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PIR - Q3 2013 Pier 1 Imports, Inc. Earnings Conference Call

EVENT DATE/TIME: DECEMBER 13, 2012 / 4:00PM GMT

OVERVIEW:

PIR reported 3Q13 total sales of \$424.5m, net income of \$23.7m and EPS of \$0.22. FY13 GAAP EPS guidance on 52-week basis is \$1.17-1.21. 4Q13 GAAP EPS guidance on 13-week basis is \$0.55-0.59 utilizing effective tax rate of 38.5%.



CORPORATE PARTICIPANTS

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Alex Smith *Pier 1 Imports Inc - President & CEO*

Cary Turner *Pier 1 Imports Inc - Senior EVP & CFO*

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Denise Chai *BofA Merrill Lynch - Analyst*

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John Marrin *Jefferies & Co. - Analyst*

PRESENTATION

Operator

Good morning, ladies and gentlemen. Welcome to the Pier 1 Imports third quarter fiscal-2013 earnings call. At the request of Pier 1 Imports, today's conference call is being recorded. All lines will be in a listen-only mode until the question-and-answer period, at which time instructions will follow.

I would now like to introduce Kelley Buchhorn, Director of Investor Relations for Pier 1 Imports.

Kelley Buchhorn - *Pier 1 Imports Inc - Director, IR*

Thank you, and good morning, everyone. Prior to market open today, we issued a press release which included the detailed financial results for the third quarter ended November 24, 2012. In just a few moments, we will hear comments from Alex and Cary about the financial results and the Company's growth initiatives, followed by a question-and-answer period.

Before we begin, I need to remind you that certain comments made during this call may contain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, and Section 21E of the Securities Exchange Act of 1934, and can be identified by the use of words such as may, will, expect, anticipate, believe, and other similar words and phrases. Our actual results and future financial condition may differ materially from those expressed in any such forward-looking statements, as a result of many factors that may be outside of our control. Please refer to our SEC filings, including our Annual Report on Form 10-K, for a complete discussion of the major risks and uncertainties that may affect our business. The forward-looking statements made today are as of the date of this call, and we do not undertake any obligation to update our forward-looking statements.

The Company will also discuss non-GAAP financial measures on this conference call. Pursuant to the requirements of Regulation G and Item 10e of Regulation S-K, the Company has provided reconciliations of the non-GAAP financial measures to the most directly comparable GAAP financial



measures in our earnings press release that was issued earlier this morning. If you do not have a copy of today's press release, you may obtain one, along with copies of prior press releases and all SEC filings, by linking through to the Investor Relations page of our website, Pier1.com.

Now, I'd like to turn the call over to Alex Smith, our President and Chief Executive Officer. Alex?

Alex Smith - Pier 1 Imports Inc - President & CEO

Thank you, Kelley. Good morning, everyone, and thanks for joining us today. Also on the call with us is, of course, Cary Turner, our Senior Executive Vice President and Chief Financial Officer. Cary will provide a detailed review of our financial results a little later in the call, so I'll just touch on the highlights of the quarter and talk about the growth opportunities for our Company.

We enjoyed another strong quarter. Our 13th consecutive period of growth in total sales, comp-store sales, operating profit, and earnings per share. Also during the quarter, we celebrated the Company's golden anniversary, 50 years since our first store opened the day after Thanksgiving in 1962. It has been a pleasure and a privilege this milestone year to acknowledge all of our current associates, along with some of our former associates, for their role in making Pier 1 Imports an exceptional Company and a great place to work.

During the quarter, sales trends were fairly consistent across all our product categories. Of particular note, we are seeing continued strength in our furniture business, which has been gaining momentum throughout the year. The improvement is, of course, due to our strong assortments and the selling skills of our store associates; and additionally, what we view as the very beginnings of a long-awaited recovery in the housing market.

As you know, we always focus on maximizing merchandise margin dollars here at Pier 1 Imports; and for the third quarter, our comp-store sales increase of a very strong 7.9% and a very healthy store-merchandise margin of 60.4% represents a great result (sic - see press release "60.2%") -- a good balance between sales growth and margin rates. We think our clear strategies and first-rate execution are a winning formula, driving robust results, and allowing us both to reinvest in our business and return value to our shareholders.

Over the last few years, we have increased the productivity of our stores very significantly; however, sales per retail square foot are still below their peak, and have plenty of room to expand as we continue to finesse our assortments and in-store experience. Additionally, with the introduction of e-Commerce, many more opportunities to drive profitable growth have opened up, both in stores and online. To that end, having just completed our first full quarter of e-Commerce, we are pleased to tell you that the business is off to a solid start. It has only been four months -- four months since the launch. Remember -- crawl, walk, run. But early indicators are very positive.

Traffic to Pier1.com has increased, and is up in the high-double digits, with over 1 million visits per week, with customers spending nearly double that of our in-store customers. Customers are shopping broadly across our online assortments, and to date have purchased over 90% of the available items. Our in-store pick-up model is trending very well, with 35% of online orders being picked up at the store, allowing for further and enhanced interaction time with our customers. We are expanding our database, adding both existing Pier 1 import shoppers, for whom we are now capturing information, as well as those who are new to the Pier 1 Imports experience.

The influence factors that our website has on our customers and our stores is profound. Through our market research, we know that 25% of customers browse Pier1.com a day or two before visiting a Pier 1 Imports store, and we think that number will continue to grow over time as we enhance the site in our stores, implement our new point-of-sale system, and further build out our assortments to develop our converging and mutually dependent businesses, which we refer to as One Pier 1.

