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PIR - Q2 2016 Pier 1 Imports Inc Earnings Call

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OVERVIEW:

Co. reported 2Q16 total sales of $430m and net income of $3m or $0.04 per share. Expects FY16 EPS to be $0.56-0.64 and 3Q16 EPS to be $0.10-0.14.

CORPORATE PARTICIPANTS

Bryan Hanley *Pier 1 Imports, Inc. - Director of IR*

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

Jeff Boyer *Pier 1 Imports, Inc. - EVP & CFO*

CONFERENCE CALL PARTICIPANTS

Brian Nagel *Oppenheimer & Co. - Analyst*

Budd Bugatch *Raymond James & Associates, Inc. - Analyst*

Adam Sindler *Deutsche Bank - Analyst*

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Cristina Fernandez *Telsey Advisory Group - Analyst*

PRESENTATION

Operator

Good afternoon, ladies and gentlemen, and welcome to the Pier 1 Imports second-quarter FY16 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 Brian Hanley, Director of Investor Relations for Pier 1 Imports.

Bryan Hanley *- Pier 1 Imports, Inc. - Director of IR*

Thank you, and good afternoon, everyone. Today after market close, we issued an earnings press release, which included the detailed financial results for the FY16 second quarter ended August 29. In just a few moments, we will hear comments from Alex and Jeff about the results, our strategy and guidance for the second half of the year, and the Company's longer-term positioning. This will be followed by a question-and-answer period.

Before we begin, I need to remind you that certain comments made during this call may be deemed to include forward-looking statements that are based on management's current estimates or expectations of future events or future results. These statements are not historical in nature and can generally be identified by such words as believe, expect, estimate, anticipate, plan, may, will, intend, and similar expressions. Management's expectations and assumptions regarding future results are subject to risks, uncertainties, and other factors that could cause actual results to differ materially from the anticipated results or other expectations expressed in the forward-looking statements included in the press release mentioned earlier and this conference call. These risks and uncertainties include but are not limited to consumer spending patterns, inventory levels and values, the Company's ability to implement planned cost control measures, expected benefits from the real estate optimization initiative, including cost savings in increases and efficiency, changes in foreign currency values relative to the US dollar.

These and other factors that could cause results to differ materially from those described in the forward-looking statements made during this call can be found in the Company's annual report on Form 10-K and other filings with the SEC. Refer to the Company's most recent SEC filings for any updates concerning these and other risks and uncertainties that may affect the Company's operations and performance. Undue reliance should not be placed on forward-looking statements, which are only current as of the date they are made. The Company assumes no obligation to update or revise these 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 10(e) 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, Pier1.com.

Now I'd like to turn the call over to Alex Smith, Pier 1 Imports President and Chief Executive Officer. Alex?

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

Thank you, Bryan, and good afternoon, everyone. Also joining me on the call for the first time is Jeff Boyer, our newly appointed Executive Vice President and Chief Financial Officer. Jeff has been with us a little over eight weeks now, but I think he's already done 16 weeks work. It's clear to all of us at Pier 1 Imports that he's a terrific addition to our senior team and will be a strong strategic partner for me, my leadership team, and our Board of Directors. He's already brought a great deal to the table. Of course his retail background in general is highly valuable, but more specifically his financial acumen, planning, and forecasting skills and supply chain experience are all layers of strength that will benefit the organization. Given the timing of when Jeff joined us, this is my first opportunity to introduce him, so Jeff, would you like to say a few words?

Jeff Boyer - *Pier 1 Imports, Inc. - EVP & CFO*

Sure, Alex. Thank you very much and good afternoon, everyone. I can truly say I'm thrilled to be part of the Pier 1 Imports team. I timed my arrival perfectly so I was able to attend our recent [annuals] to the Company meeting, which afforded me the opportunity to quickly get immersed in the culture. This meeting also gave me an opportunity to interact with all levels of the organization, including our field teams. I've discovered that the Company is full of passionate associates who are dedicated to the Pier 1 brand and love what they do. What attracted me to Pier 1 is its strong brand and leadership team, its unique niche in the home decor and furnishing space, and the Company's aggressive move into omni-channel.

As a CFO, I very much appreciate the Company's healthy balance sheet and strong cash flow. As I dive in here at Pier 1, I see a great deal of opportunity to look at processes and additional efficiencies as we continue our focus on enhancing our overall omni-channel operating model, which is a very exciting prospect to me. There are many of you in the investor and analyst community who I already know and many that will be new. I look forward to catching up with prior acquaintances and meeting new ones here in the coming days and weeks. Now I'll turn the call back over to you, Alex.

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

Thank you, Jeff. Well before we delve into the quarter, I just wanted to touch on a few other changes to my executive leadership team. First, I'm extremely grateful to Laura Coffey for stepping in as Interim CFO at the time when the Company really needed her. Laura has now moved into a new role as Executive Vice President of Planning and Allocations and will no doubt continue to be an invaluable member of the Pier 1 Imports leadership team for many years to come. In addition to Jeff and Laura's appointments, we made some other moves to strengthen our leadership bench. Most notably, Michael Benkel, who was formerly Head of Planning and Allocations, has assumed a newly created role of Executive Vice President of Global Supply Chain. Michael has been with us for seven years and has done an outstanding job creating a strong and effective merchandise, planning, and allocations function. Heading up our supply chain is a great fit for Michael and is a position vital to help us fully develop and exploit our omni-channel capabilities.

We also made an important addition to our stores organization in recent months. Michael Millonzi joins us as Senior Vice President of Stores this past spring, bringing 20 years of retail experience to the business. Michael reports to Sharon Leite, our Executive Vice President of Sales and Customer Experience. Sharon has been a wonderful field leader but has now passed the baton to Michael. Sharon has also been heading up real estate since

February and is leading the charge to reduce our store occupancy costs. Sharon, Michael, and Michael, along with other members of our leadership team, are here in the room with us today.

Okay, so looking at the business from a high-level perspective, we're not happy with our second-quarter earnings. Our principal frustration centers around the ongoing inventory-related issues impacting our business. To update you on our inventory position, as of the end of last week, our inventories are now down year over year, so the cause of our problems is going away, but the fallout continues, and we expect it to continue to be the case for the balance of the year. Despite our over-inventory-created pressures, our view of the Company, the Pier 1 Imports brand, our competitive position, and our future have not changed by one iota.

