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GCO - Q2 2016 Genesco Inc Earnings Call

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PRESENTATION

Operator

Good day, everyone, and welcome to the Genesco second-quarter fiscal 2016 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 you to this morning's earnings release and the Company's SEC filings, including the most recent 10-Q filing, for some of the factors could cause differences from the expectations reflected in the forward-looking statements made during the call today.

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

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

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

Good morning and thank you for being with us. I am joined today by our Chief Financial Officer Mimi Vaughn. Overall we were pleased with our second-quarter performance relative to our expectations. We had healthy top-line growth despite a later than usual start to back-to-school and the move of sales tax holidays in several states which shifted some sales into the third quarter versus last year.

Higher than anticipated comps allowed us to improve adjusted earnings per share to $0.36 compared to $0.34 last year despite the expected drag on gross margin from our ongoing aggressive efforts to right size inventory in the LIDS Sports Group. Profits grew at a rate less than sales due primarily to this gross margin pressure.

Total sales increased 7% and consolidated comps were also up 7%. Performance was boosted by strong trends in our direct businesses, but we were especially pleased to see solid comps in our stores as well. Direct comparable sales grew 26% and store comps were up 5%.

The shift in the timing of back-to-school and sales tax holidays due to a later Labor Day had its most dramatic effect at Journeys where comps accelerated in May and June compared to the first quarter trends and then flattened out at the end of July as a result of these changes. Despite these headwinds Journeys delivered a solid comp for the quarter, benefiting from freshness and growth on the fashion athletic side as well as the casual footwear side.

In addition, Journeys realized increases in gross margins from strong full price selling. Once again the entire Journeys team exhibited its tremendous ability for superb execution which resulted in improved profitability year-over-year.

At the LIDS Sports Group we continue the efforts that we have detailed previously to turn-around performance. In the quarter Lids' comps benefited from a favorable NHL and NBA playoff lineup and direct sales were especially robust with a 39% gain. This, however, was not enough to overcome the gross margin pressure from higher promotional activity to work down inventory and year-over-year profitability declined for the Group as we had expected.

Overall for the Company the third quarter got off to a good start. We feel good about our merchandise offerings and believe we are well-positioned for the fall and holiday selling seasons. We also have a good lineup of baseball teams that look to be headed for the playoffs. Looking ahead however, we have somewhat less visibility on our overall sales in the third quarter than we usually do at this point in the year because of the later Labor Day.

In the first three weeks of August comp sales reaccelerated as anticipated, especially at Journeys, but were impacted at the end of the month by the Labor Day weekend offset. We expect momentum to pick up again with the holiday this coming weekend. For the total Company August comps increased 6%.

Not only has a later Labor Day led to a later start to back-to-school and a holiday weekend offset, but also to a later start to the NFL and college football season and a later World Series. The start of the key selling season at Lids begins with the college kickoffs this weekend and the NFL regular season kickoff next week. We will be navigating through these one week offsets during the quarter.

Additionally, last week's World Series ended with a win in game seven with all the games falling within the third quarter. Given this year's schedule some series driven sales, especially sales of championship gear, will ship into the fourth quarter.

Lastly, with the Super Bowl scheduled later in the first quarter than it typically is, we expect some sales relating to the run up to the Super Bowl will shift out of the fourth quarter and into the first quarter of fiscal 2017.

The other significant variable in our second half outlook is Lids' inventory initiative. We are absolutely committed to taking whatever action is necessary to right size inventories. And in fact, we built more promotional activity into the back half of the year, especially in the third quarter. The level of liquidation we are tackling is a first for us in this business and therefore not entirely predictable.

So while we believe our guidance reflects appropriately conservative gross margin assumptions at Lids, counting for the additional markdown activity, our primary goal is to hit targeted inventory levels and Lids' gross margin for the balance of the year will reflect that priority as necessary.

Having said all this, the momentum we have had when not experiencing offsets in combination with a positive outlook for the footwear business for the balance of the year has led us to reiterate our full-year EPS guidance of $4.70 to $4.80. And finally, we were active buying our stock in the quarter. And with that let me turn it over to Mimi.

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

Thank you, Bob. Good morning, everyone. As a reminder, we have posted more detailed information online in our CFO commentary. So I will highlight a few key points from the reported results.

The 7% increase in total sales for the quarter to $656 million reflected a 7% increase in consolidated comp sales, an increase in non-comp sales of approximately $6 million including the opening of 12 new stores, and an increase of 1% in wholesale sales.

By division, building on our first-quarter's positive results, total costs were up again across the board: up 4% at Journeys, 8% at Schuh, 8% at Lids, and 10% at Johnston & Murphy. Consolidated store comps were up 5% and direct comps were up 26% which pushed direct as a percent of total retail sales to 8% for the quarter compared to 7% a year ago.

Lids' direct comps for the quarter were up 39%. The effect of Lids turning its Locate system, which gives online access to an additional 50,000 plus SKUs in the store, has contributed to this improvement beyond just the increased promotional sales. Increases in our other direct businesses were double-digit as well.

Turning to the third quarter, for the total Company August comps increased 6% with stores up 4% and direct up 23%. By division total comps were up for all our retail businesses: up 6% at Journeys, 4% at Schuh, 5% at Lids and 3% at Johnston & Murphy. As Bob mentioned, these comps reflected a reacceleration in the first three weeks of August prior to the Labor Day weekend offset.

Gross margin for the quarter decreased 20 basis points from last year to 48.8%. As expected, gross margins in all the Lids retail businesses were down as we executed our plan to freshen inventory. This was most evident in Lids e-commerce which has proven especially effective as a channel to clear promotional merchandise and in the Locker Room and Locker Room at Macy's concepts where the inventory reduction activity has been the most intense.

