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PIR - Q1 2017 Pier 1 Imports Inc Earnings Call

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OVERVIEW:

PIR reported 1Q17 net sales of $418m and net loss of $6m or loss of $0.07 per share. Expects FY17 net sales to decline approx. 1-3% and EPS to be $0.32-0.40. Expects 2Q17 net sales to be down approx. 1-3% and EPS to be a loss of $0.06 to flat.

CORPORATE PARTICIPANTS

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

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PRESENTATION

Operator

Good afternoon ladies and gentlemen, and welcome to the Pier 1 Imports FY17 first-quarter earnings call. At the request of Pier 1 Imports, today's conference call is being recorded.

(Operator Instructions)

I would now like to introduce Bryan 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 FY17 first quarter. In just a few moments we'll hear comments from Alex 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 regarding our business made today 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. Such 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 Pier 1 does not assume any obligation to update or revise any such forward-looking statement.

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 also available on our website at 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*

Thanks Bryan, and good afternoon everyone. Also joining me on the call is Jeff Boyer, Executive Vice President and Chief Financial Officer. Other members of our senior leadership team are also in the room with us today.

Well, clearly we are experiencing the same customer trends as the industry generally, namely the ongoing movement to purchase outside a store. Indeed, our direct-to-customer sales ordered outside the store were up 40% in the first quarter, driven by both increased traffic and higher conversion rates on our site. Overall our top-line results in the first quarter were below our plan. We had some categories that performed exceptionally well, tabletop for instance, but that was not enough to pull up our chain average.

Our shortfall came principally in outdoor furniture, the result of some new product misses and a reduction in the number of floor models. We ended the period with outdoor furniture inventory significantly below last year, which will pressure sales in Q2 as we cycle the big outdoor clearance from last summer.

Our merchandise margin softened slightly more than we had originally guided in quarter one, as we made the decision to be more aggressive on clearance to ensure clean inventories. We achieved our objective. And although we are taking down our sales forecast for full year, we expect to achieve improvements in our merchandise margin rate from here on. With our inventory levels in a healthy position and our distribution center efficiencies getting behind us we can focus resolutely on merchandise margin dollars.

Our teams are doing a good job of inventory management, cost reductions and supply chain efficiency. Last year inventory management and supply chain had a significant negative impact on our business. This year they are both positive forces. We ended the first quarter with inventories down 16% year over year and remain focused on maintaining inventory levels consistent with the sales as we carefully manage receipt flow.

Our multi-year project to improve the efficiency of our business is going well. We expect the efficiency improvements and cost reductions that come from this project to add to our profitability over time.

We're also developing short- and long-term plans that will allow us to improve productivity and capture savings within our supply chain. We believe that there is significant margin -- merchandise margin opportunity coming from sourcing, international logistics and domestic distribution.

As we think about how this fiscal year will unfold, we anticipate that our initiatives around merchandising, marketing and customer loyalty will come together and contribute to a strengthening in our top-line performance in the second half compared to first-half trends. And I'm pleased to tell you that we're making solid progress against these three areas of focus which we talked about on our year-end earnings call. Let me update you on how things are moving along.

First I'll discuss merchandise, the need to bring fresh and distinctive products to market at a faster pace than a few years ago is one of the new realities of home furnishings. We are proud to have one of the most creative merchant teams in our sector, and I'm confident they will continue to deliver products that resonate with our customers.

And as the business transitions to the fall season, the reset of our fragrance wall will reflect new packaging, new forms and new presentation and many new fragrances. Fragrance has always been an important part of the business for us, and we're excited about the opportunity to leverage our strength in this area.

Harvest and Halloween products are already in our DCs, and Holiday is shipping as we speak. You can see a sneak peek of Harvest, Halloween and Holiday on Pier1.com.

This year's fall floor sets will be more category focused with less vignettes than previous years as we work to exploit our merchandising capabilities by more strongly focusing customers' attention on the most important sales driving products. We'll also see some of our successful Spring introductions return to the sales floor and website.

We're keeping our foot on the gas to drive continued direct-to-customer sales growth through website usability, product, compelling imagery and functionality. Our website evolution is ongoing. We release new code approximately every two weeks. Our online-only SKUs are generating good performance. We are tracking to grow our online-only assortment an additional 25% in FY17, with further increases planned in future years.

We're also adding new categories to our online assortment including soft bath, which debuted to positive responses this Spring. Later this year we're planning to unveil our new gift registry on Pier1.com, yet another way in which we can drive long-term growth from our omni-channel platform.

