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PIR - Q2 2018 Pier 1 Imports Inc Earnings Call

EVENT DATE/TIME: SEPTEMBER 27, 2017 / 9:00PM GMT

OVERVIEW:

Co. reported 2Q18 net sales of $408m and net loss of $7.8m or $0.10 per share. Expects FY18 net sales growth on a 53-week basis to be flat to 2% and EPS on a 53-week basis to be $0.31-0.41 Expects 3Q18 net sales to be down 3% to 1% and EPS to be $0.08-0.14. Expects 4Q18 net sales growth on a 14-week basis to be 5-7% and EPS on a 14-week basis to be $0.34-0.44.

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PRESENTATION

Operator

Good afternoon, ladies and gentlemen, and welcome to the Pier 1 Imports Second Quarter Fiscal 2018 Earnings Call. At the request of Pier 1 Imports, today's conference call is being recorded. (Operator Instructions) I would now like to introduce Christine Greany of The Blueshirt Group.

Christine Greany

Thank you, and good afternoon, everyone. Today, after market close, we issued an earnings press release which included the detailed financial results for the second quarter of fiscal 2018. In just a few moments, we'll 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?

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

Thanks, Christine, and good afternoon, everyone. Joining me on the call is Jeff Boyer, Executive Vice President and Chief Financial Officer.

We delivered company comp sales growth of 1.8% and strong merchandise margin in what I think people would agree has been a tough retail environment. Nevertheless, it is clear that we're not living up to the full potential of our brand and our organizational capabilities. We know there is much more opportunity to be captured as we formulate and begin implementing our new operating and growth strategies.

During our June earnings call, I shared my initial findings and impressions in my first 8 weeks at the company. Since that time, we've made terrific progress with our assessment work, which we expect to complete by the end of our third fiscal quarter.

We engaged a top tier consulting firm who's been collaborating with us to analyze opportunities around 2 key areas: one, our brand proposition; and two, operating efficiency opportunities. From a brand perspective, we're identifying where we can win and how we can win; and therefore, be successful over the long term. At the end of the day, there needs to be a clear reason why a customer should shop at Pier 1. We see a clear opportunity to take a well-known and admired brand and advance it in ways that deliver value and drive new growth in a rapidly changing industry. We recognize that we need to deliver top line growth while developing tactics to mitigate pressure on gross profit from our growing online sales channel to ensure the company can thrive in any future retail environment. There is no question that technology is hastening unprecedented change in the way consumers shop and identify with brands. All of us, whether brick-and-mortar, online-only or omnichannel, are tasked with redefining the shopping experience. If you choose to be omnichannel, as we have, it is important to chart a path to more profitable omnichannel sales through offsets to the cost of fulfillment.

As we face these challenges and continue our brand consulting work, we're uncovering opportunities that we believe will deliver significant top and bottom line growth in the coming years. I say that because I'm so encouraged by the brand positioning and operational initiatives that we're identifying. They have real potential to drive substantial incremental revenue and operating margin expansion. We're currently developing detailed plans and specific initiatives, and we'll be in a position to lay out and discuss our long-term strategic plan in early 2018.

Our efforts may require operating and capital investments, but we fully expect them to reignite growth here at Pier 1 Imports. Today, I can tell you about our key objectives, which include the following: delivering clarity around Pier 1 Imports' value proposition in key categories; becoming relevant and top of mind among a broader customer base, particularly younger consumers; becoming more digital; bringing more automation to the business; and continuing to manage our SG&A.

To meet these objectives, we'll be focusing on 5 key areas: one, refining our brand positioning; two, bringing new perspective to our marketing programs; three, rethinking our supply chain, sourcing and inventory management; four, bolstering our IT systems; and five, improving our value offering and promotional programs.

So firstly, brand positioning. We have identified key customer groups who are loyal Pier 1 Imports shoppers. Our analysis tells us there is a substantial top line opportunity to, firstly, grow our share of wallet among them by building upon our core strengths in major categories such as decor; and secondly, develop ways to better communicate our offerings and make a bolder statement, both online and in-store, in those categories where they are underpenetrated.

As well as that, we also intend to expand our reach to a broader consumer base. The core Pier 1 Imports customer is 45 to 60 years old, and we believe there's an opportunity for the brand to appeal to millennials between 30 and 40 years of age. This may include new merchandise or brand extension in the future, but initially, we believe we can cultivate this audience through increased social media and digital marketing activity. Our research has emphasized the importance of value as a key consideration in our customers' buying decisions. We believe we can improve our overall value proposition through a combination of enhanced assortments across critical categories and key sourcing initiatives. Once the brand positioning is clear, we'll be redefining our marketing programs so that our campaigns better support our brand DNA.

Next, I'll talk about supply chain, which is one of those areas where we can see a route to improving our operational efficiency. First and foremost, we expect to move to a multi-echelon distribution model, so that we're optimizing inventory across the supply chain. Additionally, there are several new tactical initiatives we'll be implementing to capture efficiencies. These include: optimizing usage of our DC space; improving scanning

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technology; utilizing cross-docking; and lastly, enhancing the warehouse management systems. These actions are expected to yield several benefits, including reduced cost of goods sold, lower levels of clearance and increased labor efficiency.