Gross margins in the core domestic headwear business, which are traditionally the strongest, remained strong and were down only 30 basis points over last year. The 210 basis point gross margin decrease at Lids was offset in large part by a 100 basis point improvement at Journeys due somewhat to higher initial margins but mostly from more full price selling and fewer markdowns.

Gross margins at Schuh were down a little, in part because the sales mix in the second quarter rotated to a heavier weighting of brands with lower initial margins.

Total adjusted SG&A expense improved 10 basis points to 46.7%. Last year's expenses benefited from a bonus reversal and this year's expenses were hurt by foreign exchange, but benefited from the end of the Schuh acquisition incentive we put in place when we purchased Schuh four years ago. As a reminder, last year was the final year of expensing the incentive and there is no P&L expense related to it in the current year.

Neither Journeys nor Lids was able to leverage selling salaries in the quarter in spite of their higher comps. We have been anticipating these headwinds as our US retail businesses have been facing store level wage pressure driven by minimum wage increases and retail competitor moves.

With the gross margin headwinds offset by the small SG&A improvement, adjusted operating income for the quarter improved by 4% to $14.2 million. Operating margin was flat at 2.2% and second-quarter adjusted EPS was $0.36. Just a reminder, the second quarter is our lowest quarter from an earnings standpoint and small changes in certain line items can have a large impact on the bottom-line margin.

Turning now to the balance sheet, inventory was up 10% year-over-year with retail square footage up 3% and sales up 7% for the quarter. Journeys' inventory was up 18% on a square footage increase of 1% and sales increase of 4%. This was due to timing. Journeys had planned a buildup of merchandise to be able to maximize anticipated strong back-to-school sales that would span both the second and third quarters.

Lids' inventory was up 5% on a square footage increase of 5% and sales increase of 11%. This was a little over its inventory reduction plan target for the end of the quarter due to timing of receipts which should correct itself during the back half.

As we said before our Lids plan has been to liquidate inventory throughout the year and couple that with a reduced level of receipts in the back half to reach our year-end target of a 10% to 15% reduction. As such we did not expect to see decreases in inventory over last year's levels until the back part of this year. We are firmly committed to do what it takes to hit the inventory targets at Lids and expect reductions at the higher end of the targeted range.

Next, capital expenditures were $22 million and depreciation and amortization was $19 million for the quarter. We ended the quarter with $49 million in cash and $41 million of borrowings under our domestic credit facility and $72 million of UK debt. We made the final deferred and incentive payments in connection with the Schuh acquisition in this quarter as well.

Finally, given our stocks relative graduation and our expected levels of cash generation, we repurchased approximately 424,000 shares for roughly $27.5 million at an average price of $64.75 per share during the quarter.

Now turning to guidance, given our momentum when we are not experiencing offsets and our positive outlook for the footwear business, we are reiterating our full-year EPS guidance of $4.70 to $4.80.

A few reminders from our previous guidance. We still anticipate the strong dollar remain a headwind in weigh down earnings by $0.08 per share for the year, assuming exchange rates stay where they are. We also expect that increased expense from a legacy pension plan will reduce full-year earnings by another $0.03 per share. Finally, we will continue to benefit in the third and fourth quarters from the end of the Schuh acquisition incentive.

As we have pointed out before, the licensed sports merchandise category is predominantly a fourth-quarter business, yet we carry store and other expenses throughout the year. During last year's heavy growth we added 73 Locker Room by Lids stores and 165 Locker Room at Macy's shops to the store base. These stores were negative contributors in the first half for this year but should be positive contributors in the back half, especially in the fourth quarter.

The deleverage from the lower Locker Room sales during the first few quarters has reshaped the quarterly breakdown of earnings for the Company as a whole, moving a greater percentage of our annual earnings out of the first half of the year into the second half.

While we do not give guidance on a quarterly basis since our last call when we discussed guidance, our second half earnings expectation has become a little more heavily weighted towards the fourth quarter as a result of the calendar shift and extra Lids liquidation. We anticipate that total sales for the year will increase 4% to 6% with consolidated comps, including direct, increasing 4% to 5%. We are also planning on opening 92 new stores in total for the year.

We expect gross margins to be down year over year for the total Company, somewhat more than the last time we reviewed guidance due to the additional Lids markdown activity. This gross margin guidance includes a Lids decline and relatively flat margins at Schuh, offset somewhat by gross margin improvements in other businesses.

In last quarter's guidance we said for at least the first three quarters of the year total Company gross margins would take a hit as we right size inventory at Lids. In our current guidance we have built the Lids additional markdowns into the third quarter and now believe we will be promoting more heavily into the fourth quarter, causing total Company gross margins to decline a little then as well.

Next, we anticipate SG&A expense as a percent of sales will be down in the range of 30 basis points compared with last year. We will have difficulty leveraging comps to an even greater extent due to expense pressure. Continuation of the store level wage pressure we have felt is included in our guidance. This all results in an operating margin that is down somewhat for the year. Finally, our fiscal 2016 tax rate is expected to be 36.7%.

Looking at the balance sheet, we expect inventories at year end to be flat to up just a little including up to a 15% reduction at Lids. We are planning capital expenditures in the $110 million to $120 million range. We anticipate spending on e-commerce, omni-channel, distribution centers and other non-store capital to be a sizable portion of these amounts, but in line with last year's levels. Depreciation and amortization is expected at approximately $80 million.

