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GCO - Q2 2017 Genesco Inc Earnings Call

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PRESENTATION

Operator

Good day, everyone, and welcome to the Genesco second-quarter FY17 conference call. Just as 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 to you 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 today's call.

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

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

Bob Dennis *- Genesco Inc. - Chairman, President & CEO*

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

The headline for today's call is that while we delivered a solid quarter in terms of EPS, we have experienced significant comp deterioration in our Journeys business over the past two months related to a fashion rotation which we expect will persist for several more quarters and, therefore, has meaningfully changed our outlook for the back half of the year.

For the second quarter we had a 1% decline in consolidated comp sales and we delivered adjusted EPS of $0.34, just below last year's level of $0.36. Adjusting for increases in year-over-year bonus, operating results were on par with last year's Q2.

Let me talk through the situation at Journeys. Comps, after being positive in Q1, were lackluster in May, which is a low-volume month, and then got progressively worse through June, July, and then August, which is the peak for back-to-school selling. Journeys comp for Q2 finished at minus 4% and for Q3 is running at minus 7% to date, as of last Saturday, August 27.

Through much of the early summer, traffic into Journeys stores was weaker than we experienced earlier in the year, but we expected this trend to improve as we entered the key back-to-school period. And as we hit the end of July, traffic did indeed pick up, but conversion in our stores dropped off considerably, telling us that our overall assortment is not as on-trend as we had expected.

We have seen the Journeys consumer shift away from several of the fashion trends that have helped fuel strong performance in recent years. We are also seeing strong consumer interest and rapid growth in brands that are not yet at a size in our assortment to fully offset the declines in the weaker style. We can see clearly that this is due to a fashion shift into these new styles, something Journeys has experienced many times before, but the speed and the intensity of the shift in this instance are more pronounced than we have ever seen in the past.

Looking back at Journeys' history, about every two to four years Journeys' teen customer is ready for something new and embraces a new fashion direction. While Journeys has adeptly managed this shift before through several cycles, including grunge and urban and surf and skate, the sharp turn this time has been exacerbated by its current concentrated position. Though Journeys has benefited from being deep and narrow in its merchandise assortment for some time, a fashion rotation out of the concentrated position has more impact.

Over the last two decades of managing teen fashion, Journeys has had a negative comp for the year only four times, including the Great Recession, and with this amazing track record, has grown to well over $1 billion in sales. Over the past six years, Journeys has comped up 39%. Fashion shifts are part of the business and we have every reason to believe Journeys will remain the go-to shop for teens and that its exceptional talent and strong culture will continue its long-term record of success.

Across the Atlantic, Schuh had a solid start to the quarter with positive comps in May and June as warm weather helped break the doldrums that characterized footwear and apparel sales in the UK in Q1. However, coinciding with the UK's decision at the end of June to leave the European Union, consumer confidence dipped and the consumer environment turned challenging again for Schuh, marked by a drop in traffic and conversion in Schuh's retail stores, which led to a 1% comp decline in the quarter.

In the days surrounding the Brexit vote comps dropped precipitously. They have since recovered, but remain negative. And on top of this, reported results are negatively impacted by the weakening of the British pound post the referendum.

The challenging quarter for Journeys and Schuh was offset in part by considerable improvement in Lids Sports Group and continued strength at Johnston & Murphy. For the second quarter in a row we continued to reap the benefits of multiple initiatives we executed at Lids during FY16. This included reducing Lids retail inventories 25% by year-end through heightened promotional actions. This clearance activity has allowed us to operate in FY17 with a much cleaner inventory position to drive higher margins.

The Lids Group comp in Q2 was flat as we anniversaried last year's elevated clearance sales. Positive store comps were offset by lower online sales, since e-commerce was a primary clearance vehicle a year ago. Even with the clearance activity, last year the second quarter was one of Lids better full-price selling quarters thanks in large part to the NBA and NHL championship wins by Golden State and the Chicago Blackhawks.

The strong Cleveland Golden State NBA championship matchup this year offset headwinds from the Blackhawks NHL championship win last year. And in addition, this year our Major League Baseball business, led by the Cubs and the Blue Jays, has been stronger in the regular season than it was last year and the potential playoff lineup again looks promising.

However, the biggest difference from a year ago is the increase in gross margin, which was up 480 basis points, driven by our decision to divest the Team Sports business, plus a lower level of promotions at retail. For the balance of the year, we expect Lids flat to negative comp will be more than offset by gross margin increases, resulting in positive gross profit dollar pick up.

Meanwhile, Johnston & Murphy continued the very strong run it has been on for the past several quarters, led by the strength of its more casual footwear offering. Comps increased 3% on top of the 10% gain a year ago and operating income more than doubled thanks to increased wholesale and direct sales and meaningful expense leverage. I would like to congratulate the entire J&M team for another outstanding performance, especially in the current retail environment for footwear.

Turning to the third quarter, comp sales for Genesco overall have continued to be challenged. And for the four weeks ending Saturday, August 27, consolidated comps are down 5%, reflecting continued fashion shifts at Journeys, a tough retail environment for Schuh, and headwinds from the promotional sales Lids conducted a year ago. Going forward, we believe we have fairly good visibility on Q3 with August and much of BTS in the books; thus, we do not expect a significant improvement in the sales trend at Journeys through the rest of Q3. In addition, some of the merchandise that has experienced weaker demand carries over into the fourth quarter and will impact Journeys' holiday sales as well.

