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PIR - Q1 2018 Pier 1 Imports Inc Earnings Call

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OVERVIEW:

PIR reported 1Q18 net sales of $410m and net loss of $3m or $0.04 per share. Expects FY18 EPS to be $0.46-0.52 and 2Q18 net loss to be $0.08-0.04 per share.

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PRESENTATION

Operator

Good afternoon, ladies and gentlemen, and welcome to the Pier 1 Imports First Quarter Fiscal 2018 Earnings Call. At the request of Pier 1 Imports, today's conference is being recorded. (Operator Instructions) I would now like to introduce Bryan Hanley, Director of Investor Relations for Pier 1 Imports.

Bryan Hanley

Thank you, Karen, and good afternoon, everyone. Today, after market close, we issued an earnings press release which included the detailed financial results for the first quarter of fiscal 2018. In just a few moments, we will hear comments from Alasdair and Jeff about the results, our strategies and outlook. This will be followed by a question-and-answer period.

Before we begin, I need to remind you that any statements made today regarding our business may be deemed to include forward-looking statements that are based on current estimates or expectations of future events or future results and are made pursuant to and within the meaning of the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Forward-looking statements are subject to both known and unknown risks and uncertainties that could cause actual results to differ materially from such statements. Any forward-looking statements made today are as of the date of this call, and the company does not assume any obligation to update or revise any such 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 a reconciliation of the non-GAAP financial measures to the most directly comparable GAAP financial measures in our earnings press release that was issued this afternoon, which is available on our website at pier1.com.

Now I'd like to turn the call over to Alasdair James, President and Chief Executive Officer. Alasdair?

Alasdair B. James - *Pier 1 Imports, Inc. - CEO, President and Director*

Thanks, Bryan, and good afternoon to everybody. Joining me on the call is Jeffrey Boyer, Executive Vice President and Chief Financial Officer.

I am thrilled to be here at Pier 1 Imports and have this opportunity to speak with you on our first earnings call since my arrival here on the 1st of May. I'll begin with a review of my early findings and strategic direction, and then Jeff will take you through the quarterly results and the specifics.

When I look at the talent we have, our omnichannel capabilities, the real estate portfolio and our loyal customer base, I am very excited about the opportunity that exists to capture additional market share and to drive improved profitability. The company has historically been a strong cash flow generator, and I see a clear path to driving meaningful EBITDA growth, improving our working capital management and, in turn, expanding our return on invested capital. Our strong balance sheet affords us the flexibility to invest for growth while continuing to return value to our shareholders.

During my first 45 days at the company, I am focused on gaining a more in-depth understanding of Pier 1 Imports' strengths, identifying issues and opportunities and laying the groundwork to evolve our strategy. I've been spending time with team members at all levels of the organization and also out in the field visiting stores and meeting our sales associates.

We have a highly collaborative organization that is appropriately facing into the challenges of today's retail environment and the increasingly competitive home furnishing sector. Our senior team has worked together for many years, and everyone is aligned to our common goals. Many of them have seen the company through various stages of growth and transformation over the last few years.

Broadly speaking, I'll group my initial learnings into 5 areas: firstly, brand positioning; second, marketing and promotions; thirdly, e-commerce; fourthly, supply chain; and then, finally, the real estate portfolio.

So firstly, brand positioning. I'm proud to be leading a brand with such tremendous history and equity. We have a large loyal customer base who loves our unique esthetic and appreciates the Pier 1 Import shopping experience. Unquestionably, we have a rich heritage as the original treasure hunt destination. But in today's environment where there's so much opportunity to be copied by others, it's imperative that we continue to further differentiate ourselves while keeping our treasure hunt roots in sight. We have a great deal of strength in key categories like decor and seasonal, but our current positioning is narrowly focused on our core demographic and doesn't fully reflect the brand's true value potential in my opinion. Going forward, we'll be looking at opportunities to refine our positioning across new and existing merchandise classifications and improving upon our customer segmentation, be it from a psychographic, behavioral or demographic perspective.

Hand in hand with what the brand stands for is how to communicate the vision and the value to the customer, principally through our marketing and promotions. In recent quarters, we've made good progress toward increasing our visibility and improving our promotional effectiveness through new initiatives. These include a return to television, the introduction of new shipping thresholds and reduced markdown levels, all of which has strengthened our competitive positioning. Brand traffic has been trending in the mid- to high single digits, which is certainly acceptable when compared to the overall retail landscape, but we can and we should do better.

Looking ahead, we'll be developing a more holistic omnichannel marketing plan that contemplates specific customer segments, demographics and strategies that we anticipate will engage new customers and, therefore, enable us to reinvigorate sales.

The third area of focus is e-commerce. Our digital footprint has grown rapidly over the past 5 years and, in the first quarter, accounted for nearly 25% of our total sales. We will be exploring opportunities to leverage the solid foundation we have in place and to build on the steady momentum we gained over the last 5 years. In the coming months, we'll be further exploring and testing enhancements that we believe will see us accelerate sales growth in this area. Key areas of focus include increasing our assortment breadth and using machine learning tools to better target our promotional investments to our customers.

Next, I'll talk about supply chain. In recent years, a great deal of work has been done to streamline our existing distribution model and to operate it more efficiently. We are in progress on some tactical initiatives, which include building out large parcel fulfillment capabilities within our distribution centers and implementing new efficiency processes and programs. In fact, we're now shipping large parcel orders direct out of our Ontario DC in California and our Baltimore DC in Maryland. Looking ahead, we'll be reviewing our current sourcing model, with a goal of sharpening our merchandise offerings and positioning the business to be more profitable and productive.