We are assuming average shares outstanding of 23.5 million shares for the year. We have not included any stock buybacks in this guidance beyond the buying we did already in the second quarter. However, we do have $33 million remaining on our stock repurchase authorization of $75 million. Now I will turn the call back over to Bob.

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

Thanks, Mimi. I am going to touch on a few of the major factors in the performance of our individual businesses and our current outlook for them starting with Journeys. While we are in the final laps of a successful back-to-school period, we believe the same trends that have fueled the Journeys business, plus another solid boot season, will contribute to positive holiday selling, in spite of stronger comparisons for the back half of last year.

Journeys continues to benefit from a deep and narrow assortment leading to more full-price selling and strength in both the fashion athletic and casual categories of the business.

In addition, the Journeys initiatives we have been describing, such as an increase in catalog circulation, paid search investment and investment in music focused grassroots marketing like our sponsorship of the Vans Warped Tour and the AP Music Awards, are driving traffic to our stores and website and are building the overall brand.

The Journeys ShopperTrak work has been another important sales driver. The initial focus with ShopperTrak was to identify power hours and improve staffing levels when more customers were in the stores in order to increase conversion. Now that most stores have anniversaried their implementation dates and we have prior year comparisons, the focus has moved to improved conversion year-over-year and we continue to see nice gains as a result. So, congratulations to the Journeys team on their terrific run.

At Schuh we were pleased to see the acceleration of comps in the second quarter and sustained strength of the e-commerce business which yielded improved profits over last year. In addition to growth through comps Schuh continued executing its store opening plan to add substantial square footage in the UK and new stores in the German market this year.

Moving to Lids, comps in the headwear stores turned positive in the second quarter even with no strong new trends. Snapback's remain a healthy part of this business and contributed to growth in the quarter. More favorable year-over-year NHL and NBA playoff lineups and the Blackhawks and Golden State championships drove comps across all the Lids retail businesses.

Lids Locker Room posted double-digit comp gains, helped to some extent by favorable teams and higher promotional activity. We believe the NFL and college assortments have the business positioned nicely for fall. We are making good progress in the critical initiative to reduce Lids' inventories.

Although the promotions to accomplish this are hitting gross margins hard, fresh merchandise in our stores is essential to longer-term improvement of the Locker Room business in particular. The better comps in that headwear stores from a fresher assortment and an easier shop -- store to shop are reflected in these benefits already.

We continue the hard work on other initiatives to improve the Lids business. While we have more to do to restore the business to a higher level of profitability, focusing on execution instead of additional growth this year has helped us to make considerable progress.

Turning to Locker Room at Macy's, we are still in the formative stage of this opportunity and Macy's has been a tremendous partner in forging the path to making it a success. High-double-digit comps in the second quarter are a good sign of realizing the potential of this business and we are currently working with Macy's on some improvements to the business model aimed at improving profitability.

Lastly, we continue to be enthusiastic about the positive results of several technology oriented initiatives at Lids. Locate, the system that tracks total system inventory from online and other stores, has given access to inventory and over 500 stores since February. And our plans to turn it on in an even greater number of stores in the coming months should yield additional benefits.

We have talked about the advantages for online, but Locate is driving comp in our stores too as stores now are able to access inventory in other stores, which is particularly beneficial for serving displaced fans.

Auto Store, the robotic system to expedite picking in the warehouse and add efficiency, has been operating successfully through its ramp-up phases. In addition, seeing the success of our other retail divisions within Genesco with ShopperTrak and improved customer conversion, Lids has begun rolling it out too and is seeing similar benefits from focusing store labor more on the power hours.

Lids' role out of [Hybris], a new front end e-commerce system, is expected in the first or second quarter next year. Finally, we thank the entire Lids team for their hard work that is behind all of this positive progress.

At Johnston & Murphy strength in men's casual and dress casual footwear contributed to the impressive comp in the quarter. Results in part were due to easier comparisons given challenges last year from a warehouse management system conversion. Comps have moderated somewhat after this as expected, but are still positive given the underlying momentum of the business.

One note of caution, comps at Johnston & Murphy in the past have been heavily influenced by significant declines in the stock market and the recent gyrations may have an impact this time once again.

Also, for those of you who shop in the upper Madison flagship store in New York City, we are sorry to report we are closing this store as the lease has expired and the proposed new rent was exorbitant. We are committed to finding other locations in the city and will be back to you with updates, but in the meanwhile, remember to shop the lower Madison location at 43rd St. and then of course online.

Finally, our licensed brands team has been hard at work with the launch of the Bass footwear license. We are excited about this opportunity and the chance to leverage this brand with a great legacy and strong American Heritage since 1876. The first season of Bass product will be delivered for spring of 2016.

In closing, I would like to thank all of our teams across each of our businesses for the terrific work in delivering solid second-quarter results. There are many moving pieces that need to fall in place for the balance of the year, but we are unwavering in our confidence about the strategic position of our businesses and, most importantly, the talent and commitment of our teams. And, operator, we are now ready for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Jay Sole, Morgan Stanley.

Jay Sole - *Morgan Stanley - Analyst*

Just want to follow up on Journeys. It sounded like the trends looking ahead are solid. You mentioned May and June were good and then July the comps flattened out. Maybe just give us an idea of like if you looked at July and August combined what the trends in same-store sales look like. Was it similar to May and June? Just kind of help us understand how the business flowed over the quarter.

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

Yes, Jay, we are going to be in a better position to answer that question in about two weeks from now because obviously we took a hit on the holiday offset. You have got a ton of schools in the Northeast in particular that have shifted their openings to next week and we are told a small subset of schools to even the following week because of the Jewish holidays.