Finally, our early reads on the other winter seasonal product for Q4 have not been as promising as we would have liked, although this has been on small volumes and it is still summer.

Given these issues at Journeys and the challenges at Schuh, we have taken down expectations for sales in the back half of the year and we now expect adjusted earnings per share to range between $3.80 and $4. We have widened our range a bit given the uncertainty on seasonal sales in Q4 and, of course, an early and cold winter and a strong major league baseball playoff lineup and World Series would provide a boost.

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

Mimi Vaughn - *Genesco Inc. - SVP, Finance & CFO*

Thank you, Bob; good morning, everyone. As a reminder, as usual, we have posted more detailed information online in our CFO commentary.

For Q2, total sales decreased 5% to $626 million. Excluding Lids Team Sports from last year sales, total sales would have been flat for the quarter. Q2 sales included a 1% decrease in consolidated comp sales and increase in non-comp sales of approximately $5 million, including 36 Little Burgundy stores we acquired and an increase of 9% in wholesale sales, not including Lids Team Sports.

As Bob pointed out, comps started the second quarter stronger than they finished, particularly in Journeys and in Schuh. By division, comps were down 4% at Journeys, down 1% at Schuh, flat at Lids, and up 3% at Johnston & Murphy. We had planned flat to negative comps for Lids, but did not have visibility into the Journeys fashion shift or the Schuh decline when we planned the second quarter. Consequently, these comps were worse than we expected.

Consolidated store comps were down 2% and consolidated direct comps were down 1%. Comps for all of our direct businesses, except for Lids, were nicely positive. Direct, as a percent of total retail sales, remained at 8% for the quarter.

Lids' direct comp was negative for the quarter and brought the average for the Company to negative. Last year in Q2, Lids' new locate system, which gave online access to an additional 50,000-plus SKUs from inventory located in stores, coupled with promotional sales in connection with the inventory cleanup, helped to drive a 39% direct comp. Locate drove sales again this year, but not enough to comp positively against the promotional sales from last year.

Turning to the third quarter to date, consolidated comps through Saturday, August 27, were down 5% with stores down 5% and direct up 3%. By division, total comps were down 7% at Journeys, down 7% at Schuh, down 1% at Lids, and up 1% at Johnston & Murphy.

Gross margin for Q2 improved 150 basis points to 50.3% due to better-than-expected results in several of our divisions. Gross margin for Lids improved 480 basis points, partly reflecting the sale of Lids Team Sports which was a lower margin business, but the improvement in the remaining retail business was also strong, 170 basis points in total.

Journeys gross margin improved 50 basis points benefiting from higher initial margin. Despite the sales shortfall, Journeys carefully-managed inventory and markdowns were only a little ahead of last year. Schuh's gross margin was 90 basis points lower than last year, driven primarily by mix with athletic as a higher percentage of the overall assortment. Schuh also managed the summer clearance period successfully, with markdowns up just somewhat over last year as well.

Gross margin was down for Johnston & Murphy due to lower IMOs in the retail business and a greater mix of wholesale sales. Finally, gross margin in Licensed Brands was lower this year due to increased margin reductions.

Total adjusted SG&A expense increased 170 basis points to 48.4% for the quarter. A major factor driving this increase was the sale of Lids Team Sports, which operated at a lower level of expense than our retail businesses. However, with the negative comp, remaining operations deleveraged, due mostly to rent expense from new stores and renewals and bonus accrual.

One very bright spot is how effectively we managed selling salaries in Q2, actually leveraging them a small amount in spite of the minimum wage pressure we have been battling and the top-line weakness we experienced. We give big credit for our success to our use of ShopperTrak to measure customer traffic and make better staffing decisions for both non-peak and power hours; thereby, driving greater labor productivity.

On our last call we flagged increased credit card chargebacks in connection with the EMV liability shift from issuing banks to retailers. The increase in chargeback expense we experienced was much greater than we had anticipated when we scheduled later implementation of the technology. We have subsequently instituted a number of new operational procedures in stores to combat fraud and are working to deploy the EMV technology at point-of-sale as quickly as possible.

In Q2, chargeback expense improved somewhat from Q1 levels, but we expect this to be a negative factor until we finalize implementation.

Operating income for Q2 came in where we expected, as better gross margins offset lower sales and higher expense levels, and better performance in Lids and J&M offset the losses in Journeys. As a reminder, the second quarter is our lowest quarter from an earnings standpoint and small changes in expenses can have a large impact on the bottom-line operating margin. Adjusted operating income decreased to $12 million from $14 million last year and operating margin decreased 30 basis points to 1.9%.

We delivered second-quarter adjusted EPS of $0.34, just under last year's levels of $0.36. EPS benefited from share repurchases we have made in the last year.

Turning now to the balance sheet. Inventory was down 10% year over year on a sales decrease of 3%. Excluding Lids Team Sports, inventory was down 2% with flat sales and a 3% increase in retail square footage. Journeys' inventory was clean, even with the sales shortfall. Including Little Burgundy, Journeys' inventory was up 6% on a square footage increase of 6% and sales increase of 4%. Without Little Burgundy, Journeys' inventory was up 2%.