First, from a customer-facing perspective, our front of house is in good shape. Our merchandise, our stores, our website and marketing are telling a strong story. Our brand health remains strong. We have a basket of brand attributes which we have been measuring consistently since 2007. They are all stable or improving. And I'm particularly pleased that the work we've done to improve the value and quality of our merchandise has been noticed by our customers. The number of active customers in our database remains at an all-time high and is continuing to grow month on month. We have a strong mix of eCommerce sales, quickly approaching 20%, and we are learning more about the dynamic between web traffic and store traffic as time passes. Lastly, as I've mentioned already, we're continuing to make progress in bringing inventories back in line and reducing our cost structure. There are three principal factors that impacted our performance this quarter: slightly softer than expected Company comp sales, heavier than expected promotional and clearance markdowns, and excess costs in our distribution network.

Let's talk about the top line. In the second quarter, we achieved healthy total sales growth of nearly 3%, or 4% on a constant currency basis. Brand traffic remained strong at nearly 10%; however, Company comp sales growth of 2.5%, or 3.8% on a constant currency basis, didn't meet our expectations. The quarter got off to a fairly strong start in June with trends softening in the remaining two months. eCommerce represented 17% of sales in the quarter, highlighted by continued increases in online traffic, conversion, and average ticket. Although eCommerce is currently driving our overall top line higher, the stores are still highly relevant to our sales mix. Store activities, which is a combination of Pier [West] sales, eCommerce orders placed in store, and eCommerce orders picked up in store were flat year over year. Put another way, the direct-to-customer business drove our sales growth.

Turning to promotional activity, our margins were pressured very considerably in Q2. Last quarter, we told you that we were disappointed with outdoor furniture sales, and plan to step up promotions in the second quarter to help move through those goods to ensure clean inventory ahead of our fall transitions. Using both promotional discounts and clearance markdowns, we did indeed get our outdoor furniture inventory down to an acceptable level, but doing so came at a cost. The second item pressuring our merchandise margins is the operational issues within our distribution centers. And just to remind everyone, we are talking about the distribution centers that service our stores; the fulfillment centers that service our direct-to-customer business are running efficiently.

As we discussed on our last earnings call, second-quarter merchandise margins were expected to be impacted by distribution center efficiencies by the same order of magnitude that we experienced in quarter one. This proved to be the case. Looking forward, I am pleased that Michael has accelerated our efforts to return our service levels and costs to an acceptable level. I'm also pleased to report that the flow of holiday merchandise to our stores, clearly a priority, is running smoothly, and Jeff will provide you with a detailed look at distribution center costs and initiatives a little later in the call. Suffice it to say, we will continue to feel the effects of our elevated inventory levels the remainder of this year. This is particularly frustrating, and we are disappointed about the impact it's having on our margins and profitability. Nevertheless, we have substantially reduced inventory growth since the beginning of FY16, which puts us on the path to improvements. We have conservative receipt plans for the balance of the year and are tracking to end both the third and fourth quarters with inventories down versus prior year.

Importantly, we have our hands on the fixes in the DCs, but given the slow turning nature of our inventory, it's taking several quarters to work through this, but we will. We expect our distribution centers to begin operating with increased efficiency -- levels of efficiency beginning in the fourth quarter, with the financial benefits beginning to manifest in FY17. I'll remind you of what I remind myself every day when I look in the mirror. Nothing good ever happens when you have too much inventory, but good things will happen as we return to the sales and inventory relationship that we have sustained for many years.

The home furnishings market has changed dramatically in the last few years. To stay ahead and maintain our competitive position, we had to change. That is why we embarked on the transformation from a pure brick-and-mortar retailer to an omni-channel organization, a transformation conducted at speed and in the full public eye. What we have not changed is our competitive position in the marketplace, offering unique and special products that have a high aesthetic appeal at affordable prices. The Pier 1 Imports brand sits firmly where we repositioned the business in the middle of the last decade, priced below the high-end specialty stores to comparable product and above the mass merchants in term of design and quality. Our highly curated assortments, our wonderful stores and website, and our elevated brand imagery strongly differentiates us in this increasingly competitive home furnishings environments.

Our marketing is becoming more sophisticated and is meeting with positive customer response. We've been involving our media mix, placing a greater focus on digital, social, and e-mail. We're also expanding our direct mail program, with increases in page counts and circulation of approximately 25% this year. During the first week of September, we sent out our customary monthly mailer, and for the first time, it was distributed in multiple versions, 15 to be precise. This was accomplished by using our new segmentation campaign management tool. Complementing our September mailers was a 92-page look book, Indoor Living. Over 2 million copies of this large format book was shipped, double what we mailed last year, and we're extremely pleased with the initial response rates to both the mailers and the look book. For holiday, we're introducing a new holiday decorating look book full of seasonal decorating ideas which will complement our November mailer. We think the holiday decorating book looks spectacular and positions Pier 1 Imports as the go-to destination for holiday. With this, we have three large format books, outdoor living, indoor living, and holiday decorating.

In common with all retailers, our marketing efforts have to address both acquisition and frequency. We believe our evolved marketing strategy, when married with our customer data excellent program and non-tender loyalty, will allow us to achieve both objectives, a steady growth of new customers and greater frequency from existing customers. With our active customer database at an all-time high and growing, and as we start to capture more robust and actionable data in the coming quarters, we will be better positioned to leverage our marketing initiatives. The more we know about our customers' purchasing preferences, the more we were able to show her products that resonate.

Let me provide you with some added perspective on our customer data excellence project. First, you should know that there was enormous amount of excitement within the organization around this initiative. It is a multi-component undertaking that started with reconfiguring and dramatically improving the way our database functions. The first part of the project was an entire rebuild of our database from the ground up. Our new database is ready and will go live next month. The next component was the development of segmentation capabilities, which was just completed in the second quarter. The third element of the program was the implementation of a new campaign management tool that enables us to version our direct mail and e-mails. As I noted, we used this tool this September. We expect our expertise in this area to grow exponentially over the coming quarters.

We continue to focus on the six key strategic priorities we laid out last fall. We are executing successfully against many of these, while others have been slowed down by inventory-related pressures. First on the list is brand traffic, conversion, and average ticket. The trend has been positive, as I noted earlier. Brand traffic in particular has been consistently strong. In FY15, brand traffic was up 7%. That trend has continued in 2016, with brand traffic up 10% for the quarter; an acceleration from 5% in the first quarter. We have a rolling program of initiatives to keep the momentum going. This includes broadening our product assortments, introducing new categories, bath for instance; refining and bolstering our marketing strategies; and bringing our customer data excellence program to life.

The second area where we've registered success is the transformation of our stores into sales and customer experience centers. Our associates have done a good job leveraging our new in-store selling tools and engaging the customer regardless of the reason that she's visiting our stores: to buy, to browse, to pick up merchandise, or any combination. We've also made progress and executed well against our strategic priorities of SG&A and capital allocation. From a capital perspective, we are moderating our spending significantly in FY16, reducing our total expenditure by 27%. At the same time, we've maintained a healthy balance sheet and strong cash flow, which we've continued to utilize to return excess capital to shareholders. We've taken steps to begin to reduce our cost structure; this is across the board. This year, we're working to leverage store and admin payroll as well as marketing expense.

