in Q1 but the declining part of the assortment decreased even more than we expected. We are confident that the Journeys team with its significant talent and extensive experience is well-positioned to deliver stronger results as the year progresses, but the recovery will be more muted because the gap to fill is larger.

And now we have a more conservative outlook for sales in our stores, given the more market shift in shopping away from stores to online. In Q1, we saw some of the sharpest traffic declines in our U.S. brick-and-mortar stores that we have seen in any quarter within the last few years that we've been collecting this data.

In recent years, we have had a strong track record of success combating and overcoming lower mall traffic using initiatives like ShopperTrak to drive higher conversion and generate positive comps. However, we are now comping against the easier conversion improvements we achieved from these operational initiatives, so our capacity to observe further traffic deterioration is now more challenging. So given this, we are projecting adjusted earnings per share for fiscal '18 to range between $3.90 and $4.05.

While we are disappointed with our lower guidance, we expect Journeys comps should improve with easier comparisons as we lap the negative comps that began last summer, and we have already begun to see this. Our overall second quarter comp trend through Saturday, May 20, is better than first quarter's, in particular for Journeys, where mall traffic has also improved which is encouraging.

And with that, let me turn the call over to Mimi to go over the financials and the guidance in greater detail.

Mimi Eckel Vaughn - *Genesco Inc. - CFO and SVP of Finance*

Thanks, Bob. Good morning, everyone. As a reminder, we have posted more information online, as usual, in our CFO commentary.

Beginning with sales, mall traffic was off at the start of the quarter because of the delay in income tax refunds. When refunds are early, the customer has money to come back into the mall soon after holiday, and then comes again to buy spring and Easter merchandise. With later refunds, we believe we largely missed the opportunity for these early sales altogether, which especially affects Journeys and Lids.

For Q1, total sales decreased 1% to $643 million. Excluding last year's sales from SureGrip, which we sold in December, total sales were flat for the quarter. This includes a 1% decrease in consolidated comp sales and a 23% increase in wholesale sales. Sales this year were also impacted by foreign exchange with the pound devaluing versus the dollar. Without the devaluation, we would have had a 1% sales gain.

In Q1, positive comps at Schuh and Lids were offset by negative comps at Journeys and J&M. Building on Schuh's positive comp growth at the end of Q4, must-have fashion athletic product drove robust 10% comp in Q1 with strong increases in women's and children. Considerably better conversion and higher transaction size made up for part of the weakness in mall traffic in Lids stores, but it was the higher digital sales that resulted in a 1% comp overall. Sales were strong in the Locker Room business in both the U.S. and Canada, driven by a solid jersey trend and by Canadian teams winning multiple spots in the NHL playoffs after missing out completely last year.

Headwear, as an impulse purchase, is most affected by mall traffic and comps in the hat business were weaker as a result. Comps at Journeys continued to be impacted by the fashion shift and the decline in mall traffic and were down 5%, as Bob has discussed in detail.

Finally, at Johnston & Murphy, we are seeing a lower average ticket size given the consumer shifting preference for casual footwear and apparel, which has lower price points than the more dressy part of the assortment. Comps were down 3%, in spite of higher conversions, because of this and the weak traffic.

Consolidated store comps were down 4% and consolidated direct comps were up 28%, a much bigger gap than we expected. While traffic was down in our stores, it was up on our website, especially for mobile. Direct as a percent of total retail sales was 10% in Q1, up 200 basis points over last year.

Gross margin for Q1 decreased 120 basis points to 49.6% with declines in Journeys and Lids that were a major contributor to the profit decline for the quarter. Higher e-commerce sales across our businesses generally eat away at gross margins with a higher shipping and picking costs, as well.

Journeys' gross margin decreased 110 points. IMOs on the new fashion athletic product are lower, resulting in lower IMOs in total because of the mix change from the fashion shift. Markdowns were relatively flat to last year's level since Journeys began the year in a clean inventory position.

Lids' gross margin decreased 140 basis points. Last year, Q1 retail gross margin had improved 250 basis points, in part because there was much less markdown product sold in the quarter since it had already been cleared in the third and fourth quarter of the year before with the inventory rightsizing. In Q1 this year, sales of markdown merchandise were at more normal level, making gross margin lower and contributing to the decrease.