Schuh's inventory was also clean, even with the drop in comp. On a constant currency basis, Schuh's inventory was down 2% on a square footage increase of 13% and sales increase of 2%. Lids' inventory was down 32% on a sales decrease of 14%, reflecting the Lids Team Sports sale. Inventory for the remaining Lids retail business was down 16% on a square footage decrease of 4% and flat sales.

Next, capital expenditures were $23 million and depreciation and amortization was $19 million for Q2. We repurchased 309,000 shares for roughly $20 million at an average price per share of $64.72. Our plan had been to work through the cash flow we generated last year, plus the proceeds from the Lids Team Sports sale. We largely accomplished this by the end of the first quarter and, thus, our second-quarter repurchases were at a more moderate pace.

Turning now to guidance. Given the challenges at Journeys and Schuh, we have taken down expectations for sales for the back half of the year. We now also expect gross margins to be pressured a little in these businesses with higher markdowns in response to the sales headwinds, but this will be offset by better gross margins at Lids.

We have trimmed comp expectations for Lids, given our recent experience in going against last year's clearance activity, but the gross margin pickup should more than offset these lower sales. SG&A expense will delever at Journeys and Schuh with lower comps.

As a result of all this, we now expect adjusted earnings per share for FY17 of a range of $3.80 to $4, revised from a range of $4.80 to $4.90. Our top-line assumption for FY17 is for sales to be down, reflecting the Lids Team Sports sale, headwinds from last year's Lids promotional activity, and the impact of a stronger dollar and exchange rate and what we now expect will be negative comp for Journeys and Schuh for the year. Our comp assumption for Lids is flat to slightly negative and for J&M is in the low, positive single-digit range, resulting in consolidated comps in the low, negative single-digit range for the year.

Excluding Macy's, we plan to open 94 new stores, concentrated in Journeys Kidz, and close 82 stores, for a net of 12 new stores this year. We expect gross margin to be up between 150 and 170 basis points in total.

This is predicated on a sizable margin recovery at Lids of more than 500 basis points, some of which is a change in mix from the Lids Team Sports sale. The rest is a pickup from the lower level of promotions, which should be more of a positive factor in the back half of this year since promotional activity was more intense during this time last year.

We anticipate SG&A expense will delever 210 to 230 basis points, due to higher bonus expense in the better-performing businesses and deleverage of rent, selling salaries, and other expenses with the negative comp, plus higher expenses for minimum wage increases, new overtime requirements, and a continued elevated level of chargebacks. The third quarter will be hit the hardest because we expect comps to be more negative than in the fourth.

We expect the strong dollar will remain a headwind and weigh down earnings by $0.12 per share for the year, assuming exchange rates stay where they currently are. We expect positive impact from a legacy pension plan to offset some of this pressure. Lastly, the Schuh acquisition incentive payments are completed and are no longer a factor.

This all results in an operating margin that is down for the year and our FY17 tax rate is expected to be 36.4%. We are anticipating capital expenditures in the $110 million to $120 million range, which is down from prior plan levels and including some investment in a planned expansion of the Journeys distribution center. Depreciation and amortization is estimated at $76 million.

We are assuming average shares outstanding of 20.4 million for fiscal 2017. This includes buybacks made in the first and second quarters and assumes no additional stock buybacks for the year. $80 million remains under the recently-approved repurchase authorization of $100 million, which we can use opportunistically going forward.

Now I will turn the call back over to Bob.

Bob Dennis - *Genesco Inc. - Chairman, President & CEO*

Thanks, Mimi. Let me provide additional thoughts on the outlook for each of our businesses, starting with Journeys.

I mentioned earlier the current fashion shift at Journeys came on much more suddenly than what our team has experienced in the past. This cycle appears to be different from our historical patterns in another, more positive respect. Often in the early phases of prior shifts, our merchants have seen the customer walk away from a trend without immediately giving a clear signal as to what the next fashion driver was going to be. This time, the direction of the shift is more evident and our primary challenge is not figuring out what the customer wants, rather it is getting enough of the new on-trend product into the assortment to satisfy demand.

Based on this, combined with the experience of Journeys' leadership and the strength of our vendor relationships, we are working hard to ensure that the trough in this cycle will be shorter than previous ones. That said, it is not an overnight fix and the balance of the year is likely to be difficult to Journeys as we manage through this transition. In the meantime, we plan to manage inventory tightly so we don't get in an upside-down position, something for which our team also has a good track record of success.

There are bright spots within the Journeys Group worth noting. First, Journeys' direct business continues to perform well, driven by several recent growth initiatives that include supply chain investments to increase the speed of deliveries to customers, more web exclusive product offerings, and an increase in the catalog and direct marketing to drive higher digital and store traffic with a solid return on investment. Journeys' direct comps performed well in Q2 and are up nicely for the year.

Second, Journeys Kidz has been less impacted by the fashion shift we called out for core Journeys. We are aiming to build on current Kidz momentum with the opening of 40 new doors in FY17. Recently commissioned market research showed that awareness of Journeys Kidz is quite high and awareness and likelihood to purchase at Journeys Kidz is even higher among its target customer group.