Turning to fulfillment and home delivery, approximately two-thirds of our eCommerce sales are fulfilled direct to the customer, either through parcel or our in home delivery service. We opened our second fulfillment center a year ago in August 2014, and today, both facilities are running at the high degree of efficiency. Importantly, we are continuing to see leverage of our delivery and fulfillment costs as a percentage of fulfilled sales. While we've maintained a steady top-line trend and achieved good cost leverage, clearly, the area of greatest challenge has been merchandise margin. This is largely the consequence of too much inventory. As I outlined earlier, we're in the throes of working this down.

Before I end my remarks, I want to thank all my fellow associates at Pier 1 Imports. Our teams have remained energetic, upbeat, and resilient through our recent challenges and worked tirelessly to create a bright future for our well-loved Company. In just three short years since the launch of Pier 1.com, we've made the remarkable transformation to an omni-channel model, with eCommerce sales quickly approaching 20% of our total business. Now I'll let Jeff take you through the financials, discuss our distribution center and real estate initiatives, and provide you with an update on our financial guidance. Jeff?

Jeff Boyer - *Pier 1 Imports, Inc. - EVP & CFO*

Thank you, Alex, and once again, it's great to be here on the Pier 1 leadership team. Now let's dive into the financials for the second quarter. Total sales in the second quarter increased 2.7% to $430 million, while Company comps increased 2.5%. On a constant currency basis, total sales were up 4% and Company comps were up 3.8%. This was below what we had expected and primarily reflects the disappointing outdoor season that Alex discussed previously. eCommerce momentum continued in the second quarter with sales penetration at 17%. That's consistent with the first-quarter mix and up substantially from about 10% in the second quarter of FY15. Second-quarter merchandise margin declined to $235 million, down $10 million from a year ago. That equates to a margin of 54.6% and reflects a decline of 380 basis points versus the second quarter of last year. Of that amount, approximately 260 basis points is due to markdowns for promotional and clearance activity. We expect this mark down impact to lessen in Q3 and particularly in Q4 as we reduce our inventory levels. The remainder of our gross margin contraction, as we anticipated and previously shared with you, is primarily related to incremental supply chain costs due to inefficiencies in our distribution centers.

Our elevated inventory levels have caused capacity constraints and incremental handling costs within our DCs. We increased our capacity by re-racking the DCs and moving into additional storage space, most of which is temporary and a lesser amount permanent. In addition, the situation required additional handling efforts to hold, manage, and process the higher inventory levels. These activities resulted in added cost and impacted our productivity levels. Much of the heavy lifting is behind us, and we expect to be in basic blocking and tackling mode for the balance of the year as we continue to work down our inventories. However, we anticipate that the inventory costing effects of these inefficiencies will continue to impact margins in the third quarter, which is reflected in the financial guidance we provided today.

Moving now to occupancy. In the second quarter, we leveraged store occupancy by 30 basis points, coming in at $76 million, or 17.6% of total sales. This reflects our ability to leverage on a low comp sales base and also reflects the actions we are taking to rationalize the fleet. Delivery and fulfillment net costs increased both in dollars and as a percentage of total sales. We are continuing to leverage these costs as a percentage of fulfilled sales. In the second quarter, we saw approximately two-thirds of our eCommerce sales fulfilled to the customer through either parcel or in-home delivery, which is consistent with what we saw in last year's second quarter.

Looking at Q2 expenses, we reduced total SG&A, both in dollars and as a percentage of sales. For the quarter, SG&A came in at $128 million, reflecting 230 basis points of leverage compared to the prior year. Variable expenses for the quarter, which include compensation for operations, marketing, and a portion of operational expenses, represents approximately 21% of sales versus 23% of sales a year ago, and this leverage improvement primarily reflects a reduction in marketing expense. Fixed expenses for the quarter were basically flat to last year at approximately 9% of sales. Second-quarter EBITDA totaled $21 million, which compares to $28 million a year ago. Depreciation for the period increased coming in at $13 million; that's up from $11 million last year. Q2 operating income totaled $8 million and net income was $3 million, or $0.04 per share.

Moving to the balance sheet, inventory at quarter end totaled $534 million, up 4% from a year ago. Recall that year-over-year inventories were up 20% at the close of the first quarter, so we've made significant progress toward bringing things in line. Though we've made progress there's no question that inventory dollars remain elevated as we continue to work through the legacy issues related to last year's high sales forecast; however, as Alex stated, inventories have now crossed over and are running below last year's levels. We expect to end the third quarter with inventories down moderately and exit the year with inventory levels down more significantly, on the order of about 10%. Capital expenditures for the second quarter totaled $17 million, with approximately one-third deployed toward new store openings and relocations, and the remainder toward infrastructure and technology initiatives. We are continuing to plan for full-year spending of approximately $60 million. During the quarter, we repurchased approximately 2.7 million shares of our common stock for a total of $32 million.

On the real estate front, our optimization program is tracking on plan for approximately 30 net closures this fiscal year. During the second quarter, we had 10 net closures, which brings our year-to-date net closures to 12. For the longer term, we are still targeting for the closure of about 100 stores. In addition to outright closures, we're making good progress with our landlords in our discussion to rationalize cost and expect to evaluate additional opportunities that may exist as we move further along in the program. Focusing on our store rent expense for just a moment, the occupancy line in our non-GAAP table in today's press release includes base rent, CAM, and property taxes, as well as utilities and other store operational expenses. Stripping our lease costs down to base rent, on an annual basis, they average approximately $20 per square foot, or a little over two-thirds of our occupancy line. Rents on a triple net basis run about $25 per square foot. This is better than some on the retail marketplace, but we do see significant opportunity to become more competitive here.

Now turning to our financial guidance. For full-year FY16, we are forecasting the following. Company comparable sales growth is expected to be in the low single digits. Merchandise margin as a percentage of sales is expected to be approximately 55.5% to 56%. SG&A is expected to leverage by approximately 100 basis points. EBITDA margin is expected to be in the range of 7.5% to 8%. Depreciation will be approximately $52 million. Operating margin is expected to be in the range of 5% to 5.5%. Earnings per share is expected to be in the range of $0.56 to $0.64, and as I mentioned, capital expenditures are planned to be approximately $60 million.