And so, it is a hard read because the ups and the downs are so pronounced. We believe we are fine. The team modeled it up as best they can. And based on their model they think we are in fine shape for back-to-school. But we don't want to declare victory until we are about two weeks out from here.

Jay Sole - *Morgan Stanley - Analyst*

Understood. And maybe just if we can talk about the guidance for a second. Was the plan to liquidate more of the Lids inventory in 3Q? Because I am guessing a lot of that is baseball on inventory and 3Q is more of a baseball clearance season. Whereas really the plan wasn't to just kind of get all it -- get rid of it as much as possible as fast as possible and kind of just spread it out through the year. Is that the message?

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

Yes. The balance that we are striking on the inventory is speed obviously is helpful in any retail situation when you have got excess inventory because it adds to the freshness. But in our world the best time to clear in terms of getting a good realization is in the sports season.

So a lot of the promotions we have been running we see the greatest impact of those promotions on the excess inventory that we are promoting that is in season. So that is why it is stretching out over the period of a year. And what we have done along the way is, because this is sort of a first-time event for us at this scale, we are learning very quickly about the best clearance avenues.

One clear learning is that the online site is extremely effective for clearing goods and particularly some of the stressed goods. And we are tracking what we are doing with Lids right now and we have a plan for where they need to be at the end of every month and they are roughly on their plan right now.

They pulled forward some new receipts so they are a little over there number, but that is not a bad thing, that is just bringing NFL in a little earlier. And so, we are just being cautious as we watch how far we want to drive the clearance to be fresh going into next year. And so that was the messaging that we are giving with guidance. Mimi, anything you would add to that?

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

No, I think that is right. And I think just to emphasize, we are committed to hitting these inventory targets. And as such, when we have the opportunity within the season we are going to take the mark in order to clear the goods. And so, it is reflective of the fact that we are clearing in season, but it is also that we are committed to take the mark, even if it is a lower level, to be able to get rid of the merchandise.

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

Yes, what is interesting about the approach that the team is taking is because the Web has turned out to be very effective we brought a lot of inventory back so we could be efficient and shipping it, brought it back to our DC. And we think a contributor to the positive comps in the hat stores in this quarter is the fact that we took a lot of the markdown merchandise in headwear, brought it back into the DC and are clearing it there.

And so, when you walk the stores now they are cleaner to shop, the presentation has improved, and then obviously you don't have as much leakage from full-price selling to markdown goods. So making good progress. Congratulations to the team on how much progress they have made. And we are confident that by the end of the year this business will be right sized and in good shape.

Jay Sole - *Morgan Stanley - Analyst*

Okay, so if I can just squeeze in one more. When you are talking about Lids as a group, as a whole, Macy's -- I think you said it was -- your comp's strong double-digits. Can you talk about what has changed, because that seems like a real acceleration from where it has been last few quarters? Obviously there not every store is in the comp base, but can you just talk about changes at Macy's and why that business seems to be improving?

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

Sure. Well, first, let's keep in mind that it is a startup and we feel it -- fully expected that we would face a learning curve and indeed we have. And let's keep in mind that the business is still very young. So we are not even at the point where all of the stores have gone comp.

Right now we have 184 total doors. That said the business is in development and we are going to lose some money on it this year as we expected. But we are really pleased with where it is headed. So remember when we opened a bunch of the stores we didn't have the inventory even in the right season because the timing moved. Beyond that we are learning a lot about what mix it needs to be. So there is a lot of merchandise work that has been done.

Macy's has also been very supportive of us in moving certain stores that were not located in the kinds of places in the store that we have learned are most productive. And so they have been supportive in us making moves and there are still more moves to be made ahead of it.

When we close a strong comp, so it is reflective of both doing better, but it is reflective, to be frank, of the difficult start that we had last year when so many of the stores had the wrong inventory. But we are zeroing in on the mix that works.

Macy's has proven to be a terrific partner and they are working with us on all these initiatives, including the one we referenced in the script about tweaking the business model. This includes moving some of the stores within their box, allowing us to flex our staffing model to focus our sales efforts on higher volume days and higher volume doors. And then just some adjustments to the overall economic model to better fit our early experience.

So, the headline on this though is it is early days. And we are really pleased with the trend line, it comes from a lot of factors and we are still optimistic that we have got a good business here.

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

The other thing to note, Jay, is that first-quarter's comps were influenced by the Super Bowl. And so we were facing headwinds really in February from the Super Bowl this year. And other than that we have seen double-digit comps in every month outside of that.

Jay Sole - *Morgan Stanley - Analyst*

Understood. Makes sense, got it. Thanks so much.

Operator

Erinn Murphy, Piper Jaffray.

Erinn Murphy - *Piper Jaffray - Analyst*

Bob, I was hoping you could talk a little bit more about the G.H. Bass opportunity. I believe you guys showed the product out at Platform in Vegas a few weeks ago. Can you just talk about how that show went for you? What was the response from retailers? And then when you think about that spring 2016 launch, how many doors are you guys targeting initially and what could the ramp look like over time?

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

Well, the -- I am not going to go as far as you want on that, Erinn, because the team is still consolidating the results of that show. It got -- the line got a terrific response at the show.

In terms of the number of doors that we are going to end up with, we are going to -- that is a work in progress. So probably on the next call we will be better positioned to talk about that. This hits in spring, so right now they are in the midst of it. And let's give the team the time to do their work and then we will come back and report on where that is headed.