Combining the strengths of our 1,100 stores and our online capability to provide a seamless shopping experience will be very powerful. The building blocks of One Pier 1 are in place -- we've developed the platform, launched our e-Commerce-enabled website, and begun piloting the new POS system. We expect to commence an all-store rollout of the new POS system after Christmas, with an expected completion date by next Summer. At that time, as we anniversary the launch of e-Commerce, we will release a major upgrade to the features and functionality of the site.

We have recently begun testing some online-only assortments, and you can expect to see us accelerate that effort over the course of the next year. We have learned a great deal already; and as we continue to scale our capabilities, we expect, as I've said before, to become outstanding online merchants.

Turning now to our wonderful Pier 1 Imports stores. The portfolio continues to perform exceptionally well, and we are quickly approaching our previous goal of \$200 per square foot. As most of you know, that target was increased earlier in this year to achieve \$225 per foot by fiscal 2015. We are continuing to make progress towards our plans to enhance the store portfolio with new store openings, relocations, remodels and refurbishments.

By the end of the fiscal year, we will be nearly 50% complete with the refurbishments for the entire portfolio. Our market research tells us our customers notice and appreciate the enhancements we're making. In terms of remodels during the quarter, three stores were completed and all were reopened by early October. The returns on our investments are compelling, and the stores are producing significantly higher sales, post remodel.

We are excited, as always, about holiday. We love holiday. Our stores and website look beautiful, and we're seeing strong customer response to the assortments. Traffic and conversion, both in store and online, gained strength throughout the third quarter, culminating with an outstanding Thanksgiving weekend, the highest in the history of the Company.

December has started off well, and we feel good about where we are. Having said that, the biggest weeks of the year still lie ahead. Today, we have only approximately 50% of our holiday sales in, so we have a long way still to go. Our store teams are doing an outstanding job in maintaining the quality of the Pier 1 Imports shopping experience during this very busy time.

We made the decision to take up our marketing spend in the third quarter in order to leverage the momentum in our business, and we believe it is yielding results. Our national cable television ads are currently featuring our campaign, Find What Speaks To You, which showcases the fun spirit of our brand during holiday. This creative approach continues to deliver results and a positive emotional response from our customers.

We were also particularly pleased with the effectiveness of our email and social marketing during the quarter. We increased our spend in both, and saw improved response and interaction rates. By the way, although we increased our marketing spend in the third quarter, our plan to invest 5% of sales on an annual basis remains unchanged.

Our Pier 1 Imports Rewards Card is also serving as an increasingly important sales growth driver. The credit card program provides opportunities for us to know more about our most loyal customers, and is a highly effective sales tool for use in both our stores and online. Today, we have over 1 million active rewards card holders, which, for perspective, is up over 25% from one year ago. After partnering with Alliance Data, we collaborated on a new value proposition for the card, which is driving more frequent cardholder visits to our Pier 1 Imports stores and Pier1.com. Additionally, sales on the card are pacing ahead of plan, and sales penetration rates continue to increase.

We know that a great organization is central to our success. We continue to invest in the broadest sense in our people, their development, the development of our Organization, and our culture. This is why we are creating an increasingly successful Pier 1 Imports; it is why we execute so well. We are confident that we have the right strategies, discipline, and market perspective to take Pier 1 Imports to the next level of growth and achieve the goals laid out in our three-year plan. Those include reaching at least 10% of revenues online by fiscal-year 2016 and achieving \$225 per retail square foot in our stores by fiscal-year 2015.

Thanks for your attention this morning. Now, I'll ask Cary to discuss our third-quarter financial results and outlook. Cary?

Cary Turner - Pier 1 Imports Inc - Senior EVP & CFO

Thank you, Alex; and good morning, everyone. From a high-level perspective, we achieved a 7.9% comp-store sales gain, generated double-digit top-line growth, improved an already strong gross profit, and continued to leverage expenses, delivering solid earnings per share. This year's third-quarter comp-store sales increase came on top of last year's 7% gain, while total sales were up 10.9% to \$424.5 million. The 300 basis point

delta between total store sales and comp-store sales is primarily due to -- one, new stores that were opened this year; two, intermediate stores which were opened last year; and three, our new e-Commerce business.

The strong comp-store sales gains this quarter are primarily attributable to increases in store traffic and average ticket. Of note, the improvement in average ticket reflects an increase in both units per transaction and average unit retail. The Company has focused on initiatives, such as the introduction of new impulse items and investing in new tower fixtures in the stores, collectively aimed at helping to increase the size of the customer basket or units per transaction. On a trailing 12-month basis at the end of the quarter, sales per retail square foot were \$194, up from \$178 per retail square foot at the end of last year's third quarter.

Third-quarter gross profit increased 12.6% to \$186.3 million, compared to \$165.5 million a year ago, and gross profit expanded 70 basis points to 43.9% of sales, versus 43.2%. Store occupancy costs were \$69.4 million, compared to \$66.2 million, and declined as a percentage of sales by 100 basis points to 16.3%. The year-over-year gross profit improvement reflects occupancy leverage, as well as the continued strength of merchandise margins at the store level, which were essentially flat versus a year ago.