In connection with improved merchandising practices, Lids also continues to take markdowns earlier in the season, with the objective of clearing product using more shallow marks. Earlier timing of these markdowns hurt Q1 gross margins but will benefit Lids later this year. Finally, mix shift with less headwear sales hurt gross margin, as well.

J&M's gross margin decreased by 100 basis points, due largely to a greater mix of wholesale sales, which generate a lower level of gross margin than retail sales, and increased shipping and warehouse expense.

Schuh's gross margin improved 50 basis points and benefited from sales of more children's products, as Shuh successfully executes its children's growth initiatives.

Turning to SG&A now. Total SG&A expense as a percent of sales increased 160 basis points to 49.1% for Q1, with significant increases in both Journeys and Lids. With a negative store comp, Journeys deleveraged rent expense a lot and selling salaries to a lesser extent and made higher levels of digital and other marketing spend to stimulate sales.

Lids was able to leverage rent expense and selling salaries with closed doors, rent reduction and very careful management of store labor. However, Lids deleveraged in total due to its marketing, digital and other investments. Johnston & Murphy also deleveraged with its negative comps.

An important highlight continues to be how effectively we manage selling salaries across our retail businesses, holding them flat in total as a percent of sales in Q1 in spite of minimum and living wage pressure, overtime requirements and top line weakness. Our system for measuring store traffic and conversion has been an extremely effective tool to better match staffing with customer traffic but this remains an ongoing challenge.

We are also pleased to report we completed the roll out of new EMV technology in our retail stores ahead of schedule. For the rest of the year, we will benefit from decreased credit cards chargeback expense, stemming from the fraud liability shift to retailers in connection with the new chip and signature credit card requirements.

The net result of this is consolidated adjusted operating income for Q1 decreased considerably to $2.9 million from $21.5 million, with a year-over-year decline for Journeys, Lids and J&M. Adjusted operating margin decreased 280 basis points to 0.5%.

We had expected a very challenging Q1 with adjusted earnings significantly below last year's level of $0.62. Actual adjusted EPS of $0.06 came in a few cents below our estimates, due to somewhat lower sales and more SG&A deleverage than planned.

Turning to the balance sheet. Q1 total inventory was up 5% or $27 million on a sales decrease of 1%, attributable primarily to Journeys and Lids. Journeys inventory was up 9% or $21 million on a sales decrease of 3%. In an effort to accelerate the fashion shift by changing the merchandise offering, Journeys brought in more new product earlier than usual, including $40 million of receipts in January. Inventory was down 4% at the end of December, prior to the landing of this new product. In addition, mindful of the lower sales, Journeys is systematically working down the declining part of this inventory by carefully managing receipts. And we don't anticipate needing a higher level of markdown for this product, as a result.

Lids' inventory was up 10% or $17 million on a sales decrease of 1%. Much of this increase was product from MLB and NFL playoff teams that were contenders for last year's championships that we chose to carryover rather than markdown aggressively and then rebuy. While Lids' inventory is higher than a year ago, we are making progress working it down. We are below plan for the year currently and expect to be below last year's level by the third quarter.

Travel expenditures for Q1 were $30 million and depreciation and amortization was $20 million. Finally, we repurchased 275,000 shares for roughly $16 million at an average price of $58.71 per share early in 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, some of the headwinds from the first quarter should lessen as we get to the second half, giving us confidence that our year-over-year comparisons should get better. We anticipate total sales will grow 1% to 2% this year with consolidated comps, including direct in the range of flat to up 1%. We were heavily impacted by the more significant mall traffic declines in Q1. And while we don't know for certain if this pattern will continue, we have to assume it will to some extent.

Even with steeper declines in the legacy part of the assortment, Journeys' comp should improve with easier comparisons as it anniversaries the start of the fashion shift, and we are pleased with the improvement we have seen in May. However, we will need to hit the more robust selling period of back-to-school and holiday and have the opportunity to inject even more new product into the assortments before comps turned positive. And when they do turn positive, it will likely be at more muted levels than we first estimated.

We expect Lids' positive comp trend to continue for the next couple of quarters but lapping the Cubs World Series victory in the fourth quarter will be challenging, and the growth of mall traffic has diminished our outlook for even the positive comps in the interim.