Moving on to real estate, where we've got very strong 4-wall economics. We're presently about halfway through our store optimization plan, which encompasses approximately 100 store closings through the end of fiscal '19. We're on track to close 20 to 25 locations this fiscal year and next, which will put the portfolio at approximately 965 stores. Going forward, there will be continued opportunities to exit some locations and to further reduce occupancy costs. But our analysis tells us the vast majority of the portfolio will continue to be profitable for the foreseeable future. It's one of the most positive things about my first few weeks in this role, is the confidence I've been able to get in the robust study that's been carried out at this granular level, literally store-by-store, and which is guiding our optimization plan.

The role of stores in today's world is changing as our customers gravitate toward more experience-driven environments. Pier 1 Imports stores are an integral part of our supply chain and offer a shopping experience that is coveted by our loyal customers. Notably, we're seeing positive results from the recent introduction of in-store events that are designed to improve the overall experience, and these have been highly successful on many fronts. First, they inspire our teams to be even more engaged with the customer and to enable them to become increasingly well-versed in our merchandise offerings. More importantly, they generate significant incremental sales dollars and result in new customer enrollments in our Pier 1 Rewards program. Going forward, we'll continue to develop and expand this strategy while also looking more broadly at store format and opportunities to maximize our productivity.

Before I turn the call over to Jeff, I wanted to reiterate how excited I am to be here and to emphasize the substantial opportunity I see to drive margin and profit improvement in the immediate to long-term. In a sector that is continually evolving, we have the ability to leverage our omnichannel platform to adapt, move quickly and ensure we're at the forefront of industry shifts.

I'll be continuing to work closely with our board and executive team in the coming months to build upon the initial findings I had outlined today as we establish a strategic plan for our future. The business has been hovering around the sub-$2 billion for the past several years, and we absolutely have the opportunity to go well beyond that. With just a 1% share of the enormous market, our next chapter will need to be about how we double the size of this business. That could mean new brands and new markets, and it absolutely will mean new product offerings and new customer groups to broaden our reach. I'm looking forward to getting to know our analysts and our investors in the months and the quarters ahead and will have more to share in the fall.

Now I'll ask Jeff to review the financials. Jeff?

Jeffrey N. Boyer - *Pier 1 Imports, Inc. - CFO and EVP*

Thank you, Alasdair, and good afternoon, everyone. I'm starting with sales. Company comparable sales on a constant currency basis came in approximately flat when adjusting for the 20 basis point impact from a decline in the Canadian dollar year-over-year. Net sales decreased 2% to $410 million, while the average number of stores was down 1%.

Our first quarter sales results reflect solid performance across a number of merchandise categories relative to our expectations. However, our outdoor merchandise category was softer than we anticipated. From a channel perspective, e-commerce continues to demonstrate strong growth. First quarter e-commerce sales grew 23%, with sales penetration expanding to 24% versus 19% a year ago. From a high-level perspective, our top line sales results fell slightly below our expectations, but we delivered strong year-over-year improvement in merchandise margin and delivered against our cost initiatives, resulting in EPS within our guidance range.

First quarter gross profit improved to $152 million versus $149 million a year ago. Our gross margin rate expanded 140 basis points to 37%.

Looking at the key components within gross margin, starting with merchandise margin, we delivered strong increases in both margin dollars and rate. Merchandise margin dollars increased to $240 million from $233 million a year ago, while margin rate expanded 300 basis points to 58.6%. The year-over-year improvement is primarily the result of greater efficiencies within our supply chain as well as reduced clearance activity.

Turning now to delivery and fulfillment net cost as a percentage of net sales. We deleveraged 150 basis points on a year-over-year basis, primarily due to the lower free shipping threshold we implemented in the third quarter of last year. The majority of our fulfilled orders were eligible for this promotion in the quarter.

Store occupancy costs in the first quarter decreased by about $1 million to $72 million and increased 10 basis points as a percent of net sales. Our real estate optimization plan remains on track and together with lease renegotiations, will allow us to continue to reduce occupancy cost for the foreseeable future.

Total SG&A dollars decreased slightly in Q1 to $140 million, coming in better than we originally planned. As a percentage of sales, SG&A was up 10 basis points to 34.2%. During the period, we achieved savings of approximately $4 million in compensation for operations as we continue to drive efficiency in store payroll. As we anticipated, those savings were partially offset by a planned increase in marketing spend, reflecting continued investment in television and digital initiatives to drive sales. From a high-level perspective, our teams remain focused on balancing store operational costs against delivery and fulfillment expenses, and that will continue to be a priority going forward.

First quarter operating loss narrowed substantially to $2 million from $8 million a year ago. Net loss came in at $3 million or $0.04 per share compared to $6 million or $0.07 per share in Q1 of last year.

Turning to the balance sheet at quarter-end. We had $162 million of cash and cash equivalents and no working capital borrowings under our $350 million revolver. And the inventory totaled $418 million, down approximately 1% versus a year ago. Subsequent to the end of the first quarter, we closed on an amendment to our $350 million credit facility that extends the maturity out to June 2022. It was a great opportunity to lock in our existing pricing and extend the maturity out on the other side of our term loans maturing in 2021.

Now I'll outline our financial outlook for the second quarter and the full year of fiscal 2018. I'll begin with Q2. Our expectations for Q2 reflect some anticipated sales and merchandise margin pressure related to softness in our outdoor category and are included in the following estimates for the quarter: company comparable sales growth of flat to up 2%, net sales approximately flat, merchandise margin of approximately 57%, SG&A expenses in the range of $132 million to $137 million and net loss in the range of $0.08 to $0.04.