Including our direct-to-consumer business, merchandise margins came in at 60.2%. As we continue to build the e-Commerce business, we anticipate that merchandise margins will experience some compression as a result of the fulfillment clause associated with that business. To that end, beginning at the start of our new fiscal year, we will focus on reporting on consolidated gross profit, which is more reflective of the evolving structure of the business. Although we will not be breaking out specific merchandise margin details, effective as of the first quarter of next year, we will continue to provide directional guidance.

We continue to be diligent in managing our expense structure. SG&A expenses for the third quarter leveraged 50 basis points and were \$139.2 million, or 32.8% of sales, versus \$127.5 million, or 33.3% of sales for the same period last year. Variable expenses were \$101.5 million, compared to \$91.5 million, and as a percentage of sales were flat to last year at 23.9%.

Store salaries were leveraged as a percentage of sales for the quarter, and marketing expenses were up 30 basis points to 7.2% of sales. We are very pleased with the effectiveness of our marketing programs, and as Alex mentioned, we made the decision to increase expenditures ahead of the holiday season in order to leverage the strong traffic and sales momentum we were experiencing. Fixed expenses during the period were \$37.8 million, or 8.9% of sales, compared to \$36 million, or 9.4% of sales last year.

Third-quarter operating income was up 18% to \$38.8 million, versus \$32.9 million last year, while operating margin increased 50 basis points to 9.1% of sales, from 8.6% of sales a year ago. Net income in the third quarter was \$23.7 million, or \$0.22 per share. The Company's adjusted net income on a non-GAAP basis was \$27.1 million, or \$0.25 per share, which excluded the estimated impact of Sandy, and utilized a 35.6% annual effective rate. Last year's third-quarter net income was \$23 million, or \$0.21 per share.

For the fourth quarter this year, the effective tax rate is expected to approximately be 38.5%. For the full fiscal year, the annual effective tax rate is expected to be approximately 35.6% of pre-tax income.

Turning to the balance sheet. The Company remains in strong financial condition, and ended the quarter with \$120.8 million of cash and cash equivalents, and no cash borrowings under our \$300 million credit facility. In November, the Company paid \$4 million in cash dividends. The Company reported today that it has effectively completed its \$100 million share repurchase program, previously announced on October 14, 2011. To date under this program, we repurchased a total of approximately 5.8 million shares of our common stock at a weighted average cost of \$17.17 per share for a total cost of \$99.7 million. The Company has repurchased approximately 5.3% of its common stock outstanding under this share repurchase program. And the two repurchase programs together, we have repurchased approximately 13%.

The Company also announced today that our Board has authorized a new \$100 million share repurchase program. This is the third share repurchase program authorized since April of 2011. Approximately 106 million shares of common stock are currently outstanding, compared to 109.7 million shares one year ago and 117.3 million shares two years ago.



In addition, the Company announced today that its Board of Directors has declared a \$0.05 per share quarterly cash dividend, reflecting a 25% increase from the previous quarterly cash dividend of \$0.04 per share. The Company remains committed to returning value to shareholders in the form of share repurchases and cash dividends.

We continued to effectively manage inventories during the period. At quarter end, inventories totaled \$417.5 million, which is up 13.5% versus a year ago and in line with our expectations. The planned increase is primarily attributable to additional inventory for our e-Commerce business and slightly larger purchases in certain categories, including seasonal goods, in order to support higher sales. At the end of fiscal 2013, inventories are planned to be up approximately 10% versus the prior year.

Capital expenditures for the first nine months of the year totaled \$57.7 million. Of that amount, \$37.5 million was deployed toward the opening of 16 new Pier 1 Imports stores, new merchandise fixtures and lighting in approximately 50 refurbished locations, new impulse merchandise fixtures rolled out to all stores, and other leasehold improvements and equipment. The Company also invested \$1.7 million associated with the build out of our e-Commerce fulfillment space. The remaining \$18.5 million in capital spending was utilized for technology and infrastructure initiatives, including e-Commerce and our new point-of-sale system.

We continue to expect that total capital expenditures will be in the range of \$70 million to \$75 million for fiscal 2013, with roughly 50% allocated to stores and the other 50% allocated to technology and infrastructure. For the fourth quarter, we expect that depreciation expense will be slightly above third-quarter levels, as we continue investing additional capital into our stores and technology.

During the third quarter, we opened 9 stores and closed 6, ending the period with 1,061 Pier 1 Import stores. That includes 981 locations in the US, and 80 in Canada, for a total of 8.3 million retail square feet. During the fourth quarter of the year, we plan to open approximately 5 to 7 stores, and close 3 to 5 stores. For the full year, we anticipate to have gross store openings of 21 to 23 stores, and closings of 10 to 12 stores, for a net of 11 store openings, to end the year with 1,063 stores.

As we have discussed before, store relocations are a strategic and important part of improving the quality of our square footage, which we believe is more relevant than focusing solely on square-footage growth. This has proven to be a very effective way to increase sales, capture additional market share, and improve profitability. Our store portfolio continues to improve, and the investments we are making throughout the portfolio are helping to drive increases in both comp-store sales and sales per retail square foot.

Finally, turning to our outlook for the fourth quarter and full year. The Company's fiscal-2013 fourth quarter and fiscal year will include 14 weeks and 53 weeks, respectively, of operating results. As we reported in our earnings release earlier this morning, we are providing the following financial guidance for the fourth quarter on a 13-week basis. We expect to achieve comp-store sales growth in the mid single-digit range; earnings per share on a GAAP basis are expected to be in the range of \$0.55 to \$0.59, utilizing an effective tax rate of 38.5%; earnings per share on a non-GAAP basis are expected to be in the range of \$0.57 to \$0.61, utilizing an annual effective tax rate of 35.6%.