Keep in mind that there's been a great deal of progress made in recent years to streamline our distribution model and that drive efficiency. We see an opportunity to build upon what has already been accomplished to significantly improve productivity and profitability.

Another important component to our long-term plans will include improving our IT capabilities. There's a fair amount of work that must be done to bolster our systems and better aggregate our data so that we're positioned to utilize and benefit from new tools. We're thrilled with the addition of Bhargav Shah, our new CIO, and look forward to leveraging his experience to drive increased automation across the board. Most notably, he is establishing an infrastructure that would allow for the utilization of advanced analytics and machine learning to drive efficiency.

To that end, we expect to be able to optimize our promotional programs to capture efficiency. As we strengthen our IT platform, adding tools and automation, we'll be better positioned to gain insights, leverage those learnings and improve our agility. While we've identified areas for improvement, we're fortunate to have a solid omnichannel foundation from which to build. We also have a terrific team that has already made substantial progress in recent quarters towards stabilizing the top line and capturing efficiencies.

We're very pleased with our assortments for fall and harvest, which are now in stores and online. We're also enthusiastic about our merchandising and customer-facing initiatives for the upcoming holiday season. However, as you can see from the financial guidance we're providing today, we are anticipating a fair amount of pressure in quarter 3, predominantly because of the hurricanes in Texas and Florida. We're estimating a negative impact to company comparable sales of approximately 2 points. For perspective, over the course of 3 weeks, from late August to mid-September, we had store closures in approximately 125 locations, encompassing parts of Texas, Florida and 8 other states. Except for just 1 store, all have reopened, although traffic is still soft in several markets.

Our hearts obviously go out to all those who've been affected by this tragic situation. While many of our own associates were impacted by the storms, we're grateful they've all been confirmed safe. And I'm very proud of the way our organization has rallied around those in need and contributed to our Associates' Disaster Relief Fund and The American Red Cross, donations which we as a company have doubled up. Lastly, we're offering enhanced localized promotions at more than 90 stores in those affected markets with the goal of helping hurricane victims to rebuild.

Before turning the call over to Jeff, I want to assure you that we're eager to fully roll out our strategic plan to evolve the Pier 1 Imports brand in the new era of retailing. As I mentioned, we are halfway through and expect to be able to share with you in early 2018 a detailed agenda of the strategic plan and walk you through those initiatives blow by blow. We're grateful to our teams and associates who are continuing to work tirelessly and demonstrate tremendous enthusiasm for the opportunities ahead. We greatly appreciate your support and look forward to keeping you updated on our plans and our progress.

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

Jeffrey N. Boyer - *Pier 1 Imports, Inc. - CFO & Executive VP*

Thank you, Alasdair, and good afternoon, everyone. In the second quarter, we achieved positive low single-digit comps, improved our merchandise margin and delivered against our cost initiatives, resulting in adjusted EPS within our guidance range. Company comparable sales grew 1.8% in Q2, reflecting increased brand traffic and higher average ticket. Net sales increased 40 basis points to $408 million versus a year ago.

From a channel perspective, e-commerce continues to demonstrate strong growth. Second quarter e-commerce sales grew 35%, with sales penetration expanding to 27% versus 20% a year ago. As we anticipated, we experienced some pressure in our outdoor furniture category, which offsets -- which was offset by strength in other categories, including seasonal goods, textiles, dining furniture and home furnishings and accents.

Second quarter gross profit was $140 million versus $145 million a year ago, while gross margin rate came in at 34.4% versus 35.7%.

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Looking at the key components within gross margin, starting with merchandise margin, we delivered modest increases in both dollars and rate. Merchandise margin dollars increased to $232 million from $230 million a year ago, while margin rate expanded 40 basis points to 57%. The year-over-year improvement is primarily attributable to lower supply chain costs.

Turning now to delivery and fulfillment net costs as a percentage of net sales. We leveraged 200 basis points on a year-over-year basis -- I'm sorry, we deleveraged 200 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. And as we anniversary this program in the second half, we expect the impact on delivery and fulfillment as a percentage of net sales to lessen substantially.

Store occupancy cost in the second quarter decreased by about $1 million to $73 million, and decreased 30 basis points as a percentage of net sales. Our real estate optimization plan remains on track and, together with lease renegotiations, will allow us to continue to reduce occupancy costs for the foreseeable future.

Total SG&A in Q2 increased by a few million dollars to $138 million, and SG&A rate deleveraged by 40 basis points. Most notably, we achieved savings of approximately $3 million in compensation for operations for the quarter as we continued to drive efficiency in store payroll. This was offset by approximately $8 million of incremental expenses recorded during the second quarter of fiscal 2018 for the following items: one, a legal settlement related to a wage-and-hour matter in California; two, regulatory costs related to an ongoing inquiry with the Consumer Product Safety Commission; and three, costs associated with our brand consulting work.

Excluding these items, we delivered 150 basis points of SG&A leverage, resulting from our continued expense control efforts. Going forward, we'll continue to look at opportunities across the board to achieve cost savings with a focus on actions that are EBITDA-accretive. Second quarter net loss was $7.8 million or $0.10 per share compared to net loss of $4.1 million or $0.05 per share in Q2 of last year.