We are also introducing guidance for the third quarter of FY16. We expect Company comp sales growth to be in the low single digits, and earnings per share to be in the range of $0.10 to $0.14. As you model the back half, you'll also want to keep in mind that our net interest expense for the year will be in the range of $12 million to $12.5 million, and we're continuing to forecast the full-year effective tax rate at approximately 39.4%.

As we work through FY16 and plan for next year, we're making it a high priority to develop programs that will improve processes, further reduce expenses, and drive efficiency throughout the organization. In my initial eight weeks on board, I can see there's a great deal of opportunity to optimize our omni-channel operating model. I've also found a very high level of enthusiasm and dedication among our associates, which is critical as we work our way out of the inventory situation and look to drive profit growth next year. To that end, as we're beginning planning for FY17, we will be assuming a conservative posture overall. We fully expect FY16 will be a low point for margins and expect gross margin expansion in FY17, while also leveraging expenses. So with these assumptions, we believe the business should be able to generate improvement in EBITDA, operating income, and earnings per share next year. We appreciate your time today and will now ask the operator to open the call to questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Your first question comes from the line of Brian Nagel with Oppenheimer.

Brian Nagel - *Oppenheimer & Co. - Analyst*

Hi, good afternoon.

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

Hey Brian.

Brian Nagel - *Oppenheimer & Co. - Analyst*

Jeff, welcome.

Jeff Boyer - *Pier 1 Imports, Inc. - EVP & CFO*

Thank you, Brian.

Brian Nagel - *Oppenheimer & Co. - Analyst*

So as I dig through these results, and I'm sure everyone else on the call is doing the exact same thing, but we're really trying to separate out how much of the weakness here in Q2, incremental weakness in Q2 is self-inflicted versus something else in the markets? You guys gave a lot of color on the call, but to that end, a couple questions. If you look at the inventories now, which you said at the end of the quarter were up 4% year on year, and now they're down. Alex how should we think about what's the makeup of the excess inventory that's still in that system? We talked a lot before about the outdoor furniture. What is it really now?

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

Well, so the mix now is, you can think of it Brian as about 50/50. So 50% of our inventory is our ongoing reorder SKUs that stay with us year in and year out. And we have bought the inventory of those reorder SKUs down significantly since the end of the year, so we have less weeks on hand. And then the other 50% is a combination of seasonal product and just regular new introductions of SKUs. So this time of year, obviously, we've got an inflated level of seasonal, because all our holiday merchandise is in the DCs. And as we said, ready -- starting to ship to the stores. So I think the inventory complexion is fine. I think we bought the overall inventory down in balance, if you like. We haven't [taken great sway] out of one area of the expense of another.

Brian Nagel - *Oppenheimer & Co. - Analyst*

Okay, and so if I look at the sales line, which is also weaker than you had telegraphed, the simple -- one simple assumption would be if you were very aggressively clearing this excess product, that should be a benefit to sales. So and I understand that it's -- that maybe we have to talk about units because it was done at discounted prices. But the question I have is why didn't we see more of a benefit from the clearance activity on the sales line? And then the extension of that question is what's happening beyond in sales of products that were not in clearance? Do we have some other type of weakness there and what helps to explain that?

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

Well I want to give Jeff an opportunity to talk in a moment, but I would just say this. When you're selling a high amount of clearance merchandise, it doesn't necessarily, as I think you just answered your own question a bit, Brian, it doesn't necessarily generate a lot of extra sales. It generates a lot of extra units at a lower average ticket, so you don't necessarily get a bump on the sales. But what you do, do of course, is burn through a lot of cost of goods sold.

Jeff Boyer - *Pier 1 Imports, Inc. - EVP & CFO*

And Brian, that's what we're seeing, is we're seeing unit movement without the sales dollars being lifted because we're burning through them. From an execution standpoint, you can think about it, these clearance events were largely within the store for our current traffic. So in fact, we were really just moving that customer from a regular price sale to a clearance price sale. So we largely didn't get incremental sales, some minor amount we got overall from average ticket, but largely we burned through units.

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

Yes, and I think -- something, I think this is just an interesting perspective as well for you. If we look at the achieved margin on our marked down merchandise and if we look at the achieved margin in our full-price merchandise, and our achieved margin on our promotional merchandise, those numbers really are rock solid compared with previous years. What has changed is the mix, so we're selling less full price at the full margin and a little less promotional and a lot more clearance, and that's really what dragged the number down. So if you're asking, so in terms of your question, I think a lot of this is sell-inflected in one way or another.

Brian Nagel - *Oppenheimer & Co. - Analyst*

I'll just ask one more follow-up and let someone else jump on. But so I understand you came out here with a lot of inventory. We had to clear it; that makes sense. But is there -- what's the risk that you're training the consumer now to look for excessive promotions in the stores, as we get past this year and inventories are back in shape, is that consumer going to be coming back looking for more aggressive promotional pricing from Pier 1?

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

I don't think so. We've talked about this a lot on the calls and we've -- as you know, we've gone through periods where we've stuck to a very modest promotional pricing cadence, and then we've had pensive periods where we've had a very intense promotional price cadence. And I think we've told you before that our feeling is net-net the very intensive promotional cadence doesn't do a lot for your top line, as we've discussed. What you're seeing us do now, and I know you follow us very carefully, our promotional cadence is very closely aligned with last year, which was not excessive at all through the months of September, October, November. We're a little more promotional in December, but not in those previous three months.

Jeff Boyer - *Pier 1 Imports, Inc. - EVP & CFO*

Alex, I would just add on to your commentary, I mentioned before that we aren't going deeper on the promotional intensity. This isn't a matter of going deeper on the offers. We had more clearance inventory, and we presented that so, but so much more clearance inventory in the store, we directed her to that. I don't know that she necessarily came in and was driven in promotionally to do that. It was what was offered to us, with a much greater share of clearance product, and that's what we are seeing. So I don't think we're going to see a consumer response coming out of this period where we've trained them in some way.

Brian Nagel - *Oppenheimer & Co. - Analyst*

Well thank you. Thank you for all of the color and best of luck.

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

Thank you.

Operator

Your next question comes from the line of Budd Bugatch with Raymond James.

Budd Bugatch - *Raymond James & Associates, Inc. - Analyst*

My welcome also, Jeff. Hi, Alex.

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

Hey Budd.

Jeff Boyer - *Pier 1 Imports, Inc. - EVP & CFO*

Thank you, Budd.

Budd Bugatch - *Raymond James & Associates, Inc. - Analyst*

Couple of questions, just trying to make sure I understand. I think, Alex, if I heard you right, you said brand traffic was up 10% year over year for the quarter.

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

That's what I said; 10% for the second quarter, 5% for the first quarter, and about 7% for the first half.