Our full year guidance has been provided on a 53-week basis and reflects a 50 basis point adjustment to our previous net sales outlook, resulting from the softness in the first half. Despite that adjustment, we expect to hit the previous guidance range as we provided for the full year, including earnings per share.

The full year outlook is as follows: net sales growth of approximately 1.5% to 2.5%, which compares to the prior guidance of 2% to 3%; merchandise margin of approximately 58%; selling, general and administrative expenses of approximately 31.5% of sales, including marketing spend of approximately 6% of sales; interest expense in the range of approximately $13 million, an effective tax rate of approximately 39% for the year.

Lastly, our earnings per share remains -- our earnings per share range remains at $0.46 to $0.52 per share. We adjusted the diluted share count from our previous estimate of 81 million shares to our current estimate of approximately 80.5 million shares. We expect the 53rd week to contribute approximately $26 million to sales and $0.02 per share to earnings for the full year. On a comparable 52-week basis versus fiscal 2017, we are forecasting company comparable sales growth of approximately 1% to 2% for the full year and fiscal 2018.

Thank you for your attention this afternoon. Now Alasdair and I would be happy to take your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our first question comes from the line of Dan Binder with Jefferies.

Daniel Thomas Binder - *Jefferies LLC, Research Division - MD and Senior Equity Research Analyst*

I was wondering if you could comment on 2 things. First, what you're finding about the TV advertising and the effectiveness of that and then, secondly, with regard to sourcing, if you can discuss, high level, how you're thinking about the role of direct sourcing and how long it would take to implement an ultimate target levels as a percentage of the mix that you think you can get to.

Alasdair B. James - *Pier 1 Imports, Inc. - CEO, President and Director*

Dan, thanks for the question. Happy to answer both of those. So firstly, TV advertising effectiveness. I think we talked about this call and my predecessor talked about that at [June] this call last year. And what we've seen is a result of -- brand traffic improvements as a result of our TV advertising campaign that we ran. But what we've also found is that predominantly, we're speaking to our core customer via our TV advertising. We had 2 parts to that: one was to increase our spend on TV, but the second was actually to try speaking in 30-second advertisements rather than 15 seconds. Our judgment has been that while we got a slight lift from moving to 30-second, it wasn't enough to offset the added cost. And so we'll actually move to 15 seconds going forward.

So I think the exception will be to that. If you've got a very strong brand story that you wish to tell then you might go back to 30 seconds. But we decided to remain at 15 seconds in our TV advertising and continue speaking to our audience as there's clearly the opportunity for us when we look at our overall marketing spend around both direct mail, digital, particularly social, and then TV. We split those relatively the same across those 3. Clearly, the opportunity for us as we develop new customer outlook and approach to getting to a newer customer is to use digital, social and other means as well as TV.

The second part of your question around sourcing, I think there clearly is an opportunity for us to source differently from the way we do at the moment. We've undertaken a piece of work internally here to help model that out, just to exactly the scale of that and what that would look like. And that would form part of what we plan to come back with in November and share in a special update to the analyst community. But I, like you, believe there to be a significant opportunity for us in our sourcing.

Operator

And our next question comes from the line of Simeon Gutman with Morgan Stanley.

Simeon Ari Gutman - *Morgan Stanley, Research Division - Executive Director*

Alasdair, you made a comment in your prepared remarks, you said capture market share and grow profitably. In this space, it's -- actually, it feels like the cost of business is going up pretty much for the entire sector. There's capacity that seems like it's increasing, not necessarily in physical stores but in online players and nontraditional stores going after this. Marketing, you mentioned it's going up or it's being spent on, shipping is free. So how do you plan -- how do you achieve that balance, that capture market share growing profitably, not staying profitable, but incremental margins actually improving?

Alasdair B. James - *Pier 1 Imports, Inc. - CEO, President and Director*

So I think there's several things, if I answer the second part of your question, about profitability. If I look at our pricing, our promotional effectiveness, our marketing effectiveness, goods and services not for resale and our supply chain, I think there's opportunities for us to improve our productivity and our profitability across all of those lines which helps us to have the fire power to then invest in marketing to a broader section of customers. And by that I mean when you look at our core customer, and we can see this now across our database of customers we have where the vast majority of our transactions now are captured and we, therefore, have sort of an ability to know who those customers are. It's a relatively tight, core customer, roughly around the age of 50 years of age and the household income is over $100,000. So when you actually look at that kind of customer and you see the person that likes the Pier 1 product at the moment, and you then look at how many of those live within 5, 10 miles of our stores, we're talking to most of them. So the real opportunity for us is to, therefore, speak to a herd of customers that we aren't speaking to currently and to actually take a smaller share of a new group of customers whilst continuing to talk to our core.

Simeon Ari Gutman - *Morgan Stanley, Research Division - Executive Director*

You mentioned differentiated product, and I know it's early, but your initial assessment whether the business has invested enough into product, into its merchandising over the past few years.

Alasdair B. James - *Pier 1 Imports, Inc. - CEO, President and Director*

I think the answer is the product we have appeals very strongly to our core customer. I'm sure -- I don't think we've invested enough in considering the alternatives we would require for a new customer or a different customer. And I think as you lay out what the needs and occasions are you're trying to meet with your merchandise assortment, we can do a job to help make -- clarify that for customers, but also for yourself.

Simeon Ari Gutman - *Morgan Stanley, Research Division - Executive Director*

Right. And then there's one more, if I could sneak it, maybe for Jeff. In terms of stores being profitable and staying profitable, can you share with us the assumption for store-only comps? Is it about where they run today? Does it assume that it gets a little bit worse from here? Just curious how you model that over the next several years.