Erinn Murphy - *Piper Jaffray - Analyst*

Can you talk maybe just a little bit about the type of distribution that will be within wholesale? Is it going to be more of kind of the mid-tier or kind of better department stores or any kind of color on that? Even if there is no specific detail it would be helpful.

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

Give the team a little more time to figure that out. I don't want to tip their hand.

Erinn Murphy - *Piper Jaffray - Analyst*

Okay, perfect. And then I guess on the last call, just moving over to the Schuh business, you talked a lot about kind of the volatility in traffic in the UK market. Can you just update us on what you have been seeing specifically, just how the consumer is reacting in that market? And then looking ahead to Black Friday, will you guys be anniversarying the promotional kind of Black Friday experience in the UK as you have in the last year?

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

It is funny, things at Schuh and in the UK market seem to have leveled out a bit. I chatted with them the other day and the phrase we have been using is steady as she goes. So they ran into some headwinds with a couple of brands. Remember we called out last time that there were some brands that were working here and not working as well there.

So they have managed to make some shifts in the merchandise assortment. And there are some other brands that are working there that aren't working here where they have been able to intensify and that has improved their overall assortment and it is showing up in their comps. So it is good.

Unfortunately, yes, we are going to face another Black Friday anniversary. And we don't expect it to be -- the approach in the UK to be any less than what it was the last time. It is one of those visitor dilemmas that it probably isn't great to do it because it just moves sales around and adds expense. But obviously we need to compete in the way the market gets shaped and compete we will. So we will be out there on Black Friday playing the game as hard as we can.

Erinn Murphy - *Piper Jaffray - Analyst*

Got it, thank you. And then just my last question, Mimi, for you. Just going back to the commentary around gross margin. So in Q3 obviously it is going to be a little bit more promotional it sounds like for Lids and some of that continuing into Q4. Can you just help us think about kind of the impact on the overall Company?

I know Q1 was significantly worse than the Q2 decline. So should we look at Q3 as more similar to Q1's decline for the overall Company or for Lids in particular? Just anything you can help us to kind of make sure our models are refined as we get into the last couple of quarters would be helpful.

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

Sure. Absolutely, Erinn. I think that it is the queue that you can take is it is going to be more similar to Q1 than it was to Q2. We were down about 330 basis points in margin for Lids in Q1, we're down 220 basis points in margin in Q2.

We are really going to take advantage prior to the holiday selling season to liquidate inventory. We want to make sure that when we come off at the back of Black Friday and into December that we are not cannibalizing our full price sales, and so we are going to intensify the activity in the third quarter.

Last year, if you will recall, we were down 330 basis points in Lids in gross margin. And so, we do expect a decline in gross margin for Lids, but overall for the Company it will moderate -- gross margin decline will moderate versus the third quarter.

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

And let's just be clear, when we call out numbers like 300 points of gross margin that isn't all margin reduction, some of that is mix. And so the fact that the Locker Room business, the Macy's business and Lids online are all growing faster than they headwear stores, you get a mix shift in margin.

The hat stores run by far the highest margins in the chain and that will always be the case. So don't expect the recovery to margin levels that existed say two or three years ago because our mix of business is substantially different now.

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

There has also been a bit of a product mix shift within the Lids headwear business where you can see more branded assortment within the stores and that that is -- so there's a little bit of a margin than some of the other categories within the headwear stores. So all those dynamics are at work.

Erinn Murphy - *Piper Jaffray - Analyst*

Okay, thank you, guys, and have a safe holiday weekend. Thanks so much.

Operator

[Jonathan Comp], Robert W. Baird.

Jonathan Comp - *Robert W. Baird - Analyst*

Maybe start off just with a question on Journeys first. Obviously guidance still assumes positive growth in the fourth quarter against a pretty lofty comparison last year. And, Bob, your commentary sounded pretty optimistic about the ability to drive comps at Journeys going forward and I think you pointed to expected momentum behind the boot category.

So I am wondering if you could maybe just talk a little bit more about what you see as driving the boot category. Is that weather product on that boot side or maybe any color there would be helpful?

And I guess related to that, I don't know to the extent -- I am sure you have seen some of the reported news out there about a potential El Nino weather set-up in the year end. And I am wondering if discrete events like that are something that you actually plan for from a merchandise perspective?

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

Let me start with El Nino. No. A little bit out of our control and a little too prospective for driving our assortment. Let me talk about the comp. So, yes, we had a very strong double-digit comp last year, but then remember it is stacked on a comp that was slightly negative. So part of that gain was reflective of a challenging year before.

And then oddly -- and this is -- you don't usually get to say this, but even with the strong comp that Journeys had last year, they know that they missed sales on certain brands. And so, they are confident that the business will have similar strength to last year adding in the opportunity that they get to fill in some of the blanks that were misses -- as you always have misses, by the way. I mean you never know for sure what is going to be as strong and sometimes if you are subject to allocation which was part of the issue last year.

So they identify -- have identified the brands where they think they have upside and that is across several of the major categories of footwear. Jonathan, you are newer to the story; we do not talk about specific brands, or even trends within the specific category. So beyond saying that we think we're going to have a -- another solid boot season I think for now we are going to have to leave it at that.

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

Yes, and Jonathan, I would just add to that. If you actually go back a couple of years ago and do a three-year stack, not only was last year negative, but the prior year in the fourth quarter was negative as well. And actually in fiscal 2013 the fourth quarter turned negative after positive comps in the first three quarters after pretty significantly positive comps. And so, when you stack the three-year comparison it really is not such a bad transition into the fourth quarter.