Excluding $3.6 million, net of tax, for the legal and regulatory costs I just mentioned, adjusted net loss in the second quarter of this fiscal year was $4.2 million or $0.05 per share. Second quarter EBITDA came in at $2.8 million, and after backing out legal and regulatory costs, adjusted EBITDA was $9.4 million, approximately flat versus the year-ago period.

Moving to the balance sheet, at quarter end, we had $35 million of cash and cash equivalents, $194 million outstanding under our term loan and no working capital borrowings under our $350 million revolver. Ending inventory totaled $457 million, down 5% versus a year ago.

Now I'll outline our financial outlook for the remainder of the year. I'll start with the third quarter, which as Alasdair mentioned, reflects sales pressure stemming primarily from the effects of the hurricanes. For Q3, we expect company comparable sales down 2% to flat; net sales down 3% to 1%; merchandise margin of approximately 59%; SG&A expenses in the range of $150 million to $155 million; and earnings per share in the range of $0.08 to $0.14.

Turning now to fourth quarter guidance, which is being provided on a 14-week basis, except for company comparable sales, which is being provided on a 13-week basis. We expect the following: company comparable sales to be flat to positive 2%, which is more consistent with our second quarter performance; net sales growth of 5% to 7%; merchandise margin of approximately 56%; SG&A expenses in the range of $150 million to $155 million; earnings per share in the range of $0.34 to $0.44; and adjusted earnings per share in the range of $0.36 to $0.46, which excludes the tax impact from the regulatory costs I discussed earlier.

Our full year guidance is being provided on a 53-week basis and includes the following expectations: net sales growth of flat to 2%; merchandise margin of approximately 57.5%; 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; earnings per share in the range of $0.31 to $0.41; adjusted earnings per share in the range of $0.38 to $0.48, excluding 2 items: 1) legal costs, net of tax, related to a California wage-and-hour matter recorded during the second quarter; and 2) regulatory costs recorded in the second quarter for the ongoing CPSC matter, as well as the related income tax effect in the second, third and fourth quarters of this year. An effective tax rate for the full year of approximately 41%. This is up a few points from our prior guidance and reflects a negative impact from the non-deductibility of the CPSC expense. Our earnings per share is based on a fully diluted share count of approximately 80.3 million shares. And capital expenditures of approximately $55 million.

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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 2016, we are forecasting company comparable sales down 1% to up 1% for the full year in fiscal 2018.

Alasdair and I appreciate your time this afternoon, and we're glad to take your questions. Operator, please go ahead and begin the Q&A session.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of Steve Forbes of Guggenheim Securities.

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

If you look at the merchandise margin guidance for the back half, and maybe just correct me if I'm wrong, I think it's kind of assuming 50 to 100 basis points of moderation. So if you take that guidance, what are the main drivers of the pressure you're expecting? Is it mix? Or is it simply just some expectations around the promotional environment, right, you foresee as you look out to the back half here?

Jeffrey N. Boyer - *Pier 1 Imports, Inc. - CFO & Executive VP*

I'd say it's primarily some of the promotional intensity we've had. The biggest change we've had really is in Q3. And as you can appreciate with some of the weather effects we've had, and we've got a fairly sizable seasonal business, we are being more aggressive in moving through that seasonal product. So the pressure is a little bit more Q3-weighted, but we have -- we are anticipating a more intense promotional environment.

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

And then, as a follow-up, maybe just a high-level question regarding marketing, and maybe you'll address this in a couple months here. But as I think about it, given the scale of the business, is 6% the right expense ratio, considering the noise and the absolute dollar spend that's out there in the market, right, from some of the competitors that are also going after your core demographic? Meaning is -- does it represent enough absolute dollars for you to kind of execute what you want to do from a marketing or promotional standpoint, driving share of wallet with both your existing and potentially new customer acquisition strategy?

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

Steve, you're starting to sound like my CMO. He would say the same, to be honest, which is the feeling that actually a range of 7 to 9 is more in line with some of our competitors. So what you're calling out is something that we observe. I would moderate though those -- that view slightly, in that the clearer you are about what it is that you as a brand stand for, the more you can cut through with the spend that you have. And I think if we are to criticize ourselves, we would say that some of the spend we've had historically hasn't been clear enough in explaining what we stood for. So I think there's 2 parts to your question. Firstly, we have to do a better job of being clear why you should come to Pier 1, and I think we can therefore be more effective with the spend that we have. And then, the second question is, should we spend more in order to actually get that across to customers when they are in a very competitive share of voice situation? And the answer could be yes. But I think, I am -- I lean personally more to the 6% as a cash amount is enough for us to spend. Our challenge is ensuring that we'd use the right channels to do that and we have the right story to tell. And the research we've done so far suggests that, that is the case.

Operator

And our next question comes from the line of Brad Thomas with KeyBanc Capital.

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Bradley Bingham Thomas - *KeyBanc Capital Markets Inc., Research Division - Director and Equity Research Analyst*

My question was around brand positioning. And I know we have to wait a bit longer to hear a more detailed plan for what you hope to do going forward. But I was hoping that you could share with us some of the learnings that you have at this stage about how you think the consumer perceives Pier 1 today and where the opportunities are. And clearly, there's a channel shift going on as more customers shop online rather than in stores. But I was curious, at this point, what you know about how well you're resonating from a style standpoint and a value proposition standpoint. And maybe some early thoughts about what you might need to change about the brand.