Budd Bugatch - *Raymond James & Associates, Inc. - Analyst*

So help me do the math or get the math between that and the Company comparable sales. Run me through some logic that takes me from that down to the [2.8%] or the [3.5%], either way?

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

Well I can't give you the exact math, but it goes something like this. We get -- you get strong brand traffic online, very strong online growth, and you see improved conversion online. And you have softer store traffic and an improved conversion in stores. But the way the math worked, if you think about it, because online conversions are very significantly lower than the store conversions, it's just not enough at the moment to lift the sales level over that 4% that we discussed.

Budd Bugatch - *Raymond James & Associates, Inc. - Analyst*

I'm trying to also understand the average ticket comes into play in that, does it not? And how does it --

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

Yes, average ticket was good. Average ticket was up.

Budd Bugatch - *Raymond James & Associates, Inc. - Analyst*

And any desire to start giving us maybe a closer number on that?

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

I'd rather not, Budd, if you don't mind.

Budd Bugatch - *Raymond James & Associates, Inc. - Analyst*

Okay, you also said, and if I remember right, the first quarter we had about $3 million worth of inefficiency costs that burdened the merchandise margin, and I think you said it was comparable this quarter.

Jeff Boyer - *Pier 1 Imports, Inc. - EVP & CFO*

Yes, this is Jeff. Budd, that's correct.

Budd Bugatch - *Raymond James & Associates, Inc. - Analyst*

But as I look at the 120 basis points different from what you call that, that gets me closer to a $5 million number. How do I reconcile that, Jeff?

Jeff Boyer - *Pier 1 Imports, Inc. - EVP & CFO*

I think there was some when we isolated the number in the previous quarter, it was just a subset of that overall $5 million that we referenced. So was a handling cost and we had identified that I think last quarter.

Budd Bugatch - *Raymond James & Associates, Inc. - Analyst*

And we should, that goes away now, Alex? You've done all of the re-racking? I saw that in the Columbus area distribution center that you and I toured. Are those inefficiency costs now pretty well worked through?

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

Well the costs of -- so some and some, Budd. So the cost of installing the racking, and we talked about all that movement as the repositioning of the boxes, that work is largely done, not complete, just from working other buildings. What they're working on now is the positioning of the merchandise around the building, the slotting, and the travel times, as you remember, we talked about those quite a bit.

Jeff Boyer - *Pier 1 Imports, Inc. - EVP & CFO*

What I might just add to that, Budd, is just from a recognition standpoint, while largely we've gotten more efficient in the DCs with the racking and things, from a recognition standpoint, those costs get associated with the inventory turn. So unfortunately, we have another quarter that running off on us. So the negative 120 basis points will actually be a bit of a continuation into the Q3. We won't see the full benefit completely until next year, but we will start to see a good reduction in Q4. So as we move through more inventory in Q2, a lot of that's behind us that gets put on the balance sheet but runs off as it spins off of the inventory. So you'll see that recognition next quarter, unfortunately.

Budd Bugatch - *Raymond James & Associates, Inc. - Analyst*

Okay, so as we look as I look at some of the other costs, let me just go quickly to that and let others talk. Marketing came in significantly below what I was looking for. How does marketing look for the year?

Jeff Boyer - *Pier 1 Imports, Inc. - EVP & CFO*

I think we've given some broad guidance in the past that marketing runs about 5% of sales; that's our target. So I think if you use a 5% of sales number, you'll be pretty much spot on for the year, Budd.

Budd Bugatch - *Raymond James & Associates, Inc. - Analyst*

Okay, we do use that number, okay. And you gave us a 9% fixed number, which equates to I think about $39 million, which was a little bit better than what I was looking for. In the quarter, should we think that's a reasonable run rate, or do you think we can pare that down or does it have to go up as we get to the holiday season?

Jeff Boyer - *Pier 1 Imports, Inc. - EVP & CFO*

Well, being a fixed cost on it, it largely should, from a dollar standpoint, run fairly consistently, shouldn't move. What should happen as we go through the holiday, you will get some leverage on that a little bit. It will leverage the fixed cost a little bit in the back half of the year.

Budd Bugatch - *Raymond James & Associates, Inc. - Analyst*

Okay, and finally for me, if we're seeing improvements in the fourth quarter, I think the guidance looks like it implied somewhere down about $0.12 to $0.13 at the midpoint from the previous guidance. And if we've seen these improvements, maybe you can give us a road map of what the difference in that $0.12 to $0.13 looks like from what the previous guidance was at the end of the first quarter.

Jeff Boyer - *Pier 1 Imports, Inc. - EVP & CFO*

Budd, that's probably a follow-up call we should make to take you through that. I think we're pretty good on what our guidance is, but if there's some pieces you need some assistance on, we can do that.

Budd Bugatch - *Raymond James & Associates, Inc. - Analyst*

That will be fine, thank you very much and best of luck on the balance of the year and beyond.

Operator

Your next question comes from the line of Adam Sindler with Deutsche Bank.

Adam Sindler - *Deutsche Bank - Analyst*

Yes, thank you so much. First, Jeff, welcome to you as well. I just want to make sure I got some housekeeping right. On the fixed cost, did you say 9% of sales flat with last year?

Jeff Boyer - *Pier 1 Imports, Inc. - EVP & CFO*

Yes.

Adam Sindler - *Deutsche Bank - Analyst*

I have last year at 9.5% of sales, it was called out specifically $40 million, or 9.5% of sales last year.

Jeff Boyer - *Pier 1 Imports, Inc. - EVP & CFO*

Yes, probably 9.6%; I think we said approximately 9% this year.

Adam Sindler - *Deutsche Bank - Analyst*

So then not flat with last year, down -- leveraged by 60 basis points?

Jeff Boyer - *Pier 1 Imports, Inc. - EVP & CFO*

I'd still say approximately. I'd say pretty even with last year.

Adam Sindler - *Deutsche Bank - Analyst*

So 9.6% this year?

Jeff Boyer - *Pier 1 Imports, Inc. - EVP & CFO*

Yes.

Adam Sindler - *Deutsche Bank - Analyst*

Okay, got it. Thank you, perfect. And then just so on the merchandise, that's one thing you guys have always been extremely good at. Whether it was you're getting yourself set up on E-commerce or some of the cost issues, one thing that always seemed to be very strong for you guys was merchandise. When I do my store checks, it's tough to measure right, but customers are always smiling when they are walking out of the store. And that's one way I measure anecdotally how the customers are responding to merchandise. So I was wondering maybe why outdoor was a little disappointing. And maybe in the context of a follow-up is that one thing I think Alex said is that one thing that has not changed is your market position, how you go to market with your merchandise. But on the other hand, relative to let's say even several years ago, you've seen the rise of Wayfair online, and then you've seen some of your other brick-and-mortar competitors start to get a little bit more aggressive too. And I'm wondering maybe if that's something that you do need to look at?