Jeffrey N. Boyer - *Pier 1 Imports, Inc. - CFO and EVP*

Yes, we -- sure, Simeon. Yes, we did look out store-by-store, as Alasdair said, for all of our stores over the next 5 years. And we assumed kind of current run rate, current run rate and the POS in store that we're experiencing right now. Don't have any indication of any major changes in that, so we've modeled that out and have come up with the conclusion we'll continue to rationalize the fleet, but rationalize it at a fairly modest rate because we are starting from a fairly profitable position overall.

Operator

And our next question comes from the line of Geoff Small with Citi.

Geoffrey R. Small - *Citigroup Inc, Research Division - Senior Research Associate*

You're going to be anniversary-ing some tougher compares in the back half of this year and as well as the initiatives that drove those improved sales trends last year. And so I'm curious what gives you the confidence that you can accelerate comparable sales growth over the back half of this year to achieve your full year target?

Alasdair B. James - *Pier 1 Imports, Inc. - CEO, President and Director*

So thank you, Geoff. I mean I think the key thing that gives us confidence is that we're typically stronger in our decor and our seasonal businesses than we are in our furniture business. And as we come into the back half of the year, it's those categories that step to the fore in terms of providing the majority of the sales, and we had a good experience last year with selling through on those categories within the seasons. And the degree of uniqueness of those products relative to our competitor set is also higher.

Jeffrey N. Boyer - *Pier 1 Imports, Inc. - CFO and EVP*

And I'd just add to that, that the challenge we have in the first half is in our outdoor category and the second half, Geoff, that becomes a much smaller part of the equation. And the home decor seasonal piece becomes much more of a destination for us.

Geoffrey R. Small - *Citigroup Inc, Research Division - Senior Research Associate*

Understood. And it sort of ties into my second question. I'm just curious, I think this is the second year in a row now where you've encountered some difficulty in the outdoor category. Is there one thing you can point to that's driven that weakness, whether it be the merchandise assortment or the marketing behind the category or just promotional pressure from competitors?

Alasdair B. James - *Pier 1 Imports, Inc. - CEO, President and Director*

I mean, I think, our value proposition hasn't been strong enough, Geoff, is the reality for our outdoor furniture. Many of our competitors -- many new competitors are now doing outdoor furniture and offering entry price points and sort of very good-enough products that we just haven't had in our assortment historically. And we've seen some erosion as a result of who we appeal to with that. So what the learnings need to be going forward is how we slightly improve the value proposition that we have to offer on outdoor.

Jeffrey N. Boyer - *Pier 1 Imports, Inc. - CFO and EVP*

Interesting, Geoff, we identified that a bit last year, the value piece of it, but we've made some progress there, which helped us moderate the decline that we had in outdoor. But per Alasdair's comments, we didn't do it enough, we didn't go value-oriented enough in that equation.

Operator

And our next question comes from the line of David Mann with Johnson Rice.

David M. Mann - *Johnson Rice & Company, L.L.C., Research Division - Special Situations Analyst*

Welcome, Alasdair. Let me ask you a question, sort of following up on what you just said about not being promotional enough or priced appropriately in outdoor. Given the strong merchandise margin gains that you had in the quarter, I guess, can you talk about are you being promotional enough in general? And what are you thinking about the longer-term merch margin opportunity or static level?

Alasdair B. James - *Pier 1 Imports, Inc. - CEO, President and Director*

So let me answer that in 2 ways. So one, I think what we found from the way we leaned into pricing and promotions in the last quarter is that our customers will buy very happily at the right price, so you have to make investments occasionally to actually ensure you found that. However, I don't see us materially coming off the merch price margin aspirations that we've got at the moment on the basis that we have got significant opportunity upstream to improve our overall cost of goods both in the product itself, in the way that we source it. I would also say that I think in our promotional effectiveness, there's an opportunity for us to be more efficient in that, too, in terms of the way we invest the money. There's -- particularly, the conversations I've been having with Jeff is around advanced analytics and what we do as a business to actually bring some tools into this organization to help us to automate much of the work that's currently done manually that I think will give us a greater level of sophistication and also accuracy.

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David M. Mann - *Johnson Rice & Company, L.L.C., Research Division - Special Situations Analyst*

And in terms of that, whether it be for sourcing or some of the other places that you want to improve productivity, what's the time line should investors expect for you to be able to get the analytics in place to where you could affect the productivity, whether it be in promotions or in supply chain or somewhere else.

Alasdair B. James - *Pier 1 Imports, Inc. - CEO, President and Director*

Well, I mean, I think there's things we're doing immediately. So the immediate things tend to be hand-cranked and using the tools that you have to handle the business, but we're focused on this today, have been for the last 6 weeks. But in terms of -- the broader part of your question, I think, is around at what point do we start to have advanced analytics tools, machine learning, the rest of it in the business. Realistically, this is a significant piece of work we've kicked off as a business. It will take us 4 months to bring this to fruition, I think. And then, we'll be able to be much, much clearer with you on the timings behind that. The one thing I would say and it's likely to get reported, we have -- just have been able to fill our CIO position. We have an individual accept that role this week. And he will come to the organization with lots of knowledge of artificial intelligence, machine learning, digital online pure-play stuff as well as retail. So I'm encouraged that he's going to be able to make an immediate difference when he arrives.