Turning now to marketing. We successfully piloted our new non-tender loyalty. It is the Pearl tier in our three-level loyalty program. Cobalt and platinum are our existing tiers which are tied specifically to our private-label Pier 1 Rewards Card. The initial pilot was implemented in three states, California, Hawaii and Alaska, and we've just launched an additional four states this month, Texas, Pennsylvania, Florida and Illinois. Early results have been positive, with customers responding well to the Pearl value proposition. We'll be rolling out nationwide in August.

Developing this non-tender capability comes with numerous benefits. First, it enables us to grow our database of known customers, a highly productive group which, as you know, accounted for 70% of sales last fiscal year. We expect our match-back rates to be measurably higher this year. Second, it allows us to recognize and acknowledge these known customers. And third, it will enable us to present personalized offers reflecting merchandise and design ideas that are highly relevant and appealing. Pier 1 Rewards Card customers have, for the longest time, been a powerful asset for our Company. The new loyalty tier will allow us to add to this important customer constituency.

Now, let's talk about our digital marketing efforts. We are seeing positive results from our initiatives around frequency and retention, as well as new customer acquisition. Our e-mail strategies focused on frequency and retention generated a nearly 40% increase in demand versus a year ago. And the ROIs on those e-mails are much higher year over year. We're also seeing good results in the digital channels which we use most often for new customer acquisition. Those include non-brand search, product listing ads, performance display and social media.

The early success of these programs points back to our larger customer data excellence initiative. Its been a two-year project which now, with the implementation of loyalty and recent go-live of our new cloud-based customer service tool, has hit all the major milestones on its path to completion. With our customer data excellence initiative complete, we've now got a new, more powerful database, improved segmentation capabilities driving greater personalization, new campaign management tools, an expanded loyalty program allowing us to better engage with customers, and just completed this week, a customer relations tool that provides a more seamless path when assisting Pier 1 Imports shoppers.

From a high level perspective, our marketing strategies are enabling us to bring more customers into our new database, communicate them with more effectively and appeal to them more directly. Over time our ability to offer increasingly personalized incentives and discounts should enable us to reduce the number of broad across-the-board promotions.

Another element of marketing we talked about last quarter was our plan to layer in mass media to help fuel the flow of new and returning customers. Our return to television advertising commenced in April and we were on air for six weeks during the first quarter. We're on air now for our July 4 One Big Sale, and then back again for Fall and Harvest. While it's still early days, we're happy to be back on TV. Our TV ads provide us with the opportunity to reinforce our brand messaging, which we believe will help drive incremental traffic to our Pier 1 Imports stores and website. Its full effect, of course, will be most prevalent during the forthcoming Holiday season. Mass media is a strategic investment, one that is important in the current environment to motivate new and returning customers to shop Pier 1 Imports.

Our industry is undergoing rapid change, but we have a good handle on the dynamics of the home furnishings environment, we understand the needs of the customer groups which we cater to and what they expect from their home furnishings stores. And despite the uncertainty of late, we've had a lot going for us. Pier 1 Imports brand health and awareness scores remain consistently strong. Our healthy balance sheet and strong cash flow provide the financial flexibility to navigate this current cycle of change while also positioning the Company for long-term success. With our omni-channel transformation complete and our growing data analytic capabilities, we have evolved our business model to ensure we are competitively positioned.

Operationally we're controlling costs, closely managing inventories and executing against our supply chain initiatives. Our most pressing mandate is to do everything we can to drive traffic and remain focused on building the purchasing funnel, [grow] and of course, keep developing great products.

I have outlined many terrific sales and profit improvements we are working towards. And yet we're reducing this year's guidance. No doubt you see the same apparent disconnect that we do, but there are a couple of factors at play here. First, we thought sales would come in a little stronger in Q1, so we didn't enter the second quarter with quite as much steam as we had hoped. Second, the current retail environment has its challenges, especially with regard to visibility. This became increasingly evident throughout the first quarter retail reporting season. More to come. I'll now ask Jeff to review the financials.

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

Thank you, Alex, and good afternoon everyone. Our top- and bottom-line results came in near the lower end of our guidance in this quarter, which largely reflects soft store traffic and a competitive environment in the outdoor category. Net sales decreased 4.2% to $418 million, while Company comp sales decreased 2.5%. On a constant currency basis net sales were down 3.9% and Company comp declined 2.2%. E-commerce sales grew 10% and sales penetration reached approximately 19% in the first quarter. That's up both sequentially and on a year-over-year basis from 15% in the fourth quarter of FY16 and 17% penetration in the first quarter of FY16.