Schuh should continue at solid trends but the looming elections this summer and Brexit proceedings could create volatility. And finally, Johnston & Murphy's comps should improve, as comparisons get easier over the course of the year.

We are planning on opening around 100 new stores concentrated primarily in Journeys Kids, Canada and the U.K. The other openings largely will be 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 analyzed carefully our recent store openings to see that they exceed pro formas on average, and we'll modify our store opening program if need be.

We also plan on closing over 100 stores to prune our portfolio upon lease expirations for no net gain in stores and a square footage decrease once again this year. Although it is hard to be precise on store closures, because we will keep a store open with short lease term if the rent deal is attractive.

We expect gross margins to be flat to down a little in total for the company for the year, with pluses and minuses depending on business. Gross margin pressure from the new assortments should continue at roughly the same or at a somewhat greater pace for Journeys in the second quarter, but should lessen in the back part of the year when we anniversary the markdowns Journeys took to clear product when the fashion shift began.

Lids will be lapping more normalized comparisons starting in Q2. And while comping against strong full-priced Cubs World Series sales later this year will be a challenge, we believe our improved merchandising and inventory management capabilities have Lids well-positioned to gain on gross margin for the year. Schuh's gross margin will continue to improve due to the mix of product it is selling.

With the low comp, we expect SG&A expense will delever in the 50 to 70 basis points range. Rent has been, and will continue to be, the greatest challenge but selling salaries and omnichannel investment spending will be challenging as well. We expect the strong dollar will weigh down earnings by only $0.02 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 tax rate is estimated at 35.2%. We now estimate earnings per share for fiscal '18 to range from $3.90 to $4.05, down from a range of $4.40 to $4.55. Earnings will be almost entirely back-half weighted, given the trajectory of the Journeys recovery.

Importantly, while we don't give guidance by quarter, the second quarter has typically been our lowest quarter for earnings. And with the projected flat to low positive comps, the deleverage will make it challenging to make a profit this year, especially if comps are more heavily weighted to e-commerce.

We are planning on capital expenditures in the $135 million to $145 million range, including a major investment to expand the Journeys distribution center which is underway and will give us additional e-commerce and other capacity that causes a more elevated level of CapEx than usual. Depreciation and amortization is estimated at $80 million.

Lastly, we are assuming average shares outstanding of $19.4 million for fiscal '18. This guidance assumes no additional stock buyback, but we can use repurchase availability opportunistically going forward.

Now I'll turn the call back to Bob.

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

Thanks, Mimi. I want to briefly reiterate the major initiatives we are working on that span all of our operating companies, as they are key to meeting the challenges of the current retail environment and capitalizing on the strategic strengths of our businesses.

Declining traffic has been a recurring theme in the Q1 reports of most mall-based retailers in the sense that the consumers' appetite for buying online may have reached another tipping point, as has been featured in a lot of recent commentary. Our own first quarter experience does not provide any evidence to the contrary. Our guidance for the balance of the year reflects the assumption that this greater shift to digital represents the new normal, and we are taking a number of strategic steps to strengthen our position.

These initiatives are consistent with what I outlined on our last call. With that said, I'll talk about them again in order of what is most urgent. And they are: first, reducing our real estate risk and managing rent expense; second, enhancing our in-store experience; third, building out omnichannel and digital capabilities; and finally, increasing our use of social media to strengthen the equity of our retail brands.

So starting with real estate. This initiative is more important than ever, with the rent deleverage we have been experiencing and the reality of additional retail store closings and we are redoubling our efforts here. We carefully evaluate each lease that comes up for renewal, shortening lease life where it makes sense, in C malls, in particular. In general, we keep stores open when the landlord agrees to a rent deal in which we can make a decent profit, and today, we have roughly similar 4-wall percent profitability across A, B and C centers because of this. But we are managing that risk carefully.

For example, the average lease life for Lids store renewals in C Malls last year was 1 to 2 years, often with rent decreases, while the average in A Malls was 6 years. And we are shrinking our footprint with more store closings than openings. Equally important, our data shows traffic declines that are not that different across A, B and C malls and so we must manage rent expense aggressively to preserve our profitability across all tiers of malls. We have flexibility to do this since almost 650 of our leases expire this year.