Jeffrey N. Boyer - *Pier 1 Imports, Inc. - CFO and EVP*

David, I'm just going to add, from a timing standpoint, there's still a fair amount of near-term heavy lifting from an efficiency standpoint on the supply chain. So those things are ongoing, and that was a big piece of what happened in the first quarter. And near-term to midterm, continued efficiencies in supply chain is going to help before we start getting sourcing and more advanced analytics going, as, obviously, those benefit. The other thing I would tell you is a lot of focus right now, with Alasdair coming, on [Jim Roy], ROIC and on inventory productivity. And one of the big overhangs we always had is the level of clearance that we've had, so just reducing our clearance liability on a quarterly annual basis but also in the short-term help us get better margin experience and results. So there's some short-term things in terms of supply chain and clearance opportunities and some more midterm, long-term elements with the promotional effectiveness, analytics and sourcing.

David M. Mann - *Johnson Rice & Company, L.L.C., Research Division - Special Situations Analyst*

That's very helpful. One other follow-up if I could. On the home decor seasonal side, sort of the confidence you have in the back half, can you just give us a sense on how that performed in the first quarter so we can be a little more comfortable that, that can drive the business later in the year?

Jeffrey N. Boyer - *Pier 1 Imports, Inc. - CFO and EVP*

Home decor seasonal, we're solidly positive from a growth and a comp basis for us. And that's what our sweet spot is in the back half of the year.

Alasdair B. James - *Pier 1 Imports, Inc. - CEO, President and Director*

As I joined the business in May, David, we're just coming off the back of Easter when home decor is obviously, particularly strong. And we've seen very good growth through the Easter period this year.

Operator

And our next question comes from the line of Michael Lasser with UBS.

Michael Lasser - *UBS Investment Bank, Research Division - MD and Equity Research Analyst of Consumer Hardlines*

Can you quantify the percentage of the business that comes from outdoor and how much of a drag it was on the first quarter?

Jeffrey N. Boyer - *Pier 1 Imports, Inc. - CFO and EVP*

We never really quantify completely the size of that. I will tell you, it's about double the size on the first half as it is in the second half. So I guess, it'd be about half the size in the second half as a percent. In our comments, we do call out outdoor's being the primary reason for the decline. So I'd probably just leave it at those comments, which is more than 50% of our sales issue in the first quarter was outdoor-related.

Michael Lasser - *UBS Investment Bank, Research Division - MD and Equity Research Analyst of Consumer Hardlines*

It is more than 50%. What would be any other portion of the issue?

Jeffrey N. Boyer - *Pier 1 Imports, Inc. - CFO and EVP*

We have businesses up and down across the board, so there's other parts of the business that are up and down, the biggest one was outdoor.

Michael Lasser - *UBS Investment Bank, Research Division - MD and Equity Research Analyst of Consumer Hardlines*

Got it. And then based on your commentary, it sounds like the core customer is doing fine, but it sounds like your ability to attract new customers to the brand is challenged, and that's despite spending a lot on advertising, television advertising. So what is it going to take to be able to attract new customers to the brand? And do you think that there is a brand image issue that will prevent you from attracting those younger customers?

Alasdair B. James - *Pier 1 Imports, Inc. - CEO, President and Director*

Not necessarily. I mean I wouldn't rule that out either, but not necessarily. So I mean the good thing to take out of my comments is we target ourselves, the business, to reactivate and retain customers. And through the whole of the last year, we solidly delivered double-digit growth on both of those, so that's the good thing. So when we identify what we're trying to do with the marketing programs, we seem to have been successful. So for me, it's more around pivoting that targeting to focus our efforts more on new customers and getting the same results. I don't rule out we might need to have a different brand to appeal to a different customer. It may be a sub-brand of Pier 1. It could just be a different assortment within Pier 1. And part of what we're looking at over the next 4 months in this piece of work we've kicked off is to answer precisely that as to what we think the best vehicle is to make that approach. And I think that the marketing in that sort of TV versus non-TV will be less of the issue than how we put together the whole package.

Michael Lasser - *UBS Investment Bank, Research Division - MD and Equity Research Analyst of Consumer Hardlines*

Good luck, Alasdair.

Alasdair B. James - *Pier 1 Imports, Inc. - CEO, President and Director*

Thanks, Michael, appreciate it.

Operator

And our next question comes from the line of Steve Forbes with Guggenheim.

Steven Paul Forbes - *Guggenheim Securities, LLC, Research Division - Analyst*

So you mentioned broadening the business beyond your core demographic. So do you think you need another brand beside Pier 1 to accomplish this? As I would imagine, right, you're going to target a younger, maybe a lower income demographic. So do you need another brand? Could M&A be a part of that? Or do you want to do it organically?

Alasdair B. James - *Pier 1 Imports, Inc. - CEO, President and Director*

Michael, I think the honest answer is I don't know how to answer that question at the moment -- sorry, Steve. As I was just saying to Michael, I think -- I'm not ruling out anything at the moment. It could require a sub-brand, a different brand. It could be the core brand we have. And it could obviously take a number of options where we kicked off this piece of work that I talk about which will sort of deliver us our answers by end of October and then we are planning to share the details of that with you guys in November. So I think at that point, we'll be very clear of our view as to the best way to do that.

Steven Paul Forbes - *Guggenheim Securities, LLC, Research Division - Analyst*

And then maybe as a follow-up on that, as I think about how do you attack this new customer right inside the box with merchandising, can you expand on your store refurbishment or remodel efforts and maybe your learnings or -- from the story of the future project from last year or what -- just expand on how do you go about attacking this initiative via merchandising.