From a merchandise perspective, our living room, tabletop and home decor categories performed well, while outdoor furniture was competitive and required a greater level of clearance markdowns than we expected. First-quarter merchandise margin dollars declined to $233 million from $253 million a year ago, while the merchandise margin rate came in at 55.6% compared to 57.9% in the first quarter of FY16. This was also below our expectations. The majority of the year-over-year impact was a result of clearance and promotional activity.

As we expected, we absorbed some incremental distribution center costs, but these were fairly minimal. We continued to expect recognition effects of last year's DC issues will tail off in the second quarter and provide a favorable comparison in the back half. During the balance of the year our teams will be focused on improving markdown levels, managing promotional discounts in order to drive margin growth.

First-quarter delivery and fulfillment net costs increased both in dollars and as a percent of net sales. In the first quarter we saw close to 70% of our e-commerce sales fulfill to the customer through either parcel or in-home delivery. Store occupancy cost in the first quarter declined to $73 million compared to $75 million last year. As a percentage of net sales they were up 30 basis points year over year. We continued to expect our real estate program and cost initiatives will help us reduce occupancy cost below FY16 levels.

First-quarter gross profit was $149 million, or 35.6% of net sales, compared to $170 million, or 38.8% of net sales a year ago. Expense controls continued to be in focus during the quarter. SG&A dollars were essentially flat year over year, coming in at $143 million. As a percentage of net sales, SG&A increased by 120 basis points to 34.1%. We captured efficiencies across much of the organization, achieving savings of $4 million in compensation for operations and $3 million in other SG&A. However this was partially offset by a planned increase in marketing spend including our return to television advertising this past Spring.

Our first-quarter operating loss was $8 million, while EBITDA was a positive $7 million. Net loss for the quarter came in at $6 million for a loss of $0.07 per share.

Turning now to the balance sheet. We're in a strong financial condition at quarter end with $128 million in cash and cash equivalents and no cash borrowings under our revolving credit facility. Inventory totaled $421 million, representing a decline of approximately 16% versus a year ago. We're focused on managing inventory, and continue to expect FY17 year-end inventories to be below FY16 levels.

Capital expenditures were approximately $10 million in the first quarter. And we're tracking to our full-year plan of about $55 million, primarily for IT, stores, and supply chain programs. As we head into the remainder of the year, we are assuming that traffic trends remain uncertain. And we've built that into our outlook, while also taking into consideration the initiatives we have in place to drive the top line.

Let's turn to full-year guidance. For FY17, we expect the following. Company comparable sales in the range of down 1% to up 1%, a net sales decline of approximately 1% to 3%. Our merchandise margin guidance remains unchanged in the range of 56% to 57%, selling, general and administrative expenses in the range of $575 million to $585 million, and depreciation of $56 million with earnings per share in the range of $0.32 to $0.40 on diluted shares of approximately 80 million. For modeling purposes we continue to expect the net interest expense will be up modestly year over year in FY17 in the range of $12 million. Additionally we're forecasting our full-year effective tax rate to be approximately 39.5%.

For the second quarter of FY17 we're providing the following guidance. Company comparable sales in the range of down 1% to up 1%, net sales down approximately 1% to 3%, merchandise margins in the range of 56% to 57%, SG&A expense of $136 million to $140 million including $20 million of marketing spend, and earnings per share in the range of a loss of $0.06 to flat.

Looking a little further ahead to the second half of the year, we anticipate that our merchandise and marketing strategies will enable us to drive improvement on the top line relative to the first-half trend, while favorable comparisons will enable us to achieve an increase in merchandise margin dollars. We expect SG&A dollars to be flat to down slightly in the back half despite the investment we're making in marketing. With that, I'll ask Shannon to open the line for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Your first question comes from the line of Steven Forbes from Guggenheim Securities. Your line is open. Please go ahead.

Steven Forbes - *Guggenheim Securities - Analyst*

I realize it's early here with marketing and so forth, but can you expand on some of the learnings from the recent Spring TV campaign, especially as it relates to new customer acquisition? And I guess as you think about spend going into the back half here, is there a limit as a percentage of revenue that you would cap marketing at, even if you saw progress, or is there some flexibility in the model to increase that if you continue to see what you expect here?

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

Hi Steve. This is Alex. Well, in terms of we are on TV a relatively short time, the six weeks in the first quarter. We do, as I think we've told you before, we always follow TV flights with our standard market research, our brand tracker. And even just after six weeks we saw the unaided awareness number started to move up nicely compared to what it was when we had not been on air. So from that perspective, we're pleased.