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

So what I would say in answer to that question is that we're becoming clearer and clearer from the work that we've done. I think the response from customers has been extremely helpful in helping to clarify that for the team. We're not yet at the point at which we can spell that out blow by blow, but it is getting much, much clearer. What I would say is that if you look at our brand as a whole and you think about who we appeal to, we have a very strong core customer base that are in the age range I described and have clear opportunities to actually stretch that into a slightly younger customer. And the reality at the moment is that if you talk to them, they would describe there being a couple of things that get in the way of them spending more money with us. The 2 primary ones being the store environment, and then the second being the value proposition. So our focus in how we attract those new customers is very much focused on addressing those 2 issues. As I said, we're not yet ready to spell that out in specifics, but the investments will come at the beginning of next year, and we'll lay that out literally segment by segment. We have historically, as an organization, used a transactional volume-based segmentation. And what we've been doing over the last few weeks is to completely change that and start to look at our segmentation based on attitudes and behaviors of our customers in order for us to do a better job of actually meeting their needs with our marketing. So we'll lay that out.

Bradley Bingham Thomas - *KeyBanc Capital Markets Inc., Research Division - Director and Equity Research Analyst*

That's very helpful. And again, understanding that you need to figure out exactly what the tactical plan will be, I guess, as you start to look at this and look at the team around you, do you feel like you have the team that you'll be able to hit the ground running early next year once you have a plan in place? Or I guess, as I'm thinking about the time line of things, do you feel like there may be more hires around you that you may need to make?

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

I think our recent appointment of Bhargav as our CIO is a great example of the fact that where there is the need for us to upweight the management team, that we'll take those actions to ensure we get the disciplines and the technical expertise that we require. And very quickly, it's becoming apparent that that's adding value to us in that area. So -- and I took the decision to go outside the organization to get help from a top tier consulting business, simply because they can help us with pace. Not necessarily understanding or the ability to look at things, but just the pace to actually get the numbers, crunch the data and provide the plan. I think the challenge now, as we get to the end of the program and cost that out, is the executional elements. And the one thing this organization has shown in its past is its ability to execute once it's clear what we were trying to do, has been pretty good. So I'm encouraged by that.

Operator

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

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

Look, certainly the 35% growth in e-commerce is quite admirable. But that would imply that the store's comped down about 10%, which, at least according to my math, would mark a pretty significant deceleration even on a sequential basis. If that number is, in fact, correct, then given the prognosis, would you contemplate perhaps closing even more than the 100 stores that you've talked about in the past? And then, I do have a follow-up, please.

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

So your numbers are slightly higher than ours in terms of store traffic declines, but high single digits is in the ballpark. But I would say is that when we looked at our store portfolio, we have modeled that forward over the next 5 years with those sorts of traffic declines modeled in. So the encouraging thing for me is, when you look at our store base 5 years out with that level of traffic decline, over 900 of our stores are still contribution-positive for us. So obviously, anything that changes in the future, we will look to address as we need to. And the encouraging thing is, we have the flexibility, given the way the leases on our stores change, to actually consider up to 20% of our estate every year. So I think we've got the flexibility to adjust if we need to. At the moment, based on the models we've got and the changes we're seeing, we don't see the need to do that. And the only other thing I would just add on top of that is that when I actually think about our customer, what we're seeing is that she likes to shop in-store and online. So the conversations that I'm having with my finance team is how do we measure the profitability of our business by ZIP Code rather than focusing purely on an in-store or an online purchase. Our customers that shop online and in-store actually spend 3x those that which -- that customers that either one channel or the other. So the biggest challenge for me is not, is my store base secure, but actually, how do I get more of my current customers to shop in both channels. Anything you'd add, Jeff?

Jeffrey N. Boyer - *Pier 1 Imports, Inc. - CFO & Executive VP*

Yes. I only want to add one thing just to help fill out your picture of that 35% online growth. When we give you the e-commerce number, I would call it kind of a global e-commerce number. It includes when people order at home and have delivery in-store, which is an important delivery channel for us. And also, they order in store, we have a cash wrap PC and they'll either have it picked up in store or delivered. So kind of a broad global e-commerce definition on that. Our fastest-growing channel within the e-commerce channel is actually (inaudible) cash wrap PC, which is the in-store device that they're ordering in store on it. So that store environment is very important. And as Alasdair said, that customers, our most important customers, shop in both in-store and online.

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

I think that's a very interesting point, actually -- very important point, is the number of customers that shop in what we would describe as purely online, so at home, purely online, for deliver to home, is actually, by far and away, the smallest proportion of the way our customers engage. AS Jeff said, the majority either visit the store and execute through the store, having it delivered to home or in store, or doing it at home and having it delivered to store. So I think I'm right in saying that it's about 90% of our products that go through online actually hit the store in one way, shape or form. So hopefully that's helpful.