Alasdair B. James - *Pier 1 Imports, Inc. - CEO, President and Director*

So I think there's a couple of things I would say. So one, the advantage of having over 1,000 stores is you can test a number of things in different stores and get a pretty quick read on them. So we've got a number of trials in play at the moment where we're looking to understand the impact a different value proposition can have. We've got another trial where we're actually looking to see what we need to have for an urban customer that's more oriented towards apartment living than suburban, larger house living. Both of those have demands of a different assortment to support that. So as we get the results off the back of that, we'll be able to share with you specifically what that means for our assortment going forwards.

Operator

And our next question comes from the line of Brian Nagel with Oppenheimer.

Brian William Nagel - *Oppenheimer & Co. Inc., Research Division - MD and Senior Analyst*

Alasdair, welcome. So the first question I had, and I guess as a follow-up to a couple of the prior questions, but with regard to the sales weakness in the outdoor category, you said that was a primary factor in Q1. So here as we -- we're now maybe a month or so into the second fiscal quarter, has -- have sale -- have the outward sales picked up? I mean, have you already begun price markdowns? And overall, it was weather -- I understand that competition has been a factor the last couple of years, but was weather or maybe a late start to the spring/summer temperatures somewhat a factor as we saw some of the sales get pushed from Q1 into Q2?

Alasdair B. James - *Pier 1 Imports, Inc. - CEO, President and Director*

So I'll let you in on a secret, I have a bit of a running joke with my management team. They're not allowed to use weather as the excuse for our ails. So we're just smiling in the room here when you said that. I mean, I think there may well have been a little bit of that, to your point. But we've actually had an encouraging start to quarter 2, which gives us confidence around the sort of the guidance for quarter 2 going forwards. And sales have picked up across a number of categories.

Brian William Nagel - *Oppenheimer & Co. Inc., Research Division - MD and Senior Analyst*

I mean is it fair to say, with that encouraging start, the outdoor category has done a piece of that?

Alasdair B. James - *Pier 1 Imports, Inc. - CEO, President and Director*

It has. As we've moved to reduced pricing in order to take actions on outdoor, we've obviously seen volume lift as well.

Jeffrey N. Boyer - *Pier 1 Imports, Inc. - CFO and EVP*

The value message is stronger now, Brian. So we're seeing a lift in outdoor since we've done that.

Brian William Nagel - *Oppenheimer & Co. Inc., Research Division - MD and Senior Analyst*

Got it. And then the second question I have, longer-term in nature. But Alasdair, as you look -- if you look at the model, clearly, online sales growth has been quite strong now for a while and, as a percentage of your total sales, has ramped up nicely. Where do you see this ultimately shaking out? How much of the Pier 1 revenue base is online? And then with that, ultimately, how should the profitability -- how should profitability of the company look? In other words, are we going to reach a point with online sales and maybe there's a tipping point where that division of the business becomes -- be even more profitable?

Alasdair B. James - *Pier 1 Imports, Inc. - CEO, President and Director*

So I think one of the good things about online becoming a larger proportion of our business, obviously, the growth in that area then starts to cascade through the P&L and have more of an impact on the top line than it is when it's a minority part of the business. So I think that will be helpful. As to where I see it going, I mean if you look at our competitors, we've got a situation, Brian, where competitors that have large catalog businesses are looking at an online business of between sort of 40% and 50% penetration of online. And my view is that that's where we'll end up, I think. I mean, I don't want to try and suggest I got a crystal ball, but that's sort of what we're planning towards. And obviously, how we ensure we cover any sort of erosion that comes as a result of delivery costs that go in line with that, the ship to home, is something that we're challenged with, just working it out within the business and making it happen. And in terms of the total model, I'm sort of in a discussion at the moment internally with the team about whether we should be looking very differently at how we measure store versus online sales. I think, actually, we have to get to a place where we measure zip code profitability because we know from when we close a store that we retain about 20% of the sales from that store closure, and we retain about 80% of the online sales. We also know that over 90% of all of the online sales either are initiated in pass-through or touched by our store portfolio in some way, shape or form. So the model is changing, I think, to a place where much more showroom-ing and experience is going to be driven in store and more delivery through online, either by the store or direct to home. But as long as we understand the role the store plays in the zip code profitability as a whole, we'll make sure we do the right thing by the portfolio and have the right platform for future growth. Did that make sense, Brian?

Brian William Nagel - *Oppenheimer & Co. Inc., Research Division - MD and Senior Analyst*

It did. It makes perfect sense.

Operator

And our next question comes from the line of Alan Rifkin with BTIG.

Alan Michael Rifkin - *BTIG, LLC, Research Division - MD and Retail Hardlines and Broadlines Research Analyst*

Alasdair, some of your initiatives such as a brand repositioning and trying to expand the customer base as well as streamlining supply chain, would appear to be very long-term initiatives. How do you balance the need to focus on those initiatives versus somewhat of a sense of urgency to stabilize your business?

Alasdair B. James - *Pier 1 Imports, Inc. - CEO, President and Director*

Well, I mean I don't think we have an unstable business at the moment I would say. So we've shown an increasing profitability, and we're talking about guidance going forwards which is pretty much in line with what you guys, I think, expected. So I don't want to give the impression that the business is unstable. What I would say, though, is that if you look at pricing and promotional effectiveness and markdown management, the improvements in these things are immediate and short-term things that the business is focused on over the course of this quarter and the rest of this year. Some of the longer-term elements you're talking to in terms of sourcing, I think it's reasonable to say that once we've laid out the piece of work in the next 4 months, that it's probably going to take us a couple of years to really realize those (inaudible). When you think of the time lines that we have designing, developing products and then launch them somewhere between 9 and 10 months. So it is by nature slightly more long term in that regard, and I understand that. I think the use of machine learning and AI to actually improve our accuracy and effectiveness I think is something that we can kick off in the next few months, and that's my focus.