Strategically, the research validated the role of Journeys Kidz as a clear pathway to the teen-focused Journeys store. And when you combine this with the fact that many stores selling children's footwear have closed or are in the process of closing, it validates our decision to accelerate expansion to solidify Journeys Kidz as the go-to place for branded children's footwear in the mall.

And then finally, Little Burgundy has exceeded our expectations that we had when we completed the acquisition last December with a strong sales trajectory, including a high single-digit comp year-to-date gain, which is not yet included in our reported comp base. Another attractive feature of the acquisition was the fact that Little Burgundy provides us with a new platform by serving a slightly older customer in Canada with a heavier weighting of female customers compared to Journeys.

At Schuh, comps have remained challenged. While total retail sales in the UK have held up well post Brexit, stronger performance has been concentrated in other retail categories and the general malaise in footwear and apparel has persisted. On top of this, the UK weather in the late summer hasn't been great for business.

For these reasons, we are anticipating a challenging third quarter for Schuh. However, we do see opportunities for improvement starting in Q4 when the comparisons are easier.

We continue to make progress leveraging vendor relationships in order to further differentiate Schuh's assortment from its UK competition. We expect that these product advantages, as well as more favorable vendor terms, will yield benefits during the holiday season. In addition, we expect there will be an opportunity for better boot and seasonal footwear sales if the UK has a normal winter this year versus the unseasonably warm one last year. And, finally, we opened a third Schuh store in Germany in Essen in July.

Moving to Lids, we are pleased with how the turnaround continues to unfold. In addition to the work we did to right-size inventories and narrow the group's focus to omnichannel retail, we've implemented a host of other initiatives that will aid sales and margins going forward. The launch of a hybrid software platform, which went live during the second quarter, is a new front-end for lids.com that provides enhanced navigation, product presentation, and customer interaction. We expect this upgrade will help optimize the conversion of the approximately 5 million consumers that visit lids.com each month.

On the merchandising front, by taking more markdowns in season, we've freed up open-to-buy dollars that have allowed us to flow goods through new merchandise freshness and chase hot product, which is, in turn, driving comps, margins, and inventory turns. This strategy has especially yielded benefits in our headwear business where a number of microtrends have also helped fuel positive comps year to date and drive already robust gross margins even higher.

Finally, in partnership with Macy's, we continue making adjustments to our business there to improve profitability. This has included closing 28 shops in Q2 to reduce our footprint down to a profitable core, relocating shops to improve adjacencies, and tweaking the staffing model to better align with current traffic trends in several stores. An area of future upside is Macys.com where we are still in the early stages of capitalizing on the opportunity at this top 10 retail traffic website.

Next, at Johnston & Murphy, the team continues to do a fantastic job evolving the business and gaining market share. J&M has successfully pivoted from being mostly a men's dress shoe brand to a lifestyle brand and is currently capitalizing on the growing strength of its more casual and sports casual footwear and also its non-footwear offerings.

Sellthroughs have been strong in our full-line J&M stores, which have now comped positively for seven consecutive quarters, and in the wholesale channel, where the brand's growth is easily outpacing the overall market and several key competitors. According to NPD's retail tracking service in men's fashion footwear, Johnston & Murphy significantly outperformed the total market in the combined department chain store channel for the six months ending July 2016.

Finally, our Licensed Brands division had another challenging quarter, reflecting the weak performance of many of our key accounts in the department store and national chain channels. But we continue to be excited about the recent launch of Bass footwear, which is helping offset some of the current softness in our Dockers and Chaps businesses. The Bass team is pursuing a sell-in strategy, designed both to gain a more premium position for the footwear brand than it has had in recent years and also to introduce it to the Millennial customer. With placement in Bloomingdale's on the higher end and in accounts like American Eagle, Urban Outfitters, Madewell and Journeys in the youth market, they are nicely set up for a needed repositioning of this iconic brand.

So before I take questions I just want to take a moment and salute the entire Genesco team across all of our operating divisions and in our corporate shared services for its exceptional talent and dedication, two qualities that make all the difference in good times and in more challenging times. We are seeing the rewards of a year of hard work through some very difficult circumstances at Lids; great job in Indy.

We continue to enjoy the results of Johnston & Murphy's skillful execution of a winning strategy and we are excited about the potential of initiatives like the launch of Bass footwear by the Licensed Brands group. And we are also confident we will see the extraordinarily talented Journeys team again prove its ability to navigate successfully through a fashion shift and emerge stronger on the other side, as it has done so many times in the past.

And we know the steadfast Schuh team will overcome the current malaise and whatever tests Brexit throws its way. So thanks to the entire team for all that you do.

And now, operator, we're going to throw this open for questions. We're going to ask you to limit yourselves to one question and, if necessary, one follow-up.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Jay Sole, Morgan Stanley.

Jay Sole - *Morgan Stanley - Analyst*

Great. Thank you. Bob, wanted to ask you about this fashion rotation at Journeys. Obviously, it sounds like there's some brand issues; I realize you don't want to talk about that, but what can you tell us at least about categories or styles? Can you give us any more color on what's happening from a fashion standpoint?

And then, secondly, on the allocation issue. It sounds like that there is a hot product out there; you know what it is. Typically brands like to capture opportunities to sell. What's limiting the brand or the brands or whatever, the styles from delivering the product to you? Because if there's demand there, it seems like they would want to capture it.