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

Yes, that is very helpful. And a follow-up, if I may. So in response to your answer, I mean, you said 900 stores are actually cash flow positive. Curious, how many stores are actually earning their cost of capital? And then, my second question really was, what are you seeing in terms of wage pressures, if any, at the store level? And what's your prognosis for that over the next 12 months or so?

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Jeffrey N. Boyer - *Pier 1 Imports, Inc. - CFO & Executive VP*

Yes, Alan, I don't have a number at my fingertips on the return basis on it. I would tell you the vast majority of our stores have an over 10% contribution margin on it. That's kind of our minimum before we decide to take action on it. So they're at a fairly strong operating margin. I can't tell you the exact ROIC and return on that. From a wage standpoint, we are seeing wage pressures on there, and it's a very focused area right now for our store operations group, is to understand the areas that have that. And they're doing everything they can from an efficiency standpoint and hour standpoint, everything they can to help moderate and offset any of those wage pressures. We anticipate, as we look forward as a business, that those wage pressures are going to continue. They're not going to abate at all from a minimum wage standpoint to hours, to time off and things like that. So it is just a part of our business model; we're very sensitive to and working very hard on.

Operator

And our next question comes from the line of Dan Binder with Jefferies.

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

So you talked about kind of high level a lot of the things that you need to do. I understand you're not going to really detail the plan until early next year. But once that plan is done, what would you estimate the time is to implement and execute the plan? That's my first question.

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

So I think it's reasonable first to lay a plan out over 3 years. Obviously, there are short-term things we can do, which we'll feature in next year's plan, be part of that planning process. And things then, like for example, changing our sourcing model and looking at what we can do in our supply chain. Those things are going to take slightly longer to come to fruition. But I think the 1 to 3-year window is a reasonable period of time in which to deliver the vast majority of the savings that we're identifying currently.

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

And then, you mentioned that some areas of the business may require some capital investment. I was just wondering if you could give a little bit more color on that in terms of any particular areas and size of that type of investment?

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

Yes, so I mean, look, without getting into the specifics, because we're not yet at a stage to do that, but to give you something that helps to sort of frame that picture. If you think about our distribution model at the moment, we don't actually currently put barcodes on the outside of cartons. So the result is that we are actually moving products around very often through use of pen and paper. So you can understand and imagine the inefficiency that, that drives. In order to be able to barcode, we need to invest both in terms of the CapEx for machinery to do that, but also warehouse management systems to be able to read those barcodes and then automate the process of moving those products around. The benefit of that, obviously, as you know, for many of those of you that worked in a fully automated distribution system, is significant. So it's those sorts of items that have a very strong return on investment that are enablers of key growth or efficiency driving that we're sort of really most focused on. And they're predominantly across supply chain, our ability to source and then the software for us to be able to actually manage our inventory appropriately. So we don't currently have a model that enables us to either sort by store or to make price changes by store. So again, simple investments in IT systems to enable that, you can just consider the sort of benefits that's going to drive to our inventory model.

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

Great. I'd like to just fit one more in. On the Q3 guidance, you mentioned that you were including the impact from the hurricane activity. I was just curious, is there anything else in there other than that? Because I guess, just modeling our numbers down, 2 points on the comps and maybe some SG&A deleverage related to that modest gross margin decline, it's still kind of hard to get all the way down to that range from where The Street is today. So I'm just curious if there was anything else that you're seeing in the business that has got you to that end result?

Jeffrey N. Boyer - *Pier 1 Imports, Inc. - CFO & Executive VP*

Yes, Dan, this is Jeff. I'll tell you, I'll start with a little bit, that The Street was a couple of pennies high from where we were at before I got into the weather issues on it. So I think you guys were at $0.18, and our internal model is a little bit less than that, so we're working off of a slightly lower number on that. But the difference is 200 basis points on $460 million, is about $9 million of sales. We have a pretty strong margin on it, and that margin runs close to 60% in the quarter. So you pick up a number of cents from that sales reduction on it on top of that because we did get more aggressive, mostly because of weather, to move through products more quickly, our seasonal products on it. There's about 100 basis points, so we've taken the margin down in the third quarter for that and probably, at least 50% of that is due to the weather-related movement and had to move through the product on it. So you pick up in total $0.06 or $0.07. Our midpoint is $0.07. That $0.06 or $0.07 gets you to $0.17, $0.18, which is pretty close to your -- pretty close to, I think, the $0.20 consensus that was out there. Does that help a little bit with the math?

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

Yes.

Operator

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

Atul Maheswari - *UBS Investment Bank, Research Division - Associate*

This is actually Atul Maheswari filling in for Michael Lasser. My first question was also on merch margin, and this was discussed early in the call where you mentioned that one of the reasons for the decline that you are expecting in the third quarter and the fourth quarter relates to elevated promotions. Now promotions really have been elevated all across the industry for the past year and will likely remain so in the future. So are we right in thinking that the merch margin has probably reached a top at the 57%, 58% range? Or do you expect that this will rise in the future? And if it is so, then what will be the drivers for that?

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

No, we absolutely don't, so just to be clear. So if you look at our business and just look at our operating margin, we're just over 3% in terms of operating margin. Key competitors and other players in this industry are high single digits, low double digits of operating margin. So my expectation is that, that's the target we set ourselves in terms of the improvement we expect to deliver as a business. And so very definitely, no is the answer to your question.