The Company is providing the following updated financial guidance for full fiscal-year 2013 on a 52-week basis. Comp-store sales growth in the mid single-digit range; earnings per share, on both a GAAP and non-GAAP basis, are expected to be in the range of \$1.17 to \$1.21; capital expenditures of approximately \$70 million to \$75 million. The 14th and 53rd week is expected to contribute approximately \$25 million in total sales, and approximately \$0.02 to earnings per share.

Thank you for your continued interest in our Company, and I'll now ask Regina to please open the call for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)



Kate Wendt, Wells Fargo Securities.

Kate Wendt - *Wells Fargo Securities - Analyst*

Congratulations on a good quarter. I want to start off with e-Commerce. First, if you can break out how much e-Commerce contributed in dollars to this quarter's sales; and then, additionally, what you're seeing at this point in terms of operating margins in the direct business versus retail? And, if you think that, over time, they can actually surpass retail, as they have at some of your competitors?

Alex Smith - *Pier 1 Imports Inc - President & CEO*

This is Alex. Wow, there's a lot of questions. I'll let Cary start on this one.

Cary Turner - *Pier 1 Imports Inc - Senior EVP & CFO*

First of all, I think Alex told you that we're taking the attitude of crawl, walk, run; and when you see us disclose our sales for now for direct-to-consumer, it's going to be included in the line of new stores and direct-to-consumer. Remember, the sales number is probably the smallest piece of how important e-Commerce is in this first quarter.

Kate Wendt - *Wells Fargo Securities - Analyst*

Understood, thanks, Cary. Also, we noticed that you ran a free shipping promotion before Thanksgiving, and I'm wondering if you can comment on what you learned from that promotion and whether the lift in sales was great enough to offset the loss in shipping profits?

Alex Smith - *Pier 1 Imports Inc - President & CEO*

That's a great question, and you're right, we did that. We wanted to start testing a few of these promotional activities so we can really get a really clear benchmark on which to build the business. And surprise, surprise, the sales went up and the margin went down, so in terms of what it did for merchandise margin dollars for the e-Com business, frankly, it was sort of a wash on our preliminary numbers.

That mirrors, really, what you see on in-store promotions. You've got to get a really, pretty sizeable bump, in terms of sales, to generate incremental merchandise margin dollars. Nevertheless, we were pleased with it, and I have no doubt that, strategically and carefully, free shipping will be part of our promotional cadence.

Cary Turner - *Pier 1 Imports Inc - Senior EVP & CFO*

Kate, to get back to your other question about margin with direct-to-consumer, we are going to continue to watch that; and until we get scale, we just don't think that the margin with direct-to-consumer is going to be better than store level, but we'll keep you posted.

Alex Smith - *Pier 1 Imports Inc - President & CEO*

What you should also focus on is that 35% of our online business, which is going through the stores, because for the customers who order online and pick up in store, not only do they have nothing to pay in terms of shipping charges, but that actually is a very profitable venture for us.

Kate Wendt - Wells Fargo Securities - Analyst

Absolutely, and you're one of the only home furnishings companies where you even have that capability, so that's great --

Alex Smith - Pier 1 Imports Inc - President & CEO

We may be the only. We have 1,100 pick up points. We're very conscience of that.

Kate Wendt - Wells Fargo Securities - Analyst

Exactly. One last one for Cary. How should we be thinking about SG&A going forward? Obviously, this year, your flow through has been impacted a little bit by the investments to start up e-Commerce. Should we expect any significant incremental investment next year, or will you start to anniversary that spend? And, maybe if you can provide what level of comps we should be thinking about for you to leverage expenses going forward?

Cary Turner - Pier 1 Imports Inc - Senior EVP & CFO

Yes, as we continue to say mid single-digit comps, you're going to see variable expenses being leveraged somewhat, especially with store payroll. I think with fixed expenses, I would just build in \$1 million or \$2 million per quarter, as we continue to invest into the Company.

Kate Wendt - Wells Fargo Securities - Analyst

Okay, great. Thanks so much.

Operator

Brian Nagel, Oppenheimer.

Rupesh Parikh - Oppenheimer & Co. - Analyst

This is Rupesh Parikh for Brian Nagel. Congrats on another strong quarter. Our first question has to do with occupancy cost. We saw that growth rate pick up, I think to almost 5% in Q3 versus about 3% for the first half, so we want to get a little more understanding in terms of what's driving that increase and how we can think about that growth rate going forward?

Cary Turner - Pier 1 Imports Inc - Senior EVP & CFO

That's primarily the new stores that we added this year and the full effect of the stores opened last year.

Rupesh Parikh - Oppenheimer & Co. - Analyst

Okay, so there's nothing unusual that took place in Q3?

Cary Turner - Pier 1 Imports Inc - Senior EVP & CFO

No.



Rupesh Parikh - *Oppenheimer & Co. - Analyst*

So, is the growth rate we should expect going forward?

Cary Turner - *Pier 1 Imports Inc - Senior EVP & CFO*

I'll give more detail as we go forward.