Next, enhancing our in-store experience. Even with traffic declines, we still have substantially more interaction with consumers in our stores than we do online and we must do all we can to convert each customer walking through our doors. Our market research highlighted interaction with our Journeys store employees as one of the most compelling aspects of our customer shopping experience. We have proven formulas to hire great people and are investing in training and product education in connection with initiatives like Journeys' brand break-out strategy and integrated program to highlight a specific brand that gives our store employees more material with which to engage customers.

Another example is the customization initiative at Lids directing an increase in customer awareness of embroidery and personalization, drawing attention to this interactive in-store offering. And finally, we are experimenting with mobile checkout and other initiatives to make the checkout process faster and easier.

Next, building out omnichannel and digital capabilities. These initiatives are not just e-commerce-specific but are designed to facilitate interaction across channels, like a new order management system we are implementing at Lids.

Buy online-pick up in stores is another initiative to highlight and is a key focus of Journeys and Johnston & Murphy in fiscal '18. We've had this capability for some time at Schuh, where it drives a meaningful amount of web purchases and importantly, gets guess customers into our stores where we have an opportunity to encourage add-on purchases. We are investing in targeted digital advertising campaigns and more catalog drops to drive traffic to our sites and stores and have made progress on e-mail capture in our stores, which greatly aids these efforts.

Finally, we continue to enhance our mobile and website experiences with Hybris, as a good example, better search and navigation and simpler checkout processes have driven much higher conversion and added digital sales.

And then fourth, increasing our use of social media to strengthen the equity of our retail brands and increase followership. We are teaching influencers in our catalogs and websites to leverage their social circles to build awareness of our brands, tapping into bloggers to highlight our retail brands and product offering and increasing the frequency of our social media voice to add followers across the major social channels. We are focusing on initiatives aimed at strengthening customer relationships.

We launched a revised loyalty club program at Lids this quarter as an example, knowing that most fans purchase across multiple sports, which makes this business a good one for capitalizing on repeat purchases. And we launched a new Lids app in Q1 built around loyalty as well.

With store traffic proving to be more challenging, the strategic leadership of our businesses in their respective markets is clearly more important than ever. It's always the experience and strength of our teams to meet these challenges. So in closing, I'd like to thank the entire Genesco team for its hard work and perseverance during the first quarter. By executing well and maintaining focus on our strategic strengths, I am confident we can successfully navigate through the current industry evolution and emerge with even stronger competitive advantages. So keep up the good work.

And operator, we are now ready to take questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And we'll first move to Erinn Murphy with Piper Jaffray.

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

I was hoping you guys could talk a little bit more about Journeys and just the fashion transition there. The comp, obviously, missing kind of its plan. I think you talked about declining part of the business, obviously, worse than you anticipated. Can you just help us think about if you look forward, when do you start to see that normalize? It seems like you are getting better allocations in the stores with the new products, but clearly the balance isn't there yet. So any help on back-to-school? Anything, as you think about the visibility there? And then I guess just related to that, you did mention, I believe, quarter-to-date, is tracking better in May led by Journeys? So maybe just expound upon that, what's really driving that?

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

Yes. So Erinn, we're getting big gains in all of the new styles that we have brought in, and we're very pleased with the allocations we've gotten for the most part. And so what we highlighted is that at some of the brands that were -- our rock for the recent years of success came down a little more than expected. They're still -- they're very big sellers. And as usually is the case, a hot brand declines but it never really goes away. But these brands have not found their bottom. We are hoping that when they lap the beginning of their decline, which is really late June and July, that they'll start to find the bottom. But we're, obviously, we're not comfortable guiding off of that given what we've seen year-to-date. And then importantly, these brand partners of ours, they're not standing still. They are working both the product side and then they're investing in their marketing efforts to try and be helpful. And so we're also hopeful that those efforts will pay off. But once again, we're not really ready to take that to the bank. Some good news is ASPs are up because what is new is the higher price point. And as Mimi noted, I'll just emphasize that the inventory growth, because we brought in a lot more of the hot new products, we feel like we've got, basically, 12-month product that we need to work down in a lot of the legacy brands. And so we don't think we have markdown exposure. But the beginning of May, look, we're 3 weeks in. Traffic has gotten better, comps responded and got better at the same time. But as you know, weather broke nicely in early May. And so some of that can be weather-driven. We just got such difficult traffic numbers in the first quarter that we think that, that is something that we need to continue to be mindful of and not necessarily assume that, that's over. And then the other shift, obviously, which we called out is this heavy shift to digital. Our -- the teenage customer still tells us that they like to shop the store but the numbers don't lie. And so we've had a dramatic shift in this quarter to digital sales. And we think to some extent, that's expensive to stores and that deleverages. Mimi, anything you want to add to that?