Jonathan Comp - *Robert W. Baird - Analyst*

Got it, that makes sense. And it makes sense, Bob. I thought I would at least try to get some color out of you.

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

You get to try.

Jonathan Comp - *Robert W. Baird - Analyst*

Maybe one more kind of broader question if I could. And this could be for you, Bob, or Mimi. I know you are very strategic in kind of looking out on a five-year horizon pretty consistently. And when I look back over the last call it four or five years including this year, you have achieved some pretty healthy revenue growth and the earnings growth certainly has lagged or almost been nonexistent over that period.

So, I am wondering as you look beyond fiscal 2016 and kind of the future years at what point do start to really grow the earnings base again and any color on kind of what the type of growth rates might be?

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

Sure. So what we have traditionally done is update our five-year plan each summer. And we have done that again. We are going to review that with our Board in two weeks after which we will be prepared to discuss it with our investors. The general themes that you will see coming out of that addresses exactly what you are speaking to here, which is a reigniting of the earnings growth. We will still see revenue growth but we truly expect the earnings growth to pick up.

And if you dissect the earnings growth, or the flatness in the earnings growth, it is largely attributable to the challenges that we have had at Lids. And obviously the steps that we are taking that we just outlined in our script are all setting ourselves up at Lids to reignite growth over this next five-year period.

So the answer to your question is, in general, yes, we expect to continue to get back on an earnings growth path. And then second, stay tuned for more specifics; we expect to be getting that out pretty shortly.

Jonathan Comp - *Robert W. Baird - Analyst*

Great, well we will wait for that. Thanks for the color.

Operator

Laurent Vasilescu, Macquarie Capital.

Laurent Vasilescu - *Macquarie Capital - Analyst*

With regards to the Journeys inventory, I think you guided that the second quarter wrapped up 18% inventory growth due to the anticipation of a strong back-to-school. Can you talk about your visibility on inventory today, where it stands and then how do you think it should wrap up for the end of the quarter?

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

Let me just make some general comments and I will turn it to Mimi. So the Journeys inventory is up -- first of all you have got an offset. So you load up for back-to-school and whereas last year we had a lot of selling underway, in July this year we really had no kickoff of back-to-school. So part of that is timing.

And then another part of that is what we have brought in earlier, which is a strategy of just making sure that everything we want to have on hand we have on hand. That 18% is an extremely clean 18%. And we are really comfortable with where we are in terms of inventories. When you look at the end of the quarter what you will start to see are the benefits from producing Lids' inventory and I will ask Mimi just to talk to that.

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

Yes. No, I think that is exactly right. In fact, it was a very deliberate plan on the part of the Journeys team to pull forward merchandise and I just want to emphasize that. They were very, very clear in their understanding that they missed sales last year because they didn't have enough inventory and their intent was to make sure that didn't happen again for this year.

When we look there -- so, by the end of the back-to-school season Journeys will be right on plan as far as overall inventory and will be back in line with overall increases as it relates to sales.

When you look at the Lids inventory levels, what you have seen is that inventory was up 5% on square footage increase of 5% and a little higher amount of sales, we had 11% growth in Lids. So we have been liquidating as we have gone along throughout the entire year. And in the back half of the year plan to couple that with managing receipts.

We just didn't have enough runway to be able to manage receipts in the front half of the year, but we will be trimming receipts in the back half to couple that with the liquidation and anticipate that we'll be down in the 15% range year over year at the end of the year in Lids, which means will be flat to up just a freckle for the overall Company.

Laurent Vasilescu - *Macquarie Capital - Analyst*

Okay, great, thank you. And then I think last quarter it was guided for 115 new stores for the full year then 51 projected closures. It seems like you guys tweaked down the store openings but then tweaked up the store closures. Maybe you can provide an update on your real estate strategy for this year and then your longer-term vision. And then add -- the reduction in CapEx guide for the full year, is that the reflection of the reduction in store openings for the year?

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

Yes. So what we do when we target our new stores at the beginning of the year is our guide to our operators, which they appreciate, is tell us what you think you might to sort of best case. But let's all agree that we don't want to open the budgeted number of stores just to hit the budgeted number of stores, that we will only do good deals.

And so, for several years now we have come in a little short of what that is. And we are good with that because we budget the capital and then if we don't find a good opportunity to deploy the capital we don't do it just to chase a budget opening number.

Closures are an even more interesting one because they are becoming increasingly hard to predict. We will have some stores that aren't hitting our hurdle in terms of performance. But when they come either to a kick out or to a lease end, often times where we anticipated closing that store the landlord comes back and makes it attractive to keep it open.

And so, the process of trying to estimate how many stores we are going to close has become a tricky one. And that is fine, we just live with that because there is not a lot of capital involved. Most of those stores in that category that we keep open we are not pouring capital in. So it takes no capital in the decision process. So, but when you see our closing number move around, it is that dynamic at play. Anything?

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

And, Laurent, the CapEx decrease is all attributable to the decrease in the number of stores. We are investing quite a lot in our omni-channel initiatives and we have been for the past several years in terms of we put in new order management systems, we have put in new front end e-commerce systems, we have invested in the Locate system in Lids and also in the Auto Store system to be able to get e-commerce orders out faster.

And so, our CapEx numbers actually reflect a similar level as last year of investments outside of stores. And it is just to help to fuel the growth in e-commerce, which with the double-digit increases that we've been having, we think that those are investments that are well made. And so, we are just very careful to watch the balance between our bricks and mortar presence and our online presence. And we are just mindful of where we need to be putting the investment.