Atul Maheswari - *UBS Investment Bank, Research Division - Associate*

Okay, that's fair. And my second question is on your capital allocation and share repurchase. The amount that was spent this quarter was clearly higher than what it has been in the last few quarters. So is this the right run rate that we should expect for the back half of the year, too?

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Jeffrey N. Boyer - *Pier 1 Imports, Inc. - CFO & Executive VP*

We've shared with investors -- our investors and analysts that our capital allocation plan is to always invest in the business first, support our dividend program on it and use any excess capital that we have right now, any cash, for our share repurchase program. But really that share repurchase program is only focused at this point offsetting any equity dilution we have on it. So if you think about that, we did a lot in the third quarter to offsetting the equity dilution that we have. And it was about what we did last year. We did roughly $10 million of share repurchase last year, and we've gotten about $10 million done this year on it. I think that's the pattern as you think about going forward, is that dilution offset. And really, with all the opportunities that Alasdair and the team have identified, we're going to be looking at increasing our CapEx spend in the future versus higher share repurchases.

Operator

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

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

It looks like you controlled marketing costs nicely in the second quarter, and you still were able to post both sales and comparable sales growth. I'm just curious if there's anything to point through in that area, either in terms of any changes or efficiencies and anything that can be leveraged going forward?

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

Geoff, thank you. I think, without wishing to sound trite, just sometimes in retail, just getting back to doing the basics better really helps. So having simpler communication that's more consistent across channels, lined up more effectively in store and online, can deliver greater lift than you were expecting. I think the other thing I would say as well is that being clear on what you're trying to do by category really helps. And those 2 things together has made a significant difference for us. The good thing that we're seeing is that whilst we might see a little bit of rate erosion when we promote, there's ability to drive cash dollars, and that's also positive.

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

That's helpful. And I believe last quarter you touched upon some store-based trials, looking at different value propositions and merchandise assortments. I'm just curious if you can provide any takeaways from those tests.

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

Yes, so we got 1 -- we have 3 store concepts that we sort of talked about putting into the marketplace. One of those is live already in Harriman, in New York, and is a test around our value proposition looking at outlet stores. And without getting into details, it's very encouraging, the results we're getting from that store. The other 2 go live in the next quarter. So we can update the results from that, which are testing different concepts on our next call.

(technical difficulty)

Anthony Chinonye Chukumba - *Loop Capital Markets LLC, Research Division - Analyst*

I guess I was wondering what your thoughts are in terms of just the competitive landscape and how much you think that that's sort of forcing Pier 1 to, like you said, rethink the brand positioning and rethink the marketing, rethink the value proposition that you've talked about?

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

So Anthony, it's Alasdair again. I am -- I think the reality is that retail has always been competitive. And what we're seeing, I think, in home decor and furnishings is just that -- the reality is that as the consumer wind that's at the backs of a particular category is the whole appeal of Fixer Upper on HDTV and all these other things. As that continues to grow, more and more organizations want to get into the space. So I don't see the competition getting less. I see it getting higher and bigger. But this brand's been around for 50 years and has been able to adapt and change over those years as it's needed to. And I think this is just one of those situations where that's -- the same is true, and we'll adapt as we need to, and we'll compete as we need to in order to be in the right place. And the encouraging thing for me is, I was enthusiastic taking the role. I was pleased by what I saw when I arrived in terms of the opportunity. And now sort of as we do our second call, I'm even more excited by the opportunities I see going forward because there are so many opportunities actually for us to fund the growth that we need to drive from within the P&L. So as I said, we'll come back at the beginning of 2018, lay it out fully. But the competition that we have out there is nothing that I haven't experienced before. And I think we're well placed to be able to head it off as we choose to.

Anthony Chinonye Chukumba - *Loop Capital Markets LLC, Research Division - Analyst*

Okay, that's helpful. And then, second thing, as I think about your gross margin being down, your merchandise [market set] improved, your stock, store occupancy, you actually leveraged that year-over-year. So -- and then about what you said with fulfillment cost. I'm just trying to square that. You said the vast majority -- or the lowest percentage of your e-commerce sales are from people who order stuff from home and then have it delivered to home. I'm assuming that a lot of stuff is being picked up at the store. I'm just trying to figure out why your fulfillment costs keep going up if you have a high percentage of your online orders that are being picked up in store. And I would just think that, that would just be on a truck that was going to go to that store anyway. I guess I'm just trying to reconcile that.

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

So actually, we didn't -- it was very difficult to actually hear your question because you're breaking up slightly. But I think what you were asking us about was with regard to how do we balance the increasing fulfillment cost for online given that the majority of it goes either -- originates in store or is fulfilled in a store rather than going directly to home. So if that was your question, I'll answer as best I can. If it wasn't, then perhaps you have another bash at the question. The reality is that there are 2 big things. One of those is we introduced a free shipping from $49 from last year. And that obviously deleveraged us by about 200 basis points first part of this year. We obviously now lapped that going into the second half of the year, and that moderates to about 50 basis points. So that's where a part of the change comes from. When you actually look at the way a product that's -- online-ordered product actually touches, it either originates in store or it actually is picked up in store. It's about -- Stacey, keep me honest here, it's about 40% that actually originates in stores through cash wrap PC and is either picked up in store or delivered to home, correct? So you've got 40% of our online business, Anthony, that the lady is standing in the store talking to one of our associates, booking the product in store, but that's then being delivered to home. And that's on top of the pure, she's sitting at home, ordering it on her device and having it delivered to her home. So the overall is about 60% that's actually being fulfilled. And the margin erosion that we described really is driven most when items, large dining tables, sofas, those kinds of furniture items. And that's where we see the biggest mix effect for us in terms of cost. So as we've seen the mix change and more product go through in those channels, that, I think, exacerbated the difference. Does that answer your question?