Mimi Eckel Vaughn - *Genesco Inc. - CFO and SVP of Finance*

Yes. So Erinn, just to talk a little bit about the timing of the Journeys recovery. Initially, we thought that as we hit the second quarter that, just given how well the new styles were performing, that we would be in positive comp territory. We now think that we are -- in the second quarter, we will be flat to down a little and that will be quite a good improvement from the first quarter. But the second quarter is just a low selling period, kids get out of school, they're thinking about summer. They are not really building their wardrobe. When we get to back-to-school and in holiday, when we have a chance to inject just a lot more product into -- a lot more of the newer product into the assortment, we anticipate that comps will turn positive and will build momentum as we go through the back part of the year to be positive for back-to-school but then also, for holiday at a greater level.

Operator

The next question comes from Pam Quintiliano with SunTrust.

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

The traffic declines, can you talk about what you're seeing the magnitude versus what you're hearing is happening in the mall overall? In the past, even when there have been declines in traffic, you just kind of held on your own and then incrementally, better. I was just wondering if we're still seeing that in this really challenging environment? And then what do you think -- Bob, you mentioned it was the tipping point this quarter. So what do you think really changed with the consumer that made it the tipping point? You just mentioned weather quickly, but is it weather? Do you think at Journeys, in particular, we've heard that there's not a lot of new women's fashion out there in the marketplace. Do you think that hurt on the footwear side, in addition to just transitioning away from some of your older styles to your newer ones? Just any insights that you can provide on why it happened now? And then even though you're seeing these improvements in 2Q, why you think this is going to continue on the trajectory?

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

Well, first of all, I didn't call it a tipping point. I'm just quoting someone that I read. And I said in our view, we have to be mindful that, that might actually be the case. So let's not be the person declaring that there's been a tipping point. Look, our traffic in the first quarter, particularly at Journeys, was the worst that we've seen since we've started measuring it. We don't disclose our traffic numbers, but it was worse. And so -- and February was awful and everybody's reported that and then it got better. But if you add up the whole quarter, it wasn't really what we were hoping for. I can't explain it. I can't tell you here is the event that drove it. If I speculate, I would say that the highest period of e-commerce shopping is generally the fourth quarter. So maybe that's habit-forming but that's just pure speculation on my part. And as I've said, on the last question, we saw the improvement in May. We have a whole quarter of really tough traffic. We have 3 weeks of an improvement with better weather. We're not willing to all of a sudden say the trend has completely reversed based on 3 weeks. And so that is the reason that we are getting more cautious about things. Very hopeful that we're wrong about that, so we're not making that call. And obviously, we're going to try everything we can to try and both drive traffic. We cited the fact that we're accelerating some of the marketing spend that we're making to try and drive our own traffic, and then, obviously, we need to really work on conversion at Journeys. The product flow that we're getting should help conversion. And again, what we're seeing in May has been encouraging.

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

And if I could just add one in terms of...

Mimi Eckel Vaughn - *Genesco Inc. - CFO and SVP of Finance*

Yes, sure. I'll just add one thing and then let you ask your question. So we have been seeing traffic declines for some time in our stores, and we have been able to overcome those traffic declines with higher conversion. And so our store comps were positive, in addition to our e-commerce comps being positive, until we had the Journeys fashion rotation last year. That was the time that we saw our store comps become negative. And so it was really in the first quarter that we saw such a large divergence between our store comps and our e-commerce comps and that was the notable call out that we've made.

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

That's really helpful. And just one other question, a follow-up. When we think about the different divisions, specifically Journeys and Lids. Are you seeing the same type of momentum, in terms of the shift to online? And then can you remind us with Journeys, what you're charging the kids for shipping? And how you're seeing the average order value online? Are they trying to cover shipping costs? Are you seeing higher returns? Just anything there will be helpful.