Rupesh Parikh - *Oppenheimer & Co. - Analyst*

Okay. In terms of the promotional environment, we've seen a lot of competitors and other retailers being more promotional lately. How would you describe what you're seeing so far versus your expectations so far this holiday season?

Alex Smith - *Pier 1 Imports Inc - President & CEO*

In terms of what we're doing, I think that's the thing I'd start with, Rupesh, which is really our promotional cadence is pretty much in line with last year. We're doing limited discounting through December up until, obviously, Christmas Eve. We're holding price on our all our Christmas products, pretty much. So, for us it's -- this year and last year, it is a very similar comparison.

In terms of our competitors, it's hard to measure the totality. My sense is a little more promotional than last year, but not a huge amount. I think what we have seen is a very significant increase in the number of these very short events for the online merchants, and I think there's certainly been an increase in those. But in terms of retail, I don't think so much.

Rupesh Parikh - *Oppenheimer & Co. - Analyst*

Okay, thank you. Finally, clearly, the e-Commerce business has gotten off to a strong start. So far has there been anything that has really surprised you guys the past few months in terms of the e-Commerce?

Alex Smith - *Pier 1 Imports Inc - President & CEO*

No, I don't think so. This is a really dull answer, but it all went according to plan. Everything worked as it was supposed to work. Our operations guys running the fulfillments and the shipping, and that went off without any problems. They coped extremely well with the increased volumes we saw over the Thanksgiving weekend, so I think that was all good.

I think the only thing which may be a little bit of a surprise is the 35% that we alluded to. I don't think we expected quite as many of the online orders to be picked up in store, but I think that comes under the heading of a nice surprise, so we were happy with that.

Rupesh Parikh - *Oppenheimer & Co. - Analyst*

Okay, thank you, and good luck for the remainder of the season.

Alex Smith - *Pier 1 Imports Inc - President & CEO*

Thanks a lot.

Operator

Alan Rifkin, Barclays.

Alan Rifkin - Barclays Capital - Analyst

Just a couple more questions, Alex and Cary, on the e-Commerce. What sort of cannibalization, if any, are you seeing on the retail side of the business as you continue to grow e-Commerce? And, were there any additional one-time costs associated with e-Commerce in the quarter?

Alex Smith - Pier 1 Imports Inc - President & CEO

As far as cannibalization is concerned, we haven't seen any, in fact, quite the reverse. We think -- just don't forget those -- we are pushing with those 35% of the customers who were shopping in the store, they're there, and they can potentially do another transaction. So, we think it's going to be accretive to traffic and will certainly help the business. And of course, as we develop out, Alan, we are going to have more product online which is not available in the stores, so that clearly won't cannibalize as it will be different product.

So, no, we think it really is -- we think, as I said in the prepared remarks, that these are two mutually supportive and converging businesses. I suspect when we talk to you in two or three years' time, and we're having this discussion, that we almost won't distinguish between the two. We'll just be talking about the business.

Cary Turner - Pier 1 Imports Inc - Senior EVP & CFO

I think everybody needs to think about with what Alex said in his prepared remarks regarding the influence factor --

Alex Smith - Pier 1 Imports Inc - President & CEO

Yes, it's huge.

Cary Turner - Pier 1 Imports Inc - Senior EVP & CFO

Of the website. The fact that we're having over 1 million visitors per week has been very rewarding.

Alan Rifkin - Barclays Capital - Analyst

Okay. While obviously, Alex, e-Commerce has gotten off a terrific start, today, at the end of the quarter, by our calculation, it still only represents maybe 1.5% of total revenues. If you look at the effect on the merchandise margins, which were 30 basis points, can we infer from that, that the merchandise margin difference between retail and e-Commerce, which is we calculated maybe 1,500 basis points, would that be indicative of the difference going forward, or is that not a good number to go by?

Alex Smith - Pier 1 Imports Inc - President & CEO

Gosh, Alan, that's a really complicated bit of math. I don't think I can do that --



Cary Turner - *Pier 1 Imports Inc - Senior EVP & CFO*

Alan, as we -- remember, as we continue to get more scale, and only until we get more scale, will you see the number get closer to the store-level margin, so we'll try and give you more input on that as we go forward and see the build.

In terms of your question about start-up costs, you saw fixed costs were up \$ 1 million or \$2 million, that's what we had told you it would be this quarter, and that's what I would build in as we go forward.

Alan Rifkin - *Barclays Capital - Analyst*

Okay. One last question, if I may, if people buy online, pick up in store, you're counting that in your comp, is that correct?

Cary Turner - *Pier 1 Imports Inc - Senior EVP & CFO*

That's correct.

Alan Rifkin - *Barclays Capital - Analyst*

Okay. Thank you very much, and best of luck over the holidays.

Cary Turner - *Pier 1 Imports Inc - Senior EVP & CFO*

Thank you.

Alex Smith - *Pier 1 Imports Inc - President & CEO*

Thanks, Alan, take care now.

Operator

Simeon Gutman, Credit Suisse.

Simeon Gutman - *Credit Suisse - Analyst*

I had a quick question on marketing. Is there a sales per square foot level that you reached, or some threshold maybe with the e-Commerce business as far as sales go, when you will let that marketing expense drift down to leverage a little more?