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

Well I think that there's two points. You're absolutely right, the competition is certainly more intense than it was four or five years ago, with some smaller chains rolling out nationally and the pure E-comm players that you've referenced. And all those guys take some sales, but that doesn't in any way negate the quality of our market position or the quality of our merchandise. I think as I alluded to in our prepared remarks, we get a read on our merchandise in many, many ways. Principally, of course, by how it sells and how it's checking out, but we do, as I alluded to, a lot of market research and we get a lot of data that way in terms of how our customers are viewing our product. And if anything, our brand health check metrics are actually getting better, as we do a nicer job I think at both in store and online and in our marketing presenting our merchandise in ways that are more attractive to our customers. So listen, you've got to be, in this environment, you've got to be on your game all the time. Your product has to be spot on. Your marketing has to be spot on, but I don't see any weakness in what we're doing.

Adam Sindler - *Deutsche Bank - Analyst*

So just to wrap up on the outdoor product, was there any feedback you got from your customers, especially core customers, as to maybe why they didn't like it at full price? Was it a style thing?

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

Well I think part of it I think we talked about last time, and I think we it was our sales plans were a little aggressive. I think we got a little, the competition came out of the box discounting and we didn't, and that crosses out earlier in the season. And apropos that comment about merchandise, and I think I did allude to this last time: some of our new collections didn't resonate as well as they should have done. I'd have to be clear about that.

Adam Sindler - *Deutsche Bank - Analyst*

Okay, that was very helpful thank you, I appreciate it.

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

You're welcome.

Jeff Boyer - *Pier 1 Imports, Inc. - EVP & CFO*

Adam, just one clarification on your fixed cost number.

Adam Sindler - *Deutsche Bank - Analyst*

Sure.

Jeff Boyer - *Pier 1 Imports, Inc. - EVP & CFO*

For the quarter, it is 9.2% on that fixed cost piece of it. I was looking at a year-to-date number first half, so 9.2%. It did leverage about 30 basis points in the quarter.

Adam Sindler - *Deutsche Bank - Analyst*

Okay, perfect. Thank you, I appreciate it.

Jeff Boyer - *Pier 1 Imports, Inc. - EVP & CFO*

Sure.

Operator

Your next question comes from the line of Aram Rubinson with Wolfe Research.

Aram Rubinson - *Wolfe Research - Analyst*

Hey everybody. Jeff, welcome aboard.

Jeff Boyer - *Pier 1 Imports, Inc. - EVP & CFO*

Hi, Aram.

Aram Rubinson - *Wolfe Research - Analyst*

Hey. You mentioned a couple times about people spending more time on the rent, you stripped out the occupancy to get us at a $25 a foot. Can you talk a little bit about timing there, because I think if I'm doing the math right, if I look at your occupancy cost, you leveraged in total. But as a percent of retail sales, you do leverage pretty significantly. So when that E-commerce business slows down, that could be something you're going to want to take care of. So what's the timing and what are the tactics, if you can help us around that?

Jeff Boyer - *Pier 1 Imports, Inc. - EVP & CFO*

We're continually really increasing our aggressiveness in terms of our store program and taking a look at portfolio and what we need to do there, both our internal efforts and some outside brokers that help us with the landlords on it. I'll tell you though it is -- you do need to step back a moment, Aram, and think about it, as Alex said, and don't think just about POS. It's really store activity, and store activities are relatively flat. And we take a look at the store activities, we're actually leveraging pretty well against the total store activity measure on it. We do completely understand that we have these different channels going on. We need to be as efficient in all of them as possible on it. But there is a little bit of a math issue. If you just look at pure POS, you have to look a little bit broader at total store activity and how you're doing there, and there's a decent leverage story on that piece of it. That said, do agree that we need to continue to rationalize our store base as we go.

Aram Rubinson - *Wolfe Research - Analyst*

You came from a place where they were paying $9 a foot, so see what you can do to get down there. Thank you, guys.

Operator

Your next question comes from the line of Matt Nemer with Wells Fargo Securities.

Matt Nemer - *Wells Fargo Securities, LLC - Analyst*

Thank you. Thank you for taking my question. Jeff, good to be working with you again. I had a question on the distribution centers, the store distribution centers. Assuming that sales continue to shift to the DTC channel over time, and I realize there's some short-term pressure, but is there an opportunity or a need to maybe take more cost out of the store distribution infrastructure?

Jeff Boyer - *Pier 1 Imports, Inc. - EVP & CFO*

I would say yes, that definitely in our supply chain, just broadly speaking, we need to get more efficient there. And we have had, as you commented on and we've commented, we've had a short-term challenge with our detention to [merge] our process and handling costs. Those things will largely go away, but we do need to get more efficient from an inventory management and the DC standpoint, as we have these different channels. We're really working through the strategies and what those programs are, more to come. But much like we need to rationalize our store base, our DCs have to go through the fundamental strategic review, as well as how do we make those efficient as possible for the changing dynamics of our distribution model.

Matt Nemer - *Wells Fargo Securities, LLC - Analyst*

And then as a follow-up on the traffic numbers, I'm just curious how much of those are driven by multiple visits from the same customer to your website? Are you actually scrubbing the data to look at what we would call unique visitors? Or is part of that the numbers being pressured higher by people going back and browsing online multiple times?

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

No, we know who the unique visitors are, but when we give you the traffic, that's the total number; that would include people going back. We don't disclose we have this many unique visitors, but we do know that number.

Matt Nemer - *Wells Fargo Securities, LLC - Analyst*

Understood. Thank you so much.

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

You're welcome.

Operator

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

Seth Basham - *Wedbush Securities - Analyst*

Thanks a lot. Good afternoon, and Jeff, I look forward to working with you.

Jeff Boyer - *Pier 1 Imports, Inc. - EVP & CFO*

Thank you, Seth. Same here.

Seth Basham - *Wedbush Securities - Analyst*

My question first is on store traffic. If you could help us better understand what kind of trends you're seeing in store traffic and how they've been over the last couple quarters? That's my first question.

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

Well, I think what we are trying to do is focus on brand traffic, because we think that is going to be the more important measure as time goes by. But you can work it out if from what we've said. If our overall brand traffic is up 7% or 8%, and you can just work that back. So the store traffic is down on a year-on-year basis, which is what we've seen for the last five, six quarters, I think, yes, so it's a fairly consistent pattern.

Seth Basham - *Wedbush Securities - Analyst*

Got you. As you plan the business going forward, do you expect that type of in-store traffic decline to persist, or do you expect it to improve or not?