Laurent Vasilescu - *Macquarie Capital - Analyst*

Great. And if I can squeeze one more in. Can you talk about your border stores near Mexico and Canada, how they are performing? And if there is any reflection of the comp due to the strong US dollar?

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

We have had great success with our border stores and, to be perfectly honest with you, I am not the current on them right now. We could find out for you.

Laurent Vasilescu - *Macquarie Capital - Analyst*

Okay, thank you very much.

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

The interesting though that has been happening in Canada is that Canadians have been staying in Canada and shopping more in Canada. So we have benefited from that fact within our Canada market. And to the extent that we are giving up any sales within the US border we are making those up in Canada. Unfortunately we don't have too many stores in Mexico, so that trade-off wouldn't be the same.

Laurent Vasilescu - *Macquarie Capital - Analyst*

Okay, great, best of luck with the third quarter.

Operator

Scott Krasik, Buckingham Research.

Scott Krasik - *Buckingham Research - Analyst*

I guess first, Mimi, just a quick clarification. The comp in August you said was up 6, but I think just reading the commentary every division except for Journeys was below 6 and Journeys was only a 6. So maybe it is just a rounding thing, but how --.

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

You know, it is funny --.

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

It is a rounding thing.

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

When she was reading it I went back and double checked for that reason, it is rounding.

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

Yes, Lids was a fat 5, it almost made it up to 6. And because Lids and Journeys are our two strong divisions that is where we ended up (multiple speakers).

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

I love that term. Journeys was a fat 6 and Lids was a fat 5.

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

No, those two together are a 6. I checked that one as well.

Scott Krasik - *Buckingham Research - Analyst*

All right, that helps. And then, so Bob, just going back to Lids, you said last quarter I think we still need to prove the concept and we are talking a lot about the inventory clearance activity is longer than expected.

So you liken this to the hat business, but here you actually have a major online pure play competitor. So again, how much of it is that just you need to rethink what the margins are in this business?

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

Scott, I tell you I don't recall wavering in our commitment to how strategically sound we think this business is. The realignment of the inventory is just adjusting for the difficult growing pains that we had as we made a lot of moves in one year with new stores in Macy's and everything.

We are -- first of all, we consider ourselves a pretty major online pure play competitor -- or a major online competitor. We are not as big as a pure play guy. But we also know that online is dominated by displaced fans and the universe of sports fans is dominated by local fans and local fans prefer to shop stores. And we see that with the very sharp spikes that exist as games arrive and there is a need it now aspect to the license board business that is pronounced.

And we also believe that for the purposes of efficient inventory liquidation, if you are selling product in both directions, that is online to the displaced fan and in your store to the local fan, you have a very, very privileged position. So, both against smaller mom and pops who are only playing the local game and a pure play online guy that is only playing a displaced game.

So we like what this business looks like. We -- as we have said last time, opening new stores in the way we did we need to revisit that. And that was the part of the strategy that I think we need to go revisit and say when we resume growth in this business in what way will we do that. And I acknowledge that we have some questions about where we are going to go there. But we still believe that this is a business that is ripe for consolidation. And so hopefully that makes it a little more clear.

Scott Krasik - *Buckingham Research - Analyst*

Maybe then so what are some of the types of things that you are having success selling at full price or what categories or maybe what changes do you make to get a higher percentage of full price sales? What things just to have to compete on price opposing that, sorry?

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

Well, you just have to have your inventory right sized. That is the single biggest thing. If you are sitting on 20% more inventory than you need and your demand at full price isn't going to allow you to liquidate that, you then need to get promotional in order to clean up.

And that is disruptive to the entire store, right, because you end up with leakage from full price selling to markdown selling. You end up with a store that is not as attractive to shop as you would like.

And so, what we need to do is get this inventory squared up and then really just start executing on an assortment that is right sized that allows us to have a much, much higher percentage of full priced selling, which we know is very achievable.

Scott Krasik - *Buckingham Research - Analyst*

Okay. All right, thank you very much, good luck.

Operator

Jill Nelson, Johnson Rice.

Jill Nelson - *Johnson Rice & Co. - Analyst*

Just a bit clarification on your stance of holding your annual guidance despite the second-quarter beat. With the Lids uncertainty on gross margin, is it more weighted to having to take deeper discounts or is it more weighted to having to work through more units than you anticipate today?

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

A little bit of both.

Jill Nelson - *Johnson Rice & Co. - Analyst*

Okay, okay. And then just talking about some of the payroll headwinds you are facing, whether it is internal with adjustments you are doing with the ShopperTrak information or whether it's macro, higher minimum wage, could you just talk about kind of the timeframe you expect to face those headwinds and maybe when we might start to lap some of those higher expenses?

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

Well, there is two different things there. With ShopperTrak we have added a marginal amount of hours perhaps, but it is mostly taking hours where it has been less productive into the power hour days -- and those hours or where you would expect them. There was not a major surprise other than how steep the power hours were.

And so, it has required a little bit of a shift into a little more part-time in order to accommodate that. That is a model that Journeys, in particular, can address because of their demographic. And so, we are really excited about how much more there might still be there as we continue to tweak that.

The wage pressure is completely independent of that. So, if you had X number of hours that you apply to the store but you have increases in minimum wage that is coming both from legislation but really it is also coming from a number of retail competitors who have committed to paying a higher wage rate, we obviously have to be tuned into what market is and that has brought our average wage rate up. It is heavily weighted to certain states, it is led by California.

And so, when we lap that is a little dependent on what continues to happen because some of the minimum wage increases are stepwise events as opposed to a cliff. And so, we are expecting that for us and a lot of other retailers this wage pressure and what kind of comp you are going to need to leverage its is going to be sustained.