Alex Smith - *Pier 1 Imports Inc - President & CEO*

That's a very interesting question. Never say never because who knows, but all I can tell you is in the modeling that we've done for the business for the next three to four years, we've kept it firm at that 5% number. I guess, theoretically, you could conceive a time when the business is so strong that we feel that we don't need to spend that amount. But at the moment, I think the business model can handle that 5% very comfortably, so we feel it's most prudent to just keep reinvesting those extra dollars into marketing.



Cary Turner - *Pier 1 Imports Inc - Senior EVP & CFO*

I would say, as we continue to grow the sales per square foot as you said, the traffic number is going to continue to become more and more important; and therefore, we are seeing marketing as an investment.

Simeon Gutman - *Credit Suisse - Analyst*

Right, okay, that makes sense.

Cary, can you talk about the fulfillment costs a little bit and maybe drill down? I think there's some puts and some takes, I think, when you ship direct from the warehouse, you don't have the freight that's going to a store, unless it's being picked up there; but then, you have certain partners that are in the middle that, I think, may dilute some of the margin. Also, can you talk about the pure merchandise margin of that product, before those costs, is the same, I just want to clarify that. Then, talk about some of the puts and takes of the other side of the equation?

Alex Smith - *Pier 1 Imports Inc - President & CEO*

We can talk -- the merchandise margin, per se, actually runs higher than the store because we're selling a little less markdown and a little less promotional merchandise. So, if you looked at it purely at that level, it would be ahead. However -- do you want to talk about the other line?

Cary Turner - *Pier 1 Imports Inc - Senior EVP & CFO*

If you just do the math and assume we're breaking even on the freight, then you can see that, with those additional fulfillment costs, the rate goes down.

Simeon Gutman - *Credit Suisse - Analyst*

Right. So, it levers over time because of the volume that overcomes with the dollars, but the rate may still be a little lower?

Cary Turner - *Pier 1 Imports Inc - Senior EVP & CFO*

That's correct.

Simeon Gutman - *Credit Suisse - Analyst*

Okay. The last question to sneak in -- I think, Alex, you mentioned furniture in your prepared remarks. Is it broad based across all your categories? Is some of it customized assortment that Pier is getting into, any more color on that?

Alex Smith - *Pier 1 Imports Inc - President & CEO*

It is remarkably broad based, actually, Simeon. We are very, very pleased with that business in totality. I don't think I can -- it would be invidious, I think, to call out any particular department. It is all doing very nicely.

Simeon Gutman - *Credit Suisse - Analyst*

Okay, thank you.



Operator

Brad Thomas, KeyBanc Capital.

Brad Thomas - KeyBanc Capital Markets - Analyst

Good morning, and let me add my congratulations, as well, on another great quarter, here.

Alex Smith - Pier 1 Imports Inc - President & CEO

Thanks, Brad.

Brad Thomas - KeyBanc Capital Markets - Analyst

Just to follow-up on this line of questioning of the effects of the internet sales on the margins, so as we then zoom out and think about the net effect on gross margin and on total operating margin, is it still reasonable to think that what an incremental dollar of internet sales would help you leverage your occupancy cost, so that would be a positive for total gross margin and the same for operating margin? Is that the way to think through it?

Alex Smith - Pier 1 Imports Inc - President & CEO

Cary?

Cary Turner - Pier 1 Imports Inc - Senior EVP & CFO

Yes. I mean, simply said, yes. And, that's why we're going to have you focus on gross profit, as a percentage of sales, as we go forward.

Brad Thomas - KeyBanc Capital Markets - Analyst

Great. Then, just to think about the retail merchandise margins, specifically, this was the first time in a number of years that we didn't get an improvement. I think we've had six years that it's been on a very positive upward trend. It's getting to that point that it's around the 60% level that you all have talked about now for two years as maybe being about as high as you want to bring it up to. Was there anything specific in this quarter that kept you from driving it up more, or are we just at a level that it probably starts to stabilize at?

Alex Smith - Pier 1 Imports Inc - President & CEO

First of all, of course, we did increase the dollars very significantly, so merchandise margin dollars are what we focus on, so that was a good number. However, I hear your question. There was really nothing very significant in it. I think, what we've always told you is, in terms of the components of our merchandise margin is, as far as the buyers' margin, the initial margin is concerned, we think that's as high as we want it to go. We really think it's -- to push it any higher would impact our competitiveness of our pricing, so we're certainly pretty much at the maximum that we feel today.

In terms, then, of the promotional and the promotional discounts and the markdown discounts, that sort of ebbs and flows. I can't say -- Cary is sort of looking at me, so I can't say too much, but we don't think of it in terms of a ceiling, but we don't actively push it. If we have really good quarters, and the markdown number is really small, then the margin will drift up a bit. If the economic climate gets really, really strong, and we



think that we don't need as much promotional dollars, then the margin will drift up. But, for where we are today, I think 60%-ish is, actually, a pretty good number.

Cary Turner - *Pier 1 Imports Inc - Senior EVP & CFO*

Yes, and I would only add that with where the consumer is right now, our planning, as we go out the next 12 months, is really that 50% of promotional and clearance activity and the other 50% being regular price is a good place to be, and that's something else that's going to keep that 60% at its ceiling.

Brad Thomas - *KeyBanc Capital Markets - Analyst*

Great. Thanks, Cary. Thanks, Alex. Best of luck.

Operator

Anthony Chukumba, BB&T Capital Markets.