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

We are -- in our plans, we are talking about in-store traffic declines through this year and into next year.

Seth Basham - *Wedbush Securities - Analyst*

Okay, that's helpful. And then one last question is trying to think through the financial hit from the inventory issues both in supply chain as well as with the mark downs, if you could try to aggregate each of those buckets and tell us what your overall hit with it was and if those are temporary, therefore, what you should get back in the next fiscal year?

Jeff Boyer - *Pier 1 Imports, Inc. - EVP & CFO*

I would tell you the mark-down number is largely temporary, actually probably all temporary, bought too much inventory, we need to clear through it. With the mix, it's moved to the clearance bucket. When we get our inventories right sized for our sales base, we should return back to the right mix overall, and we should snap most of that back. Over this year, we'll see some improvement, minor improvement in Q3, more significant improvement in Q4, and then cycling into next year, the mark downs should get much better.

On the supply chain piece, there's 120 basis points in the quarter. The way to think about that is we'll have a continuation of that in the third quarter. It should get measurably better in the fourth quarter as we exit this year. About half of those costs are due to temporary storage, detention, demurrage, and those are all inventory related. So a good chunk of those will also go away. The remainder, which leaves you about 60 basis points of costs, there's probably some element of that because we have some additional space and some additional racking and how we pick probably is structural in there. But you're probably getting to half of 60 basis points, can't say right now; we haven't planned next year. But the vast majority of the mark downs go away completely, and a good portion of the supply chain hit that we're looking at right now was also temporary with some structural pieces underneath that they will have to deal with from additional space we have as well as different pick paths that we have in the DCs.

Seth Basham - *Wedbush Securities - Analyst*

Got it. Okay, thank you very much.

Jeff Boyer - *Pier 1 Imports, Inc. - EVP & CFO*

Sure.

Operator

Your next question comes from the line of Denise Chai with Banc of America.

Denise Chai - *BofA Merrill Lynch - Analyst*

Thank you very much and hello, Jeff.

Jeff Boyer - *Pier 1 Imports, Inc. - EVP & CFO*

Hi, Denise.

Denise Chai - *BofA Merrill Lynch - Analyst*

Hi, so just on the topic of store traffic, backing out E-commerce from your total revenue, looks like the remainder of sales was down about 5.3%. And last quarter, you were talking about the customer becoming more surgical in her shopping as she goes online more and pre-shops. Can you talk about what you're seeing at this point?

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

Yes, I think that trend is exactly what we're seeing, and it's again, it shows up all the time in our research, the percentage of customers that are doing pre-shopping online and then coming into the stores, so we have that more purposeful visit. And I think you can see that also in our pick up in store number, Denise. So 30% of our online business is pick up in store, and those are customers who have decided the other way around. They've said we are going to browse online, we're going to order online, but we still like to go in and see the goods when we pick it up. So I think that's the power of the omni-channel model, which is using both the store and the online as browsing vehicles, depending on what you want to do.

Denise Chai - *BofA Merrill Lynch - Analyst*

So how is this affecting your store basket?

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

Well, in terms of the units per transaction, and the average ticket, those are pretty stable. Our UPTs have not changed very significantly. Our average ticket, I think as we said in the prepared remarks, has grown a little.

Denise Chai - *BofA Merrill Lynch - Analyst*

Okay, thank you, and then with E-commerce now 17% of sales, presumably you're at or at least approaching scale. So could we get some color on both merchandise margins and operating margins on E-commerce and retail, at least directionally?

Jeff Boyer - *Pier 1 Imports, Inc. - EVP & CFO*

Really don't like to break that out. We're taking a look at the business on an omni-channel basis across everything, so we haven't gone -- we're not going through the process of breaking out the individual channels on it. You can see some of that in the supplemental materials that are in the back, you get some idea of some of the additional cost for fulfillment there. But that's what we provide to you.

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

Yes, and I think what we have said consistently, Denise, is that as a contribution from operations level, a fulfilled sale has a higher margin than a store sale, and we have been very consistent on that. And that's been the story as how -- as that fulfilled sale percentage grows, it will over time move that contribution from operations up.

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Denise Chai - *BofA Merrill Lynch - Analyst*

Got it.

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

There's really no change in that. That's still the case.

Denise Chai - *BofA Merrill Lynch - Analyst*

Okay, thank you so much.

Operator

Your next question comes from the line of Seth Sigman with Credit Suisse.

Seth Sigman - *Credit Suisse - Analyst*

Thank you. So you guys provided some color on lower comps that you've seen over the last couple of quarters. Just wondering if you've seen any impact from these supply chain issues maybe impacting the flow of inventory. Has that had an impact on sales at all?

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

That's a very good question, and it's likely that there has been some minor impact that it's really impossible to quantify. And so we've tried not to use that as a discussion point when discussing our comp sales.

Seth Sigman - *Credit Suisse - Analyst*

Okay, and then as you look to next year, I realize it's still far out, but Jeff, you did discuss a margin improvement for next year. I think previously, you needed or talked about a mid single-digit comp needed to really achieve the operating leverage across the enterprise. Obviously, you're not tracking mid single-digit comps right now. How do you think about some of the changes needed to get to that place for margin expansion?

Jeff Boyer - *Pier 1 Imports, Inc. - EVP & CFO*

We are taking a conservative posture as we're looking at FY17, and the goal in doing that is to plan the business more aggressively from a cost standpoint. If we do in fact chase the sales and are successful in gaining the sales, we'll get great leverage on it. So we're going to plan the business for next year to be able to get some level of cost leverage at a very modest growth rate overall. When you take that position on it and you do get the sales increase, we should be able to leverage nicely.

Seth Sigman - *Credit Suisse - Analyst*

Thank you.

Operator

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

David Mann - *Johnson Rice & Company - Analyst*

Yes, thank you. Jeff, good speaking with you again.

Jeff Boyer - *Pier 1 Imports, Inc. - EVP & CFO*

Hi David.

David Mann - *Johnson Rice & Company - Analyst*

Couple of questions. On the timing of closure of stores, can you give us any more sense on how that should progress? And with the initial group of stores you're closing, how do you think you're going to -- what's your initial thoughts on how you'll recapture sales from those stores? Thank you.

Jeff Boyer - *Pier 1 Imports, Inc. - EVP & CFO*

As we go through the store closure process, we do go through a transfer analysis and largely can see some of that transfer coming over on it. So it will happen ratably over the time period that we're closing them. From a store closure this year, the bulk of the closures, a good chunk happened in this quarter, but then we have another chunk happening really in Q4. We really don't close a lot of the stores in Q3, which is going right in through holiday, so they'll go through the holiday period. And then we'll close really probably the February, end of January, February time frame, we'll probably finish up with 20, 22 stores we closed in that time period.