Our hope is that this puts a little more jingle in the pocket of teenagers who work retail and that might give us a little bit of help on the demand side. But it is certainly going to be a headwind for the next year and probably a little longer than that. Mimi, anything you would add to that?

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

No, I would just call out that 23 states increase their minimum wages this year. So, when you have almost half the states in the country you will face the pressures through the course of the year.

And I think beyond that, as Bob pointed out, it has not been because certainly unemployment has improved, but there is still plenty of labor there for retail. Retailers have decided to bring up their wages. And so we just -- we do expect to continue to see this pressure certainly throughout this year.

Journeys is working hard to look at their commission structure, because they are on commission, to figure out ways they can try to minimize this impact. And so, while they are not able to leverage labor, they are working hard to just keep labor flat.

Jill Nelson - *Johnson Rice & Co. - Analyst*

Thanks so much.

Operator

Sam Poser, Sterne Agee.

Sam Poser - *Sterne Agee & Leach - Analyst*

First of all, what same-store -- how much same-store sales do you need by concept or just in total to lever the SG&A right now?

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

Yes, we were able to leverage in about the 3% range in the past. What we are seeing with this wage pressure is that we are not able to -- Journeys had a 4% comp this year and we are just a bit over on in terms of the percentage of selling salaries. And so that came up just a little bit. And so I would say that we are probably in the 4% range right now as we move through the wage pressure and once the wage pressure goes away that should mitigate somewhat.

We were benefiting -- at one point during the aftermath of the downturn we were actually able to leverage at a lower threshold because our rents were going down as we renegotiated taking advantage of additional vacancies in the mall. But right now we are above that 3% threshold that we have experienced in the past.

Sam Poser - *Sterne Agee & Leach - Analyst*

And just to follow up on that, we are talking about all in or are we talking about the stores?

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

We are talking about the stores.

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

Stores.

Sam Poser - *Sterne Agee & Leach - Analyst*

Okay. And then -- because you have more variable cost. And what kind of increases could you -- I mean where is like the tipping point for e-commerce where you can --?

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

A tipping point in regards to what, Sam?

Sam Poser - *Sterne Agee & Leach - Analyst*

Well, I guess in regard to -- can you get leverage there or is that going to end up being more of a gross margin story?

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

It's much harder to get leverage in e-commerce because it is a much higher variable cost business. Shipping and warehousing expense are the elements of e-commerce that really make it more of a variable business. For every item that you ship out you have to send somebody to go get it and then put it in a box and pay the UPS charge.

And so, we aren't able to see the same type of leverage in our e-commerce business as we are in our store business. However, we, unlike some of our pure play competitors, do operate our e-commerce business to be profitable. And so, they are very nice contributors to our businesses and we are making money in our e-commerce businesses.

Sam Poser - *Sterne Agee & Leach - Analyst*

Thanks. I've got a couple more. One, are you seeing any return to the fitted hat business versus snapbacks? Number two, Mimi, are you expecting gross margin to be up in total in the fourth quarter? And number three, could you give us for the quarter the -- like how the ASPs, traffic and conversions look like at Journeys?

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

So on the fitted hat question, essentially that is a fitted versus snapbacks question. And, Sam, as we said snapbacks continue to be a significant part of our business. In your note that you put out this week we would disagree with your statement that we don't have a competitive advantage in snapbacks. What we have always said is have a -- we believe we have a slightly bigger advantage in fitted because the degree of difficulty is higher.

So when we think about our advantages in snapbacks, we are still the destination for a person who wants to buy a hat. We know from our research that the fact that we out assort everyone else in the space is the major draw. And that is as important to the snapback buyer as it is to the fitted buyer. And then we also have scale in our purchasing and operations which is an advantage that also applies to snapbacks.

So, whereas we have the additional competitive advantage on the degree of difficulty and the replenishment requirements for fitted, we certainly feel like we have a competitive advantage in competing in the snapback space.

You are recalling that back in when it got really hot a number of nontraditional headwear retailers entered the space. They then got out of it which tells me that they got clobbered, because if you are making money in a category you stick with it. And so I think that turned out to be painful, but then proof of the thesis that we are still the advantage retail in all styles of hats. So that is that question. Gross margin, Mimi?

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

Yes, Sam, we are now not expecting gross margins to be up in total for Q4; we are expecting them to be down just a little bit. And then as far as the Journeys questions, ASPs have been up, they were up in the second quarter and also up in the first quarter. Traffic unfortunately like all other mall-based retailers has been down. We have been converting at a higher level which translates into our higher comps.

So we really have been making most of the traffic that comes across our doors. ShopperTrak has given us incredible insight into it. For every half a point of conversion increase we are able to get multiple points of comp increase. And so, the Journeys folks are focused on that, focused on the fact that traffic in the doors need to be converted.

Part of what we have talked about in the past, Sam, is that traffic in the malls we think have a greater intent to buy these days. In the past you would come and browse and see what you wanted to buy. But much of that browsing and that prepurchase activity is done online these days. And so, we think not only is the traffic in malls these days just has a higher intent to purchase. But that coupled with our activities in the stores to drive conversion have been yielding good results for Journeys.

Operator

And, ladies and gentlemen, that is all the time we have for questions today. I will turn the call back to your host, Mr. Bob Dennis. Please go ahead.

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

Well, thank you all for joining us. And we look forward to having a conversation with you three months from now. Have a great holiday weekend.

Operator

And, ladies and gentlemen, this does conclude your conference for today. We do thank you for your participation.