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

So the reason that we think that there is something more going on is that all of our businesses are seeing a pronounced shift into online, and that's even true in the U.K. And so everywhere we look, we're seeing the shift. Now, part of that is we're very pleased in the sense that we have made some important investments to help make that happen. And if you look at the numbers that are being reported for overall e-commerce growth, we are outpacing that. So good for us that we're not in any way disappointed that we're growing our e-commerce business so nicely. It just is hazardous to our health when it comes at the expense of stores because of the deleverage. Hence, we're redoubling our efforts on what we're going to do, in terms of correcting at the store level, for rents and total square footage. So that's sort of how we're thinking about it.

Mimi Eckel Vaughn - *Genesco Inc. - CFO and SVP of Finance*

And as far as shipping or shipping threshold at Journeys, it's $39.99. And the reality is we ship most of our product for free. And all we -- that threshold is in place so that we just don't ship sale products a lot, and we see much of our products go out at free shipping levels because we are so full-priced selling-oriented.

Operator

Next question comes from Jay Sole with Morgan Stanley.

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

Bob, I want to ask just a little bit more about the declining part of the assortment in Journeys. Is there any way to maybe dimensionalize it for us, in terms of what percent of the assortment it represents? And what options that are hard to offset that part of the assortment with other brands? If we can start there, that will be great.

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

Well, Jay, I don't think I'm going to get into percentages of what different brands represent in the mix. You just -- we've called out, for many years, one of the benefits we had was a deep and narrow assortment and a number of brands and styles that we're working very, very well that gave us better sell-throughs and higher gross margins. And so -- we're not disappointed that we ended up there. We were giving our customers what they wanted, which is the business that we're in. These brands are now coming back to a more normalized level. And given that they were so concentrated, the impact is a little higher. Again, I want to emphasize what I said, these brands are not standing still. And so they are working with our teams trying to figure out ways to accelerate sales, adjust the assortment in other ways. And so we're hopeful that there will be a bottom we find in these brands. I think the point we're -- the place we're pointing at, in terms of timing, is when we start to lap there a decline, which was late June or early July.

Operator

Next question comes from Laurent Vasilescu with Macquarie.

Laurent Andre Vasilescu - *Macquarie Research - Consumer Analyst*

I know you don't typically talk about the cadence of earnings by quarter. But I just wanted to get a better sense of the earnings power for this year. Are there any onetime factors we should consider between 3Q and 4Q EPS? And should we assume the historical rate of 50% of full year earnings driven in the fourth quarter?

Mimi Eckel Vaughn - *Genesco Inc. - CFO and SVP of Finance*

Yes. Laurent, we don't give guidance by quarter but let me just give you a sense as to how the year is going to unfold. So as I said, it is going to be really challenging to make a profit in the second quarter of this year. It is our lowest quarter and it is very much, with the flat to negative comp, we will deleverage pretty significantly. When we think about the year in total, we have a lot more opportunity to be able to move the needle in the third and fourth quarters, when we have back-to-school and holiday selling opportunities. And so the deleverage that we've been experiencing through the course of the first and second quarters really become much easier. And if you look at the comp guidance that we've given, we have an opportunity in the fourth quarter to move the needle even more significantly. What we have seen is that customers are actually shopping much closer to their need occasion. And so with back-to-school and with holiday, we see an enormous amount of traffic come into our store locations, and we have an opportunity to capitalize and take advantage of that to a greater extent than we do in the earlier part of the year.

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

And the one caution I'll call out on that one is with respect to Lids. Their fourth quarter last year included the Cubs World Series victory and so, that's a challenging compare. But other than that, as Mimi said, we think the fourth quarter is a big opportunity for us.

Operator

Next question comes from Mitch Kummetz with B. Riley.

Mitchel John Kummetz - *B. Riley & Co., LLC, Research Division - Senior Analyst*

I actually have 2. I'm a little curious on the guidance. You're most optimistic about comp for Journeys in Q4. It seems to me Q3 is an easier compare, and then Q4 also is more of a boot quarter and could be dependent upon weather. So the first question is, why are you guiding that way? And then secondly, just on the real estate, Bob, you mentioned that real estate is one of your initiatives. I guess if you -- I've got a couple questions there. What is the margin? How much of -- well, maybe let me ask you this. How much margin -- how much of the growth there is operating margin? So operating margin was down 290 bps. How much of that was the mix shift to digital? And is there anything you guys can do with the leases that aren't necessarily up for renewal? I mean, are there really anything like kick out clauses or anything that you guys can work with the landlords to try to get better rents, even if something is not up for renewal?