Bob Dennis - *Genesco Inc. - Chairman, President & CEO*

Sure. Jay, you're right; we're not going to call out brands and we're not going to call out styles. We think that, for competitive reasons, we're best off keeping that to ourselves. I know that will frustrate some of you, but that's our policy.

The shifts are going on. You guys will all probably figure it out. But in terms of your question on why can't we rotate more quickly, the thing worth noting is how sudden, in terms of timing, and severe, in terms of swing, that this was. So we're chasing product that is essentially totally on allocation. The vendors were caught -- that are the beneficiaries of this -- I think were caught a little off guard in how pronounced this is.

To be clear, these are fashion trends that our buying team were all over. It's just that the extent to which the swing has occurred is more pronounced than anyone would have anticipated. As we noted in the remarks, on several brands we are seeing huge gains, but we just can't get any more product other than what's on order. We're chasing like crazy, but there's not anything to chase.

You're right; if we were in a category where -- we were chasing a category where there was supply, it would not be the issue. It's just the fact that the whole supply chain is backed up at the moment.

And the timing on that is -- we don't think we can get a really meaningful move beyond what was in the order book as we recognize the severity of this. We didn't think we could move the order book until the spring, so when we drop spring, which arrives in the first quarter, we will have a pretty pronounced move beyond what we had anticipated. But between now and then we think we're going to be a little bit challenged, selling out of what is really in highest demand and a little long on what has gone soft.

Jay Sole - *Morgan Stanley - Analyst*

Understood. So you're saying once we get to the spring assortment, that supply will start to fill in at a rate that's more appropriate for the level of demand. Is there any reason to think that beyond that you won't get the supply that you are looking for?

Is there an issue of -- whatever the hot product is, is there a scarcity value that maybe they're worried about delivering too much or anything like that? Or do you feel like this is just like any other cycle, where once the supply chain catches up, you'll get the product you need and be able to satisfy the demand that's out there?

Bob Dennis - *Genesco Inc. - Chairman, President & CEO*

I think it's a little more like the latter. There is some release approaches that are being used on select styles, but in the main -- I think this is mostly about the supply chain catching up to the unanticipated level of demand.

Jay Sole - *Morgan Stanley - Analyst*

Great, got it. Thank you, Bob.

Mimi Vaughn - *Genesco Inc. - SVP, Finance & CFO*

And, Jay, you know that Journeys has just tremendous relationships with vendors and so, in the past, we have been able to get our fair share of product. Vendors do like to manage supply and we, in partnership with them, tend to like the fact that supply is managed carefully into the environment. So as Bob said, spring is going to be the time that we will catch up.

Jay Sole - *Morgan Stanley - Analyst*

Understood. Thanks, Mimi.

Operator

Scott Krasik, Buckingham Research.

Scott Krasik - *Buckingham Research - Analyst*

Thanks for taking my question. Just a follow-up on Journeys. The order of magnitude, just given the presence of the brands that are down-trending, is it as major as when Doc Martin fell off about 10 years ago?

Bob Dennis - *Genesco Inc. - Chairman, President & CEO*

You know, it looks kind of like that in terms of the -- we had a very, very important brand -- and we've talked about that one in the past, because it's way in the past -- and, yes, it has that kind of flavor. The difference here, Scott, is how quickly it happened and so the curve is steeper, if you can think about that way. Right?

Scott Krasik - *Buckingham Research - Analyst*

Okay, that makes sense. And then switching to Lids for a second, the amount of margin you're getting back, Mimi -- I think it was 150 to 200 bps or around there -- from promotions, is that -- do you expect to get more going forward? Is that the right order of magnitude and what will determine that going forward?

Bob Dennis - *Genesco Inc. - Chairman, President & CEO*

This is Bob; let me just give you color and then I'll hand it to Mimi. We're going to continue to see pretty big margin pickup. And when we got down to the fourth quarter, because we had set an end-of-year target for the Lids team, things got especially aggressive.

Now that said, if you go way back, you go say three years back -- three or four years back, where we had really high margins, don't expect us to get back all the way to those levels for two reasons. One, we had snapbacks, which in the early stage of the snapbacks we were basically getting higher-than-average margins because of an imbalance in supply and demand.

And then, secondly, we are being very aggressive in-season, marking down products now to make sure that we're clearing more timely, and we're being reasonably aggressive. A good example of that -- this year the free agency in the NBA was more active than most people had expected and so -- using Kevin Durant as an example -- our team got really aggressive to make sure that we were able to sell-through the OKC jersey pretty quickly.

And so the disciplines we're bringing on are bringing gross margins to the appropriate normalized level, which doesn't get us all the way back.

Scott Krasik - *Buckingham Research - Analyst*

Okay.

Mimi Vaughn - *Genesco Inc. - SVP, Finance & CFO*

Scott, when you look at the gross margin pickup we've had -- and I'll just talk about the first part of this year and then the back part of the year. In the first quarter -- and this is including Lids Team Sports because you have that comparison from last year -- but both that and the underlying retail businesses, the fewer promotions that we are running within the retail businesses are definitely helping us.

Our pickup in the first quarter was 570 basis points. This quarter it was 480 basis points. And really this quarter -- in the second quarter of last year we had the biggest amount of full-priced selling because of the championships that we described on the call. When you move into the back part of the year, we have even more opportunities for gross margin pickup in Lids and it's because the intensity of the promotion was greater.