I can't tell you that we discerned any measurable difference in store traffic. What I can tell you is we do see every time a spot airs we do see a blip in our online traffic. So we know people are watching it. So we're pleased so far. As we speak, we're just working on creative for the Fall and Holiday flights. And we're feeling good about it.

As far as ramping up TV, that's kind of practically very hard to do. I mean, we're sort of bought out now for the year. It's not impossible, but I think it extremely unlikely that we would invest any more in the back end of this year. Do you want to add to that Jeff?

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

Exactly, Alex. I would concur with those comments, really probably a longer-term cycle to make investments in television. So this is an important year to invest and learn in what television acquisition and awareness does for us. And we'd really modify things for next year.

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

Yes.

Steven Forbes - *Guggenheim Securities - Analyst*

And then as a follow-up. As it relates to opportunities within sourcing, I think Michael Benkel has been in his position now for 10 months, the new position. What are some of the key things him and his team are working on? And I guess as you think about, and I believe we've talked about this in the past, but as you think about the need to create a sourcing team or a sourcing office, whether that be in the US or overseas, where do you stand with your thinking on that in general?

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

Wow. So a lot of questions in there. Let me just answer them as succinctly as I can. In terms of domestic distribution and transportation, we are just embarking on a network study which will help us to decide over the medium term exactly how many distribution centers we need, exactly how many fulfillment centers we need, and whether those are optimally placed to get costs to the most efficient level we can. So that's the sort of headline on domestic distribution.

On sourcing, we are really on the bottom rung of that ladder. We have a very well established vendor base, as you know. Lots of them, we've worked with many of them for many, many years. So we're working with those vendors going forward, or we will be, rather, just to see how we can help those guys be more efficient, run their businesses more efficiently and pass on some cost savings to us. But a lot more to come on that. It really is -- it is very early days.

Steven Forbes - *Guggenheim Securities - Analyst*

Thank you.

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

You're welcome.

Operator

(Operator Instructions)

Your next question comes from the line of Dan Binder from Jefferies. Your line is open. Please go ahead.

Dan Binder - *Jefferies & Co. - Analyst*

Thank you. I was wondering if you could just talk a little bit more about the seasonal outdoor weakness. You mentioned product misses and fewer floor models, but then you also talked about a fairly promotional environment. And obviously we had a late start to the season. So I was wondering if you could talk a little bit about cadence and then whether the weather patterns had a bigger impact than the product misses and what those product misses were?

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

Okay. Well, thanks for the question, Dan. And thanks for giving us the opportunity to play the weather card, which we will decline to do although it clearly was a factor in the early part of the season.

But I think if you just go back four or five years, maybe a little more, our outdoor business was pretty minimal. And the team have done an outstanding job over multiple years in really growing that business so that it is now a very significant part of our [hard won] business. And I think this year we tried to push the envelope a little hard in terms of price points and some of the higher price points that we put into the store were a bit too much of a stretch for our customers. So although they sold they didn't sell at the rate that we had anticipated. So we've had to sort of move through that. So next year we'll be sort of moving a little more towards our historical price pointing. So it wasn't a question of the aesthetic, it was really more a question of the price points in our judgment.

The good news is, based on last year we had bought one, as you know, we had a mountain of outdoor to move through. We bought much, much more conservatively this year. And so we gave you that overall inventory decrease of 16%, I think it was. Our outdoor inventory is significantly greater decrease, I'll get the right word out, is much lower versus last year than the change. So we've cleaned up what we need to clean up. We're in good shape as we move through sort of June and July. And then as you know as we move into August and September then outdoor pretty much fades away in terms of importance.

Dan Binder - *Jefferies & Co. - Analyst*

And then just as a follow-up. Is the merchandise margin improvement for Q2 versus the original guidance simply because of lower clearance? And you also mentioned that you expected inventory to be lower this year as we end the year versus last. I was just curious if you can put a number to that.

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

I'll let Jeff dimensionalize it for you. But I would just make this point, is our clearance inventory is really under control and we expect to see far fewer clearance markdowns through the rest of this year. Our promotional activity is pretty much in line with what we anticipated. So we're feeling pretty good about the merchandise margin. Do you want to?

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

Yes. That's great, Alex. Any further questions, Dan, on that? I think Alex explained it pretty well. It's really a comparison year over year on the clearance level. Last year as we're moving through quite a bit of clearance, [integrate] our merchandise margin. We will be rebounding from that nicely. Our promotional levels are competitive, we think, for the marketplace out there. And as we've been cycling through the other merchandise margin elements, there is the supply chain inefficiencies. Those are really a non-issue in Q2. And by the time we do the back half of the year we get into a favorable position. So we feel good about our 56% to 57% margin guidance that we have for Q2 out there.