Anthony Chukumba - *BB&T Capital Markets - Analyst*

I wanted to switch gears a little bit. I wanted to talk a little bit about your tax rate. I think there was a little bit of confusion out there. Essentially, on your second-quarter earnings call, you guided to a tax rate of 38% to 39%, and it looks like you pretty much came in line with your guidance, but then you're backing out \$0.02 because of the difference between that and your normalized annual rate. And, I guess I'm trying to understand what the thought process is there? Then, in addition to that, just understand where you think your tax rate will be for next year? I understand you aren't giving full guidance, but just wanted to get some sense for that because it does impact the numbers a bit.

Cary Turner - *Pier 1 Imports Inc - Senior EVP & CFO*

Number one, if you take a look at the second quarter, we took away \$0.02 for the effective rate because the effective rate was so low at around 21%. So, all we're trying to spell out is for the third and fourth quarter, they were more at the 38% to 39% to 38.5%, but when you take a look at the full year, it's 36.5%. That's all it is. And then for next year, who knows what's going to happen in Congress, and whether or not they touch the tax laws; but for now, I would probably just keep the 38% to 39%.

Anthony Chukumba - *BB&T Capital Markets - Analyst*

Okay. Then, one last follow-up question. In terms of your guidance, your full-year guidance, you basically say that the -- on a both a GAAP and a non-GAAP basis, it's going to be \$1.17 to \$1.21. I guess I was a little bit confused about that because, for the fourth quarter, you are saying there's going to be this \$0.02 difference, so I guess I was just wondering why --?

Cary Turner - *Pier 1 Imports Inc - Senior EVP & CFO*

Yes, so again, Anthony, go back to the second quarter. We took away \$0.02 for the interest expense -- the interest income that we got. We had to back that out; and for the third quarter, we added \$0.02 for the hurricane, so it all washes out.



Anthony Chukumba - *BB&T Capital Markets - Analyst*

Okay, so it washes out. Okay, thanks a lot, guys. That's helpful.

Operator

Adam Sindler, Deutsche Bank.

Adam Sindler - *Deutsche Bank - Analyst*

So, real quickly, going back to the \$0.02 from Sandy for this quarter, could you help us walk -- walk us through where the \$0.02 came from? Was there some hit to sales, or was it all on the SG&A line?

Alex Smith - *Pier 1 Imports Inc - President & CEO*

It was both. We had a significant number of stores -- we had almost 25% of our estate closed for a considerable number of days, so we lost the income there, and then we had costs associated with it. We decided that, even though we were not required to, we decided that we would pay our associates who were scheduled to work those weeks when the stores were closed, so --

Cary Turner - *Pier 1 Imports Inc - Senior EVP & CFO*

Including the part timers.

Alex Smith - *Pier 1 Imports Inc - President & CEO*

Including the part timers, so we took those costs on the chin. And then, what else was it, Cary?

Cary Turner - *Pier 1 Imports Inc - Senior EVP & CFO*

Just some inventory and fixtures that were damaged due to the storm.

Adam Sindler - *Deutsche Bank - Analyst*

Okay, so then using, though, the sales number of -- reported sales of \$424.5 million, without adding any sales, lost sales back, we should still get to the \$0.25 for the quarter?

Cary Turner - *Pier 1 Imports Inc - Senior EVP & CFO*

There was about \$0.01 that was lost sales.

Adam Sindler - *Deutsche Bank - Analyst*

Okay. Then, real quickly, if you could walk us through the pace of sales through the quarter, and maybe provide a little bit more color on some commentary that the strength that carried through into December so far?



Cary Turner - *Pier 1 Imports Inc - Senior EVP & CFO*

I think the way to look at the third quarter -- remember, September is an important month because it's five weeks. October is a -- probably, one of the lighter months of our fiscal year. October and February are slowest. Then November, of course, at the beginning, we had the storm; and then, as the month proceeded, we saw a nice pick up, and it ended with the strong Thanksgiving weekend.

Adam Sindler - *Deutsche Bank - Analyst*

Okay, very good. Thanks, guys, appreciate it.

Operator

Denise Chai, Bank of America.

Denise Chai - *BofA Merrill Lynch - Analyst*

Congratulations on a great quarter, and thanks for taking my question.

You said that your rewards card is an increasingly important sales driver. I just wondered if you could give us more color on traffic with the ADS relationship; and also, what percentage of your sales are now on your credit card?

Alex Smith - *Pier 1 Imports Inc - President & CEO*

You want to take that one, Cary?

Cary Turner - *Pier 1 Imports Inc - Senior EVP & CFO*

Sure. You've noticed we haven't given out that full number yet, and we want to wait until we've anniversaried our relationship with ADS to be able to give you a number and have it be meaningful. But, you heard the prepared remarks, we are very pleased with the relationship. We're seeing more approvals at the store level. The process is easier, and it's a win-win.

Denise Chai - *BofA Merrill Lynch - Analyst*

Great, thank you.

Operator

Budd Bugatch, Raymond James.

TJ McConville - *Raymond James - Analyst*

It's actually TJ McConville filling in for Budd. Congratulations on the quarter.

Let's talk about something besides tax rates and \$0.02 for a minute. We talked about -- Cary, you told us that the average ticket this quarter was a function of both units per transaction and average unit retail. I don't recall there -- I think this is the first time we've heard that units per transaction

number being up. Is that accurate? And then, would some of the ADS benefit that you're seeing be driving some of that? Would there be some benefit from e-Com? How would you put those benefits into buckets, if you can?