Anthony Chinonye Chukumba - *Loop Capital Markets LLC, Research Division - Analyst*

That does. That's helpful.

Operator

And our next question comes from the line of David Magee with SunTrust.

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David Glenn Magee - *SunTrust Robinson Humphrey, Inc., Research Division - MD*

My first question has to do with the millennial commentary that you had earlier. You mentioned some of the challenges with regard to indexing better, I think you said, the store environment and maybe the method of marketing. I'm curious what you think about the look of the merchandise, the assortment for that age group versus the taste of your more traditional customers over time. And do you think that there will be a needed change in that regard?

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

Yes, I'm sure there will be. So when we talk to them, it is really clear that they like quite a lot of the products that we have and the merchandise that we have. Sometimes, however, it's difficult for them to find that product the way our stores are currently assorted because they describe the situation where it's almost slightly overwhelming, sometimes is the words that they use. So we've got a program we're working to amend on how we adapt and change that so we make it easier for them to do so. And then the other thing I would say is it's really like if you decorate your house. If you have a room that's completely neutral in color and you put a couple of unique items in there, they pop really easily. People love those unique items. But if the whole room was made up of unique items, they don't tend to pop in the same way. It's almost too much. So actually, our challenge is to take the things we're best at and strongest at, and customers consistently tell us that is unique, new and interesting product, and ensure that we actually just put it in front of them in a way that's easier for them to see and understand and then to sort of like back off some of the other stuff.

David Glenn Magee - *SunTrust Robinson Humphrey, Inc., Research Division - MD*

That's good color. My second question is about the furniture versus sort of home decor products. And any color on the momentum of those sides of the business?

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

Well, that's a very broad question. But basically, if you look at our heritage and our core strength, it's all in decor. And if you look at sort of the newer categories, in the areas with larger sort of retail tickets, it's typically the furniture. So they split in our business roughly 65%, 35%. So 65% of our business is decor and then 35% is what we describe as furniture categories. So our challenge is to remain strong and to grow out of our core, and we think we can do that very effectively without saying goodbye to any business in any other channel or category.

David Glenn Magee - *SunTrust Robinson Humphrey, Inc., Research Division - MD*

With regard to current trends though, which side are you happier with?

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

I mean, it's really interesting that when you look at our decor business, we're significantly stronger in our decor business. You'll have seen this from our numbers in our previous quarters when, before my time, as Jeff was talking to you in Easter, we saw significant sales strength, and that's predominantly driven by decor. And likewise, last year, in the third and fourth quarter, you saw strength across the run up to holidays and, again, driven by decor. So as we said on our call last quarter, we called out the fact that our outdoor furniture was actually one of the key categories that caused us to actually lag slightly the performance we had expected. And if you just had a breakeven on the outdoor versus prior year, our comps would have been up another 1% or so in that quarter. So I think you can see fairly clearly that we've got greater strength and stronger growth out of our decor business than we have out of some of the other categories.

Operator

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

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Adam Harry Sindler - *Deutsche Bank AG, Research Division - Research Associate*

First I wanted to thank you for the very forthcoming comments that you made both on this call and on the last call, it's very refreshing. I guess, my question is, as I'm looking at the model right now, somewhere around 4% operating margin for the year. You still charge for shipping. I see there's now $99 for White Glove, and that's room of choice. But as you think about addressing the younger customer, clearly we know from one of your major competitors, you know who they are, that the majority of customers actually choose free shipping. If you had to move to free shipping for furniture, what type of impact would that have on the operating margin? And then, sort of having to layer in costs on top of that to potentially launch these new businesses, should we expect margins to be under pressure for some time as you move through this process? Or do you think there's enough cost savings to offset some of those types of initiatives?

Jeffrey N. Boyer - *Pier 1 Imports, Inc. - CFO & Executive VP*

Adam, I'd tell you, at this point in time, we're not looking at moving to free shipping on furniture. We know that is a strong offer that some competitors offer. Oftentimes, when they do that, they price that into their goods, which is another way to attack it. But at this time point in time, we're not looking at that -- on it. So I would say, not an issue on that side. In terms of the other initiatives and layering in costs, I think Alasdair mentioned it a little bit earlier, which is the great thing about the opportunity here at Pier 1, there's a lot of cost savings and promotional efficiency opportunity that we can do some things to really offset some cost elements and cost pressures by these other initiatives. So we don't know exactly how they're going to play out over the next 3 years, but there's the ability to really offset some of the cost pressures with other efficiencies we have in the business model, really because the opportunities...