Alan Michael Rifkin - *BTIG, LLC, Research Division - MD and Retail Hardlines and Broadlines Research Analyst*

Okay. And then, as a follow-up to Brian's question, obviously, you're not responsible for strategies of the prior management team, but maybe put another way, e-commerce from a revenue standpoint has exceeded just about everybody's expectations, right, going from 0% to almost 25% of your business today. Yet, it seems like during that exact same period of time is when your EBIT margins plummeted. Do you have an idea as to when e-commerce may start to be accretive to your overall EBIT rather than be dilutive?

Jeffrey N. Boyer - *Pier 1 Imports, Inc. - CFO and EVP*

Alan, that's a great question. And the EBITDA margin contraction that we've had has been twofold. Some of it's been self-induced by some of our inventory issues. And you're seeing some of that come back again, which is why we're performing well, both from reduction and clearance and more efficiencies in the supply chain. The one fundamental part of our P&L, and we break it out for you guys, is the delivery and fulfillment piece, which has grown to about 400 basis points overall. That's our major pressure point, is having to deliver to her home on it. So that's where we are working so hard on all the elements that Alasdair has laid out in terms of sourcing opportunities, supply chain opportunities, even the stores themselves, how well we can operate, how efficiently we can operate all those. So there's probably no single bullet to make that equation. We continue to work really hard on all those elements to offset that delivery convenience piece that our customer wants and continue to build the EBITDA and grow the EBITDA this year. From a forecast and plan standpoint, we are expected to have a stronger EBITDA performance and margin we had last year. But it will be a constant battle of delivering to her home, because that's how she wants to have the product delivered to her, and the offsetting cost elsewhere.

Operator

(Operator Instructions) Our next question comes from the line of Budd Bugatch with Raymond James.

Beryl Bugatch - *Raymond James & Associates, Inc., Research Division - MD and Director of Furnishings Research*

Welcome again, Alasdair. I'd like to talk about the inventory for a little bit, if we could. With the weak outdoor sales, are we in a situation now where clearance has grown again? Last year, as I recall, we had a significant amount of clearance as well that we worked pretty hard for much of the year. So what's the quality of the inventory at this point in time?

Alasdair B. James - *Pier 1 Imports, Inc. - CEO, President and Director*

We're actually in a pretty reasonable place, Budd. So as Jeff said in his comments to one of the earlier questions, one of the learnings from the outdoor buy last year was that we bought down this year, and we're slightly tighter in the buy. So that meant that we didn't have as much in the first place that we had to deal with. And I think the second learning is that the team was on to it far faster this year and, therefore, we've taken smaller reductions earlier and those actually cleared through. So I think I don't mind saying our inventory is 10% better than last year.

Jeffrey N. Boyer - *Pier 1 Imports, Inc. - CFO and EVP*

We're going to be in a good position exiting Q2, Budd, and all the clearance issues that we deal with. And it's not a significant element relative to last year, but it is versus our plan, we've had to take a little more clearance expectations in Q2. So we'll be nice and clean coming out of Q2 from a seasonal outdoor standpoint.

Beryl Bugatch - *Raymond James & Associates, Inc., Research Division - MD and Director of Furnishings Research*

Okay. And on delivery and fulfillment, could you parse those for us a little bit with delivery versus fulfillment? You have the $45 -- $49 shipping cost, you've got a $99 furniture delivery cost that I would assume that $99 flat fee goes into revenues. How does that break out for you? And what's the future? Do we totally anniversary that in the third quarter? How do we think about it?

Jeffrey N. Boyer - *Pier 1 Imports, Inc. - CFO and EVP*

Budd, we don't give that much -- we have a lot of detail, we don't give that much detail on breaking out fulfillment and delivery. I would tell you, we will anniversary the introduction of that plan in August, September of this year coming up. So one more quarter of what I would say a little bit larger deleveraging on that line item. And then, it will be more reflective of just the growth of e-com versus the fact that we have that offer out there. At this point, both those offers are performing well and they help support our e-comm business on it. We're not anticipating any major changes there other than the natural growth in e-comm.

Beryl Bugatch - *Raymond James & Associates, Inc., Research Division - MD and Director of Furnishings Research*

Furniture has historically been about 40% of sales. I think it's gotten now down to the mid-30s. Is it running higher than that for the first half? It usually runs I think a bit higher in the first half and then -- than it does in the second half. Am I correct on that? And is that about where it's sitting today?

Alasdair B. James - *Pier 1 Imports, Inc. - CEO, President and Director*

It is sitting right about mid-30s or so. And your understanding is correct, Budd. And really what happens is our seasonal decor business really grows quite a bit in the back half of the year. So furniture stays, on a relative dollar basis, fairly constant. But as a percent, it becomes a lower percent because of the weighting to seasonal and decor.

Beryl Bugatch - *Raymond James & Associates, Inc., Research Division - MD and Director of Furnishings Research*

Congratulations again, Alasdair, and good luck on the balance of the year.

Alasdair B. James - *Pier 1 Imports, Inc. - CEO, President and Director*

Thanks, Budd.

Operator

And our next question comes from the line of Seth Basham with Wedbush Securities.

Seth Mckain Basham - *Wedbush Securities Inc., Research Division - SVP of Equity Research*

My question is on your ideas of new assortments and marketing to new customers. When you are talking about that, are you thinking about expanding your assortment online or in store or both? How do you think about that equation?