Last year, roughly speaking, the first half we would give up 200 to 300 basis points in Lids. In the back part of the year, we were giving up 500 and 600 basis points. So relatively speaking, it will be a mirror of what happened last year in terms of how we pick up this year.

Scott Krasik - *Buckingham Research - Analyst*

Okay. That's helpful. If I could just sneak one last in on SG&A, you talked about maybe addressing some staffing to help the comp declines. Is there anything else from an SG&A standpoint or is it really just occupancy and staff -- labor?

Mimi Vaughn - *Genesco Inc. - SVP, Finance & CFO*

We are buckling down across the board. When you have negative comps, you just tighten up everywhere. And, as I mentioned, we were actually, in spite of the negative comp, able to leverage selling salaries.

And so in the peak periods when there is more variable labor in our stores, we will have an opportunity to manage that, but it's the rent expense that really creates the most amount of deleverage for us. And, given that we anticipate that comps are going to be more negative in the third quarter, we're going to be hit a little harder in the third quarter than we will in the fourth.

Scott Krasik - *Buckingham Research - Analyst*

Okay.

Bob Dennis - *Genesco Inc. - Chairman, President & CEO*

Then, Scott, just when you go into Lids, nothing has changed there in terms of the bonus accrual that we've discussed in the past. So there is delevering there around a bonus accrual which is expected to be paid out both this year and in future years, assuming they don't go backwards. So we're putting some money in the bank for them.

Scott Krasik - *Buckingham Research - Analyst*

Interesting. Okay, thank you.

Operator

Mitch Kummetz, B. Riley.

Mitch Kummetz - *Robert W. Baird & Company - Analyst*

Yes, thanks for taking my questions. Bob, you've had a lot of experience at Journeys with trends coming and going and, as far as what you're seeing now, you talked about -- your buyers, your merchants are all over it; they just can't get enough product. I'm guessing that other retailers are probably struggling to get enough product, too. And I'm just wondering how you think about this cycle versus other cycles, where maybe in other cycles there weren't as many retailers competing for the things that were trending, versus this cycle, where it seems like a lot of people are selling the same shoes. Any thoughts on that?

Bob Dennis - *Genesco Inc. - Chairman, President & CEO*

This one came suddenly, but to me the thing we called out, which I'll call out again because I think it's distinctive, is we've gone through some cycles where Jim and Mario from Journeys have said we don't really see where our next basis of advantage is coming from in terms of trend. And that's not the case here.

And so we are really in chase mode to try and get into the businesses that are in the greatest demand. And that, in a way, is more comforting and gives you more confidence that you can see from a timing standpoint and from an action standpoint what needs to happen and how quickly it might happen in order to try and get out from the trough. So I think that's what distinguishes it.

Who else is selling the shoes? This is not -- it hasn't changed a whole lot. Journeys is really the only national footprint, team-focused fashion retailer and so it was that way; it will continue to be that way. Some of what's going on here is on the athletic side -- fashion athletic side, so some of the athletic guys will also dip their toes in here. That's not unusual for us.

I wouldn't say the competitive situation is all that different from where it was. This is just pedal as hard as we can to get to the point where the assortment is in a better mix for our demand pattern.

Mitch Kummetz - *Robert W. Baird & Company - Analyst*

Got it. And then a follow-up. It sounds like you took down your Q4 comp outlook, partly based on this trend that we're talking about, but I think you also made a comment that you are now maybe a little less bullish on other holiday stuff.

I'm just wondering: was that a comment on the boot category in general or was there something more specific to a style or a brand -- not that you're going to name it -- that relates to more Q4-oriented selling?

Bob Dennis - *Genesco Inc. - Chairman, President & CEO*

No, it's more generally around seasonal and, as I said, how good a read do you get in August? History says that you do get a little visibility, but this was hot out there and some of these brands are truly seasonally driven. So it just caused us to say let's just be a little more cautious, because the little bit of news we had wasn't as positive as we hoped. But let's just call it a little bit of news.

Mitch Kummetz - *Robert W. Baird & Company - Analyst*

Got it, all right. Thanks, guys.

Operator

Jim House, Piper Jaffray.

Jim House - *Piper Jaffray & Co. - Analyst*

Good morning. This is Jim House on for Erinn Murphy. Could you speak a little bit more about trends in the UK post Brexit? And then also, as you look at the holiday season, what are you planning for the promotional calendar for both the UK and the US?

Bob Dennis - *Genesco Inc. - Chairman, President & CEO*

Let's just start with Schuh. The Brexit hit -- the week of the Brexit, really going into the vote, coming out of the vote, was a very, very difficult stretch. And then, as probably you've all read, the UK has normalized and its consumer is spending much more than the market had anticipated.

If you look inside of the data, the shape of that swings to other categories. Apparel and footwear has been, more or less, flattish. We're running a little bit below that trend, but it isn't one of the strongest categories. And those retailers who have been reporting out have been mixed. What we're -- that's what we're looking at.

When you look -- and the one thing I'll call out on Schuh is that there is an offset that they are going through right now with back-to-school. In England, the back-to-school is later and so we are actually in a window right now where they are performing a little bit better, which is giving us some encouragement.