Alex Smith - *Pier 1 Imports Inc - President & CEO*

Yes, it's accurate, or we wouldn't have told you, so it's real. We had a very concerted effort when we did our planning at the beginning of this fiscal year to try and get back some of the unit sales that we have in the business. Because what had happened, TJ, is over the years, as we've reduced the amount of markdown merchandise in our stores very significantly, we lost some unit opportunities.

So, the merchants and the planning teams have worked very hard to identify where we can get those units back by putting effectively low-priced items in the store in very prominent places, and those were the impulse towers that Cary alluded to, so we are really pleased with the results of that strategy. It's really helped.

Cary Turner - *Pier 1 Imports Inc - Senior EVP & CFO*

And the other thing I'd say, TJ, retail is detail, but if we had to pick out the top sales drivers that are helping us this year and next year, yes, it's the impulse towers, it's having the unit drivers, and it's having the relationship with ADS and driving our best customers on that rewards card. It's all of the above, and like I said before, the influence factor with the Internet is huge, so it's all of it.

TJ McConville - *Raymond James - Analyst*

Okay, that's good to hear. Alex, I wasn't questioning whether you were accurate, I was questioning whether I was accurate. Is this actually the first quarter that we're seeing that sort of shift happen in the units per transaction, or has that been building over the last --?

Alex Smith - *Pier 1 Imports Inc - President & CEO*

I think it really came to fruition as we did the holiday floor sets, and those fixtures were only delivered at the back end of August into September, so yes, this is the first quarter.

TJ McConville - *Raymond James - Analyst*

Okay, that's fantastic to hear. For my obligatory e-Commerce question, what are you learning, Alex or Cary, from maybe the behavior of the customer online that you can maybe transfer into the stores, and possibly, help drive some more Pier 1 to go sales or something along those lines, which may even be more profitable than the direct-to-customer sales themselves?

Alex Smith - *Pier 1 Imports Inc - President & CEO*

I'm not quite sure what you're driving at there? In terms of what the customers -- just have another run at that for me, TJ.

TJ McConville - *Raymond James - Analyst*

Right, so if you can share with us a little bit of what you're learning from a demand perspective, maybe, that might allow you to stock stores with some additional merchandise that could help you drive Pier 1 to go sales, which as we know, helped drive the attachment when the customers come into the store or something along those lines, just from a general customer-behavior perspective?



Alex Smith - *Pier 1 Imports Inc - President & CEO*

Okay, thanks. First of all, the sales mix online is not the same as the sales mix, so in terms of the departmental participation, there is a difference. It's not mirroring the store, exactly. Within the departments themselves, the best selling SKUs online are very similar to the best selling SKUs in the stores, so from that point of view, there's not much difference.

What we have now is a great opportunity to expand our testing strategies. We already have pretty well-established testing strategies in store, particularly on high-ticket merchandise, to allow us to minimize markdown risk. We now have many, many more opportunities to use the web for testing; and if we get good response, we can always roll those products back into the stores. So yes, it gives us a lot more opportunity, and I guess makes experimentation even a little bit more safer than we've already got it.

TJ McConville - *Raymond James - Analyst*

That's good to hear, guys. Again, congratulations on the quarter. Best of luck on the rest of the holiday season and the rest of the year.

Alex Smith - *Pier 1 Imports Inc - President & CEO*

Thanks.

Operator

John Marrin, Jefferies.

John Marrin - *Jefferies & Co. - Analyst*

Very impressed with this 35% of online transactions taking up the store. Is the average transaction size on that 35% in line with what you're seeing in direct overall? And, can you speak to any incremental SG&A leverage you might see on those transactions at retail?

Alex Smith - *Pier 1 Imports Inc - President & CEO*

Any extra what, John, sorry?

John Marrin - *Jefferies & Co. - Analyst*

Like incremental SG&A leverage, the cost of SG&A on those sales, in particular.

Alex Smith - *Pier 1 Imports Inc - President & CEO*

On the SG&A, it really doesn't have much of an impact. What it does is it, obviously, we save shipping costs, our portion of the shipping cost, so that's a save. As far as the complexion of the transaction, I haven't looked in total detail, but I don't think there's much -- I can come back to this one. I don't think there's much difference between the transactions that were going to direct-to-consumer and the transactions going direct to the store. I'm just looking at my guys in the room here, and they're nodding, so I think that's pretty much the case.



John Marrin - *Jefferies & Co. - Analyst*

Okay. Just one more quick question, then, again on fulfillment. Cary, is there a fixed component there that gets absorbed as the business grows, or is that all variable?

Cary Turner - *Pier 1 Imports Inc - Senior EVP & CFO*

It's pretty much all variable.

John Marrin - *Jefferies & Co. - Analyst*

Okay. That's it, thanks.

Operator

I will now turn the conference back over to Alex for any closing remarks.

Alex Smith - *Pier 1 Imports Inc - President & CEO*

Okay, thank you, Regina. Thanks for your questions, everybody.

We will be releasing December sales on January 3, fourth-quarter sales on March 7, and our fourth-quarter and year-end earnings on April 11. We are also going to be rescheduling the Investor Day, which we had to cancel for all the reasons that we all know about, so we'll get back to you on that. Lastly, from all of us at Pier 1 Imports, we hope you have a very happy Christmas and a peaceful New Year. Thank you very much.

Operator

Ladies and gentlemen, this does conclude today's conference. Thank you all for joining, and you may now disconnect.

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