Alasdair B. James - *Pier 1 Imports, Inc. - CEO, President and Director*

So it's predominantly online, Seth. There may be some expansion in store. But actually, in store, my focus is more on how we take product out of the store rather than add more product in. So what we are -- what we will be looking at though is whether we should be testing in some stores to have a different assortment as a stand-alone test which, to my earlier comments, could be a sub-brand, a different brand, a different look and feel.

Seth Mckain Basham - *Wedbush Securities Inc., Research Division - SVP of Equity Research*

Got it. That's helpful. And in terms of the investment, would you be owning this inventory? Or would it be direct ship (inaudible) assume the ownership. And as you think about that equation, would you expect your inventories to rise next year?

Alasdair B. James - *Pier 1 Imports, Inc. - CEO, President and Director*

So I think, I'm very focused on ROIC in terms of how we actually look at our inventory. I think there are opportunities for us to not own this inventory in first instance, particularly while we're testing stuff out. Then typically you don't make the same level of margin, obviously, when that's the case. So when you then clear, there's an opportunity for us to take this [home], and I think we'd look to own that. But it depends a little bit on online versus in-store and whether you're doing it by drop ship or whether you're doing it by a different means.

Jeffrey N. Boyer - *Pier 1 Imports, Inc. - CFO and EVP*

And I think on our last call, we commented on building out drop ship capability. So with the drop ship capability, that enables us to be able to introduce some additional SKUs and product and not owning it. So the drop ship capability should be available to us in the second half of the year.

Operator

And our next question comes from the line of Cristina Fernández with the Telsey Advisory Group.

Cristina Fernández - *Telsey Advisory Group LLC - Director and Senior Research Analyst*

So this is for Alasdair. On your comments, you talked a couple of times about enhancing value. When you look at the price points for the Pier 1 brand, do you see the opportunity to lower price points across other categories beyond outdoor as you look at your price points relative to competitors?

Alasdair B. James - *Pier 1 Imports, Inc. - CEO, President and Director*

Well, golly, that's a broad question, Cristina. I mean I think the answer is yes in some and no in others. It really does vary by category and by assortment and competitor and stuff. So we're not just focused on outdoor. If you take away (inaudible) let's call it, we're looking at our value proposition across each of the categories. We're looking to be clear on the role of the categories within our overall assortment and, obviously, the value proposition of each of those within that. So we'll be looking at most of them.

Cristina Fernández - *Telsey Advisory Group LLC - Director and Senior Research Analyst*

And then as a follow-up, with the loyalty program, the nontender one you launched last year, how has [finance] progressed in the fourth quarter and what is that now as a percent of your sales?

Alasdair B. James - *Pier 1 Imports, Inc. - CEO, President and Director*

So good memory. I mean, I think our Pearl -- keep me honest here, Jeff, I think our Pearl sign-ups are now over 1 million, customers that signed up with our loyalty program Pearl. And the encouraging thing for us as a management team is that, that hasn't in any way detracted from our Rewards customer, our credit card customers and, therefore, it's been positive.

Jeffrey N. Boyer - *Pier 1 Imports, Inc. - CFO and EVP*

And we don't talk too much exactly about that, but what we do mention, Cristina, is that the amount of match back that we have. And with the added loyalty -- nontender loyalty members that we have, the Pearl members, we have the match back quite a bit more. We're well north of 80%, 85% of match back on that, which gives us a lot of visibility into what she is purchasing and allows us to talk to her more directly.

Alasdair B. James - *Pier 1 Imports, Inc. - CEO, President and Director*

Did you catch that Christian?

Cristina Fernández - *Telsey Advisory Group LLC - Director and Senior Research Analyst*

Yes.

Operator

And we will take our final question from the line of Charles Grom with Gordon Haskett.

Andrew James Minora - *Gordon Haskett Research Advisors - Research Associate, Retail*

This is Andrew Minora on for Chuck. I just had a quick follow-up on the comp question from earlier. Can you guys give us any additional color on the comp trends during the quarter, traffic versus mix or how the comps might have progressed month-over-month through the quarter and month-to-month through the quarter? And then just one follow-up on that. Based on our estimates, it looks like the decline in in-store sales in the comp base has got a little bit worse in 1Q. Can you talk about what, if any, drivers of that would have been?

Jeffrey N. Boyer - *Pier 1 Imports, Inc. - CFO and EVP*

Yes, I would tell you that the comp driver is a combination, as you know, Andrew, of both in-store performance and online, and you can do some of the backwards math on that calculation. And I would tell you that really directionally, the in-store performance really didn't change that much from a trend standpoint. Overall, as we take a look at it, it's fairly consistent with what we're seeing last year and it's really reflective of what's going on out there in the retail industry overall. I would tell you from a trends perspective, the quarter was a little bit variable and choppy. Alasdair mentioned that we had a good period through Easter, and we did. We did really well through the Easter period. We're feeling pretty good about the business at that point. We did get a little bit of softness through Mother's Day, which is a little bit unusual for us. We tend to deliver better on Mother's Day. We've seen business strengthen, really, since that time as we get into the last part of May and into June. And we feel good as we're at this point in June right now.

Alasdair B. James - *Pier 1 Imports, Inc. - CEO, President and Director*

Operator, I think that wraps it up. We appreciate your help, we appreciate everybody calling in today. And we look forward to updating you in another 90 days with our Q2 results. Thanks.

Operator

Thank you. Ladies and gentlemen, this concludes the Pier 1 Imports first quarter fiscal 2018 earnings conference call. We thank you for your participation, and you may now disconnect. Everyone, have a great day.