Longer term, you get into the promotional period and they are going to -- they've laid out their promotional calendar for Black Friday, which is going to be a little bit different from the way we did it last year. I don't want to go in -- for competitive reasons, I don't want to go into any more detail than that. And likewise, Journeys will be similar to what they've done in the past.

Now that's all dependent on sales trends. Obviously, that's an opportunity to get more liquidation, if that's necessary, and so that decision will be made on the fly depending upon what we feel like we need to do. But the current promotional calendar for Journeys did not anticipate anything significantly different from what we've done in the past.

Mimi Vaughn - *Genesco Inc. - SVP, Finance & CFO*

And one other note, Jim, the fourth quarter in the UK last year, the holiday season, was especially promotional and it was a confluence of factors. It was a weak footwear market, but also was due to an unseasonably warm winter, and so there was just a great amount of promotions that this year we're hoping in general that the category doesn't repeat. And so our plans for the back part of the year, for both Journeys and for Schuh, is, as always, to promote to clear seasonal merchandise. We're anticipating that given the year that we had last year, that we have opportunity for less promotional activity, particularly at Schuh.

Jim House - *Piper Jaffray & Co. - Analyst*

Great. Thank you for the detail.

Operator

Jonathan Komp, Robert W. Baird.

Jonathan Komp - *Robert W. Baird & Company - Analyst*

Thank you; just want to follow-up on Journeys first. Bob, a broader question. I know you've talked a lot about the supply and allocation side of the fashion shift you are seeing and trying to get more product. What about from the consumer standpoint?

I guess the nature of my question is: do you think the consumer is more likely to go to other competitors -- and I'm thinking more of the performance athletic competitors in the mall -- rather than Journeys for some of the hot styles when you do get it? Or any thoughts about that dynamic?

Bob Dennis - *Genesco Inc. - Chairman, President & CEO*

Yes, a lot of thought about that dynamic. Our research shows that our core customer, who is a fashion-oriented teenager, puts Journeys at the front of their list. And so, even in instances where there is some like-for-like product, we are more the preferred shop for that customer.

And then what we do is, both in terms of presentation, in terms of how we assort around the core styles, we position ourselves more as a destination for these styles and brands. And then stylistically, in the store the kinds of people we have doing the selling, our approach to selling, just is a better fit for what is a fashion-driven product than what would occur in the athletic stores, who do a great job around what they are really built for, which is performance athletic.

Mimi Vaughn - *Genesco Inc. - SVP, Finance & CFO*

And, Jon, I think that the traffic patterns that we saw through the course of back-to-school will help inform what the consumer is thinking about as far as Journeys goes. We had weaker traffic in early summer, but when back-to-school came, traffic picked up in our stores back to the levels where they were earlier in the year. And so it was really conversion that was the issue.

We had customers coming into the store looking for products, searching for their needs for back-to-school and not finding the product that they wanted. And so it's conversion that dropped off and traffic continues to come in at the pace where it was before. So that gives us the confidence that when we have the product the consumer wants, they are going to come back. They're going to check and make sure that we have what they need and will return to the Journeys stores.

Jonathan Komp - *Robert W. Baird & Company - Analyst*

Okay, great. And then if I could ask a follow-up on the areas you're seeing trade away from. I know you don't want to name names. Could you talk -- is it a single brand, is it maybe multiple brands? And what are you seeing from those vendors in terms of some of that response? Is there any opportunity to reinvigorate some of the trends there or do you think it's a more negative outlook, at least for a few quarters?

Bob Dennis - *Genesco Inc. - Chairman, President & CEO*

For competitive reasons, we're not going to go into really what it is. I'll just highlight the fact that a lot of our brand partners are very good at pivoting and reworking what they are doing in order to remain competitive and so I wouldn't count any of them out. They probably have a little bit of work to do.

Second thing I'll point out is Journeys' history with all of our brand partners is one where we are very collaborative with each other. And so what we generally get from them is a reasonable amount of help in terms of working our way through this, which is something that can benefit both of us in the long run. So we're confident that this ship will get righted and all the vendors will be doing their best to try and help us get there.

Jonathan Komp - *Robert W. Baird & Company - Analyst*

Okay. And maybe last one, if I could. I'm wondering if you could just comment -- I know previously the operating margin outlook for Lids was to roughly double versus last year. Is that still the case; has that changed at all?

Mimi Vaughn - *Genesco Inc. - SVP, Finance & CFO*

We think that we've been seeing stronger gains in gross margin than we had started the year anticipating and so we expect that those pickups will continue. What we have moderated in Lids, though, is some perspective on the top line. The challenges that we're seeing just comping against the promotional activity in the e-commerce channel is more challenging than we had thought and so we've moderated our outlook for the top line., but that is offset by gross margin increases. And so net-net we're thinking that we're going to come out about where we thought we would be with Lids.

Jonathan Komp - *Robert W. Baird & Company - Analyst*

Okay. Thanks for taking my questions.

Operator

Pam Quintiliano, SunTrust.

Pam Quintiliano - *SunTrust Robinson Humphrey - Analyst*

Great. Thanks so much for taking my questions and for all the granularity that you guys are providing.