Adam Harry Sindler - *Deutsche Bank AG, Research Division - Research Associate*

If -- I have a follow-up then though, so you talked about the fact that, clearly, the store environment and the value proposition are the 2 key things to address. I mean, if you're not going to move to free shipping on furniture, I would have to assume you're going to have to be lower priced on the actual furniture itself by a similar amount of money to make the total cost of the ring the same. And as of right now, it's -- relatively speaking, it's significantly higher costs for relatively [similar.] I'm just not sure how you would improve the value proposition and match price of, clearly, the competitor you're trying to take some share back from without seriously considering free shipping.

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

Yes. So let's just clarify a couple of things. So I think you're flagging that we don't have free shipping. If you spend more than $49 with us, we do have free shipping.

Adam Harry Sindler - *Deutsche Bank AG, Research Division - Research Associate*

On furniture, specifically.

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

That's correct, on furniture. So I think you may have misunderstood perhaps the offer that we have out there. We do have a white glove delivery system, which you can pay $99 for, which is where we actually build it, put it up in the house for you. And that's very much aligned with what competitors have out there in the marketplace as well. So it may...

Adam Harry Sindler - *Deutsche Bank AG, Research Division - Research Associate*

Is it, you actually put the furniture together? Or do you just deliver to room of choice? There's definitely differences there.

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

Yes, both depending on the item.

Adam Harry Sindler - *Deutsche Bank AG, Research Division - Research Associate*

Okay. But free shipping on furniture is out of the question.

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

No, we do, do free shipping with furniture. You can get furniture shipped to your house free-of-charge today.

Adam Harry Sindler - *Deutsche Bank AG, Research Division - Research Associate*

We can?

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

Yes, you can. That's why I'm just trying to clarify the difference. We have a free shipping of furniture, which is where we're seeing some of this erosion in margin that other people are talking about. But if you get it just shipped to your house and you have to carry the sofa up the stairs yourself, take the packaging off, put it in the room yourself, all the rest of it, you can get that done free-of-charge. But if you want to have a White Glove Service where someone else does that, then it costs $99. But that's very competitive with what others in our industry are offering currently.

Operator

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

Cristina Fernandez - *Telsey Advisory Group LLC - Director & Senior Research Analyst*

I wanted to go back and touch on the acceleration in e-commerce growth to 35%. How big a factor do you think has been the lower free shipping threshold? And as you look at the second half, what rate of growth are you assuming given you start lapping that change now in mid-September?

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

Yes, thank you. Okay. So let me do 2 things first as I answer your question. And then, I just want to come back and answer the previous question, because there was a second part in the previous question I'm not sure we answered fully in terms of how we see the value proposition changing. So to your question, we've been seeing our online business growing at sort of approximately 30%. And that's partly driven by the free shipping offer that we put in place last year. And as we've started to lap that, what we're seeing is a moderation in our sort of growth online. But we sort of modeled our business going forward at sort of between 15% and 17% growth online, and we're achieving those levels currently as we speak. So we don't see a reason to be concerned by that. If anything, we're encouraged that our growth is slightly ahead of plan on online, so some moderation but still strong. And did that answer your question specifically?

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Cristina Fernandez - *Telsey Advisory Group LLC - Director & Senior Research Analyst*

Yes, yes, that's helpful. And then I understand, obviously the pressure on Florida and Texas. But can you comment on your performance in the markets outside of those so far this quarter? Or I guess, just from mid-August to mid-September when the pressure has been felt?

Jeffrey N. Boyer - *Pier 1 Imports, Inc. - CFO & Executive VP*

Yes. I would tell you that, actually, from mid-August through early September, we saw good performance across all the regions. When we got into the first few weeks of September, we had the hurricane issues. We did see some distraction impact that did disrupt some of the other regions as well, but we have seen some moderation as we're coming out -- or we just come out of that past the hurricane situation. So with the weather conditions that were in Florida and Texas, many people have friends and families, so many people were concerned about that versus out there shopping for room decor. We have seen some stabilization now as we've gotten into the back half of September and our business overall. So it's primarily in Florida and in Texas, particularly Houston, where we saw the biggest impact. But we did see some collateral impact in other regions just during the height of the storms.

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

I just wanted to come back to Adam, on the second part of Adam's question. So we're just trying to explain and clarify our sort of delivery options. So the second part of your question, Adam, was around whether I saw other things about our value proposition that we needed to address to appeal to a younger customer. And what I would say is a very forthright yes, we do. And one of the key things that we're driving is looking at our sourcing, particularly to understand what we can do to take the base cost down on our products in order to make sure our value proposition is in line with where we believe it needs to be based on the conversations we're having with customers. So alas, I agree with, and it's a key part of our plan. We shouldn't see further deterioration from the delivery, which I think was the first part of your question. So hopefully that answers Adam's question in full.

Operator

That concludes our question-and-answer session for today. I'd like to turn the call back over to Pier 1 management for any closing comments.

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

Okay, thank you very much. No further comments from us, but I look forward to talking to each of you over the coming days.

Operator

Thank you. Ladies and gentlemen, thank you for your participation in today's conference. This does conclude the program, and you may now disconnect. Everyone, have a great day.

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