David Mann - *Johnson Rice & Company - Analyst*

Then the initial thoughts for closures next year?

Jeff Boyer - *Pier 1 Imports, Inc. - EVP & CFO*

Initial thoughts for closures on it, probably about 20 to 25.

David Mann - *Johnson Rice & Company - Analyst*

Okay, no go ahead.

Jeff Boyer - *Pier 1 Imports, Inc. - EVP & CFO*

No, about 20, 25 closures.

David Mann - *Johnson Rice & Company - Analyst*

And just going back to that transfer analysis, can you give us any sense on how -- what kind of percentage we should be using for our models?

Jeff Boyer - *Pier 1 Imports, Inc. - EVP & CFO*

It really varies. It's really an individual store by store decision on it. We will close stores that are just low performers, so there will be some stores that will just be under-performing and won't be making our hurdle rates. There will be other stores performing better but we're overstored in a market, and then we'll look at a transfer. We use a fairly modest one when we do the planning on it, and we're doing post-mortems to confirm those, but I would tell you it's a 10%, 15% transfer rate for some of these closures. Okay, thank you.

Operator

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

Simeon Gutman - *Morgan Stanley - Analyst*

Thank you, good afternoon and welcome, Jeff. Alex, you mentioned it was more about the mix of what you sold in hurting the gross margin. Can you remind us what the typical mix has been of full price versus either promotional or clearance? And can you tell us where it was this quarter?

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

Yes, what we've told you that when we are at our best, we're at about 50/50. So 50% of our sales are regular, full-priced sales, and the other 50% is mixed between clearance and promo, but with a heavy emphasis on the promotional pricing rather than the clearance pricing. Because that's obviously a higher margin. And you will not be surprised to know that, that is not the mix that we achieved in the second quarter of this year. The 50/50 is the sweet spot.

Simeon Gutman - *Morgan Stanley - Analyst*

Okay, and then I think Jeff mentioned you'll try to get back to that proportion next year, that's what's planning. Is that being planned at what kind of merch margin? Is that back to 60%? I realize the guidance this year is a little lower because of some of the items and the issues, but is 60% the right merch margin or the way you're thinking about it for next year?

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

No, I don't think we get back there next year. I think the way -- and the reason is, because don't forget in, that merchandise margin are all these other things we've been talking about, which is the distribution costs. If you ask the question another way, which is will our mark down and promotional pricing dollars as a percentage of total sales get back to historical norms, I think the answer to that is they will get very close. But it's all about other noise underneath the mark down and the promos that will stop us getting back to that 60%.

Simeon Gutman - *Morgan Stanley - Analyst*

Got it okay and--

Jeff Boyer - *Pier 1 Imports, Inc. - EVP & CFO*

I think that we'll make a good progress as we cycle through some of the inefficiencies in the supply chain and mark downs we had this year, but we haven't put a number out there. I will tell you 60% is too high. That much I can tell you coming off where we're at right now. But I think we'll make some sizeable improvements in our merch margin next year.

Simeon Gutman - *Morgan Stanley - Analyst*

Okay, and my last question is just on the sales and margin tradeoff, in two ways. One, and this is something that Brian had asked earlier on the call, where your merch margin was down. It doesn't look like you got the exact lift. I think you said units moved, but I thought maybe that -- I don't know if you can clarify that, were units actually up? And then second, with marketing, and Alex you mentioned that you're moving to different mediums. I'm curious if you tone marketing down, are you seeing a direct response to that, such that, again, you mentioned that marketing will be back at 5%. But curious how much more sensitive or lack thereof the businesses to those two levers, both price/promotion, and then marketing.

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

Well, I think that's a really complex discussion really. We've always tried to focus, as you know, historically on merchandise margin dollars rather than hitting a sales number or a margin percent. And our business, as you know, is far more sensitive to movements in the margin than it is to movements in the sales. So our job is to try and get the right balance between our sales line and how we're trying to drive the sales line and our merchandise margin dollars, which we can protect by not having too much promotion. And that's what we do all day, every day, is try and get those things in the sweet spot. As far as the marketing is concerned, don't be too concerned about that marketing number in the quarter, because there is all sorts of timing issues in there, in terms of production versus media. And for the year, it will wash out.

Simeon Gutman - *Morgan Stanley - Analyst*

Okay. Thank you.

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

Does that answer your question?

Simeon Gutman - *Morgan Stanley - Analyst*

Yes, that's helpful, thank you.

Operator

Your last question comes from the line of Cristina Fernandez with Telsey Advisory Group.

Cristina Fernandez - *Telsey Advisory Group - Analyst*

Hi, good afternoon and welcome, Jeff. I had a follow-up question in inventory. You talked about inventory being down 10% at the end of the year, but that's up against up 27% last year. With the sales environment now seeing a low single digit, is that a good number on an absolute basis, or should we still see continued inventory pressure going into early next year?

Jeff Boyer - *Pier 1 Imports, Inc. - EVP & CFO*

I don't think you'll see inventory pressure, but you raise a good point, Cristina, which is we are making good progress on our inventory levels. We will be down estimated 10%-ish or so at the end of this year. Still up versus two years ago, as we had some high inventory all those last year. I think we will continue to see moderation in our receipt flow, particularly on the regular rebuy product replenishment product. So we'll continue to work that down until we get that right balance, but we aren't anticipating a significant margin issue for mark downs in FY17 as we continue to work down inventory levels.

Cristina Fernandez - *Telsey Advisory Group - Analyst*

Thank you, and then another question. Can you share with us what the penetration of the Pier 1 credit card sales was in the quarter? Had that been trending higher?

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

We just -- it is trending higher. We just, do we give that number out? I don't think we've ever given the absolute have we? It's in the Q. Do we have that? Hold on, Cristina, we're just looking for it.

Jeff Boyer - *Pier 1 Imports, Inc. - EVP & CFO*

We just give a 12-month number. It has been trending higher. I'll tell you it has been trending higher on that, and we'll disclose that when we issue the Q.

Cristina Fernandez - *Telsey Advisory Group - Analyst*

Okay, thank you and good luck this quarter.

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

Thank you.

Bryan Hanley - *Pier 1 Imports, Inc. - Director of IR*

I think that wraps up.

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

It does, yes.

Bryan Hanley - *Pier 1 Imports, Inc. - Director of IR*

The call today, and we appreciate everybody dialing in and asking good questions. Look forward to talking to you in about 90 days or so.

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

Thank you, everybody.

Operator

Ladies and gentlemen, this concludes today's conference call. You may now disconnect.