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

Yes. Let me start with your last little bit there, the whole thing about what did digital cost us. It's kind of actually hard to do the math because it isn't clean. We have a distribution center and we have -- we know it's a higher cost to both pick and ship single pieces for e-commerce customers. And we sort of know that at the granular incremental level, but we can't sort of parse it out when you look at our total economics. But we do know that it is indeed dilutive. With leases, the most important thing that we're doing is keeping lease a lot shorter. So when you asked the question, what we do for leases that are not necessarily up for renewal? We've got a lot that are up for renewal, and then we do have kick out clauses in a number of our malls. Again, the kick out clauses you get are generally tilted towards the lower half of the universe, which is where we want them because as Macy's and JCPenney and others close doors, we're assuming that they will be concentrated in the lesser malls. So we think we're actually pretty well-positioned to continue to both negotiate better rents, exit stores where it makes sense to exit stores and to overall kind of battle the deleverage of the rent expense.

Mimi Eckel Vaughn - *Genesco Inc. - CFO and SVP of Finance*

One more thing I'd add just before Bob goes on is that even in the interim on the kick out, we have co-tenancy clauses and anchor tenant clauses. So as we see some of the closures in malls even if we don't have a kick out, we have some right for some rent reduction, and ultimately, are able to exit the location if the situation doesn't improve. So that is really beneficial even beyond us having kick out.

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

Yes. On Journeys comp, I'll give you some themes but Mimi could chip in on it. First of all, one of the things we're noticing is that some of the fashion styles that we have assumed are seasonal are 12-month. And so in Q4, we expect to be doing more -- being able to do more in the non-boot category to help drive comps relative to what we've done in the past. And then secondly, in Q4 last year, if you remember how the weather didn't kick in to help boots sales, the merchant team ended up canceling a lot of what we brought in, in the boot category. And by the time we got to the end of the quarter, when the weather did in fact turn, in like that week before Christmas, we found that we were actually under bought. So we think for a normalized weather pattern in the fourth quarter, we have upside opportunity.

Operator

Next question comes from Sam Poser with Susquehanna.

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

I've got a few questions. One, Bob, can you give us some idea on -- well, for Journeys in the cadence of the comps by month? I know you don't normally do it, but this year is -- it appears extreme. So if you could give us like what February looked like and what March and April looked like together maybe? Anything we can have just to get a feel there?

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

March -- our February was horrible, March was better and April was pretty good.

Operator

We'll move to our next caller, Steve Marotta with CL King and Associates.

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

Bob, at what point as a percent of the total mix, will digital be accretive to operating margin and not dilutive?

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

It's not -- I don't think that's the right question, to be honest. Because there are two things that need to happen in order for it not to be dilutive. We need to get a little more ahead on the store side of the decline. So it's dilutive more because we've got a minus 4 comp in the stores than it is -- that we're obviously profitable on the incremental digital sale. We just need to try and work the store side very hard. The other part of it is as we scale digital, the investments we make in digital, which are ongoing and will probably continue because it is a continuous improvement effort, but those investments will get spread over more dollars. So just over time, it becomes less dilutive in the sense that those investments get paid for more easily. I can't give you a point at which it happens. It's always going to be continuous. And again, as I've said, that's -- the single most important thing we do to combat this is attack on the store side. Mimi?

Mimi Eckel Vaughn - *Genesco Inc. - CFO and SVP of Finance*

Yes. I think that -- Bob, I just to underscore what Bob said, it isn't that digital sales are not profitable for us. They are, in fact, profitable. We run our digital businesses in order to make a profit and are doing that. In addition, we're working hard on the economics of our digital business where we -- if you think about the variable cost of shipping and picking, we're doing a lot to enhance the efficiency of our warehouses to be able to get orders out faster. We have invested in robotics picking systems at Lids. We were upgrading the picking systems within Journeys, as well. So with scale and with size, our e-commerce economics will improve even further. It's just a matter of all the deleverage that we saw this quarter was due to that negative comp in the store.