One broader one. As we think about your Millennial customer and how they are shopping, do you think part of this is reflecting --? Has the shift happened quicker than you've seen in the past because the way they're shopping is different and they are doing more research online before coming into the stores? And does that change the way your buyers have to approach their job versus historically?

Bob Dennis - *Genesco Inc. - Chairman, President & CEO*

Well, first of all, Pam, our core customer is a teen customer and we're puzzling over a lot of why this seems to be more sudden and severe. It's easy to speculate that social media is a piece of it. And so -- and we are also spending some time saying is there another way to be more anticipatory of this, which is just that's the job of a merchant, period.

So we don't have any clear answers for you on how to do that. We've done a little bit of work, tiny amount of work on social media predictors and they weren't very good predictors of this. So it isn't clear -- and particular given the lead times to buy large amounts to really move the needle, I'm not sure that we know what the solution is.

And I don't want to make this one sounds like it's gigantically different from what we've seen in the past. It's just the onset of this came on a little faster, but the general theme here is a fashion shift to which we need to react, to which we are reacting. Again, the beauty of this is we believe that we see the endpoint on -- we know what we need to do and we can figure out how long it will take to do it.

Mimi Vaughn - *Genesco Inc. - SVP, Finance & CFO*

And, Pam, one other thing I would note is that we have talked over the past many quarters about how much we have benefited from being narrow and deep in our product assortment. We think that part of the reason -- certainly social media will have an impact on teen shopping, but we think that the large majority of the reason for this sharp turn here is just because of how concentrated we are in some of our brands.

And we benefited from that, but a more concentrated position -- coming off of a more concentrated position will give more of an opportunity for a sharper decline. And so that's as much a reason that we can point to as anything else.

Pam Quintiliano - *SunTrust Robinson Humphrey - Analyst*

That's very helpful, thank you. And then another one just regarding the orders. Were you able to cut any orders based on what you saw?

And then, I know you touched on holiday and how you'll typically -- you'll do what you need to do to be clean. But have you already started becoming more aggressive with some of the slower-moving goods? Just how do we think about your promotional cadence through the remainder of the year? Do you approach events differently? Do you send more of the direct mailers with the coupons? Just anything there would be helpful.

Bob Dennis - *Genesco Inc. - Chairman, President & CEO*

Pam, this will be a combination of everything. There will be maybe some opportunities to do some returns for some of the stuff that -- and a lot of this is 12-month products. You push out deliveries.

The brands that have softened, they are not going away, and so we're going to do business with them. We just have to space out receipts. Maybe we have to accelerate sales in a few instances and we may or may not get some assistance with that.

The important thing is that Journeys has been through this before and Journeys has demonstrated that in partnership with our vendors, we always work through this. It's not without maybe a little bit of pain, but it's never the scale of the pain that many other retailers experience when they have this kind of swing. And that's the strength of our team and the strength of our relationships with our vendors.

So we're pretty confident we'll end up with inventories in good shape at the end of the year. Gross margins are being adjusted a little bit to reflect what we may have to do, but we've been there and we've done that and it will be a combination of all different tools to get this done.

Mimi Vaughn - *Genesco Inc. - SVP, Finance & CFO*

And, Pam, I think we're already off to the races on that one. If you've looked to see, we had anticipated a positive comp for the third quarter -- for the second quarter for Journeys, and we ended up negative, and you can see that our inventory was up only 2%. So the management of the inventory has -- is in place; it will continue through the course of the year. And that's an area that our merchants are particularly focused on and particularly feel that working with their vendors to make sure we come out where we need to be.

Operator

Jill Nelson, Johnson Rice.

Jill Nelson - *Johnson Rice & Company - Analyst*

Good morning. A couple of footwear retailers are -- as we've talked about back-to-school shopping season starting later than previous years. If you could maybe just talk about that. I know it's a bit befuddled with the fashion shift, but any insight into that?

Bob Dennis - *Genesco Inc. - Chairman, President & CEO*

Yes, there is a slightly later pattern going on. We've accounted for that in our thinking about guidance, so we're talking about week-to-week sales and we've budgeted that in. So, yes, there is slightly later back-to-school and that's all in play right now.

Jill Nelson - *Johnson Rice & Company - Analyst*

Okay. And then third-quarter comp guidance for Lids looks to have lowered from previous plans. I guess could you just point out some factors behind that revision?

Mimi Vaughn - *Genesco Inc. - SVP, Finance & CFO*

So I had talked about the -- comping against the promotional activity online and we actually are finding that to be more challenging. And so when I made comments talking about the fact that we had moderated our outlook on top-line growth for Lids, but it would be offset by increased gross margin pick up, that was really in reference to the third quarter.

In the third quarter last year -- if you'll remember, last year in Lids we used online as a great vehicle to right-size inventory and to clear product. We were very intensely using the e-commerce channel in the third quarter. Our level of promotions ramped up in the fourth quarter, but we used stores more, proportionately more in the fourth quarter. So we've moderated the Lids' comp for the third quarter in response to what we've been witnessing so far in comping against the promotional activity online from last year.

Operator

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

Bob Dennis - *Genesco Inc. - Chairman, President & CEO*

Just thank you, everyone, for joining us. We look forward to chatting with you about progress three months from now. Have a good day.

Operator

That will conclude today's conference. We appreciate your participation. You may now disconnect.