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

Yes.

Operator

Next question comes from Benjamin Bray with Robert W. Baird.

Benjamin Bray - *Robert W. Baird & Co. Incorporated, Research Division - Junior Analyst*

So given the lower traffic, what are you doing to control operating expenses? And how should we think about that in the context of the investments that you're making within the Lids business?

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

Yes. It's a good question. And it's another good layer to the question previously asked. When we get things -- when we get sales moving from stores to digital, it is toughest on us in the first 2 quarters because as a small box retail operator, we're pretty much running on a fixed cost basis. You're at -- you're on most days at minimum levels of staffing. And so you don't actually have a lot of degrees of freedom in how you manage that. In the third and fourth quarter, if you can anticipate what your sales pattern is going to be, you're going to be able to staff a little more readily to that level. So we're really focused more on trying to -- again, as we've said before, focus on the stores and make sure we have the right level of profitability on the stores, that we're getting the right rent deals. We're of a view that keeping leases short almost everywhere at this point becomes more advantageous to us because we think that the traffic trends, and then the occupancy trends, both give us the opportunity to come back and renew at a better rate. The old model in the old days was always try to get along a term, in order to preserve the rent deals that you negotiated. So it really starts to pay off in the end of the lease term. And I think that has flipped, and we're probably better off going short and managing it that way.

Mimi Eckel Vaughn - *Genesco Inc. - CFO and SVP of Finance*

I think we're really focused on the fact that it's important to contain expenses in times of transition like this. And the rent line, when you think about our economics outside of our merchandise costs, rent and selling salaries in a small-box fixed economic environment are our 2 biggest costs. So Bob talked about rent, I'll talk a little bit about selling salaries. We've been working really hard to make sure that we maximize all our store labor and have been able to hold store labor flat over the last many quarters, with a whole lot of work to make sure that we optimize for when traffic is in our stores. Beyond that, we don't have a big line item that is marketing spend. In fact, we've been spending more on digital advertising and that has proven effective. And so we're focused hard on store expenses and making sure that all of the other investments that we are making have positive returns.

Operator

We next move to Sam Poser with Susquehanna.

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

I just wanted to know, from the down-trending styles, could you -- you talked about what you're transitioning out of, could you give us some idea what that is? And two, in February, one of the things that happens is people want to buy boots in February, and then when those dollars shift to March, they don't buy boots. So can we assume that February is also impacted by significant -- just the size of those sales relative to what happened subsequently? And secondly, what is -- when you look at Journeys or Lids, I mean, what is the optimum store base? I mean when you think about the whole thing? Or should you have, given what's going on, just a smaller store base? And how do you -- what do you think?

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

Yes. So we have a thesis that one of the things that made it a little more challenging for Journeys in the first quarter was exactly what you cited, that the tax dollars coming out later moved money out of boots and into spring. And so with ASPs, obviously, much lower, we captured less of those dollars. And that's a thesis that I think has some merit, Sam. On the optimal store base, we don't think about it as having -- we ought to be targeting, pick a number, 500 stores. What we do is we really go lease by lease and figure out what we want to do under the assumption that if we close a Journeys store, but the mall stays open, that we don't capture a lot of the lost sales from that Journeys store, and we've been analyzing it and it doesn't look like we get any material uptick if we close a store. What happens is when a mall closes, and we have a good evidence of this, when a mall closes and all of that traffic disperses to the other nearby malls, that's when we get the pickup. So our approach to this, Sam, is we have no doubt that we're going to end up with a smaller store base. We're going to end up with a smaller store base that is going to be metered by the pace at which malls close or malls get so bad that we can't make a buck in any way, and so we close it just because the economics demand it. So we're going to be on a path that is going to be tied to the decline of the mall universe, which we think is getting accelerated by all the store closings. So we think at the end of the day, we will be at a much lower number but it's just hard to predict what that number is and what the pace is to get there.

Operator

And ladies and gentlemen, that does conclude today's question-and-answer session. I'd like to turn the conference back over to Mr. Bob Dennis for closing remarks.

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

Thank you for joining us. Thank you for all the questions, and we look forward to speaking to many of you in the next several weeks. See you.

Operator

Thank you, ladies and gentlemen, that does conclude today's conference. We thank you for your participation. You may now disconnect.