Dan Binder - *Jefferies & Co. - Analyst*

Okay, great. Thanks.

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

You're welcome.

Operator

Your next question comes from Adrienne from Wolfe Research. Your line is open. Please go ahead.

Adrienne Yih Tennant - *Wolfe Research - Analyst*

Thank you for taking my question. Good afternoon.

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

Hi.

Adrienne Yih Tennant - *Wolfe Research - Analyst*

Hi. A question sort of longer term about sort of the right store count, and if this year tracks toward the lower end of expectations would you consider closing more than the 20 that are slated for this year? And then for Jeff, you're obviously not changing the merch margin guidance for the full year. So are we to think of it as just a shift of the timing of the promos or are you expecting the back half to rebound a little harder?

And then my final question is the inventory being down so meaningfully and clean, below sales, to achieve the comp guidance, you have to drive it through AUR or transaction. I'm just wondering how you're forecasting those, kind of that differential between the inventory and then yielding the comp you expect. Thank you.

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

I think there were three questions in there if I got them all, Adrienne. There was --

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Adrienne Yih Tennant - *Wolfe Research - Analyst*

Yes.

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

Closing store discussion given sales performance. There was a margin discussion really about timing. And then there was a more detailed one about where does the sales increase come from.

On the closing store discussion, it's really not -- it's a little bit like that marketing comment we had earlier, which is it's not really a matter that you flex in the short term given store performance. Leases are coming up on a cycle. We have X amount that come up a year. We make more strategic discussions about staying in a store or exiting a store. So really don't make a big change if sales are different by 1% or 2%. That doesn't really impact the store closing equation.

What we continue to do is aggressively manage our lease negotiations and look very closely at what we can do to get lower rent structures out there, and have been fairly successful in being able to do that against our options that out there, existing rent. We're also looking at all of the operational costs around our store, such as store labor and hours and things to see how we can also reduce that cost element as well. So I think that answers kind of what we do on the store basis on it.

On the margin piece of it, I'll tell you that we did undershoot the margin a little bit in quarter one over maintaining our full-year guidance. We had a fairly healthy range that we provided last year for the full year. There's a little bit of shifting between the quarters on it, but really relative to our longer-term forecast we had, or plan that we had out there. It's really pretty consistent in quarters two, three and four. Q1 is a little bit of a smaller quarter for us so therefore it doesn't have as much of an impact throughout the year. So it's kind of an averaging effect that happens that doesn't really affect the outer quarters that much, and allows it to maintain our 56% to 57% for the year. And the last one was --

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

Was just about inventory and sales. Well, a couple of points I'd make on that. First, although our inventory is significantly down overall, don't forget we hold the vast majority of our inventory is in our DCs. So our store inventory is only down marginally -- on a comp store basis our store inventory is only marginally down on last year, but that's not across the board. We've obviously invested in those categories and departments that we feel are going to be strong.

And the same is true of what's coming in the back half. It's not a vanilla approach we take with following the products that we think are going to be successful in the back half of the year. So even though we've made great strides on reducing our inventory, this is still a relatively slow turn business. There is -- I think we're in a good position.

Adrienne Yih Tennant - *Wolfe Research - Analyst*

Okay, great. Thank you very much, and best of luck.

Operator

Your next question comes from the line of David Mann from Johnson Rice. Your line is open. Please go ahead.

David Mann - *Johnson Rice - Analyst*

Yes, thank you. Good afternoon. My question relates to the moderation of online sales growth which has been happening over the last few quarters. Just curious what you think is going on there and what you might do to try to accelerate that given, as you acknowledge, that's where the customer's moving towards shopping?

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

Well, I think you have to sort of segment. So you're right in terms of the total number. And I think as we said in our prepared remarks, David, the actual direct-to-customer piece is actually growing rapidly. Where we saw a slowdown in first quarter was in our [cash wrap PC] orders, which had been running I think about at 30% or something of our e-comm business and that fell a little bit. And I hate to say this, but that also was pretty much a function of our outdoor business, which last year was extraordinarily strong in terms of sales generated through the cash wrap PC. As we move into Q2 -- sorry Q3 and Q4, the cash wrap PC business becomes a smaller percentage of the total. So we think that sort of moves in our favor in terms of the overall e-comm business as we move into the back half. Did I say that correctly, Jeff?

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

Yes.

David Mann - *Johnson Rice - Analyst*

Thank you. And then for my follow-up. Jeff, in terms of the stores that you have closed, as you're tracking the sales that might be recaptured, any new data you can share with us on how you think that's trending? Thank you.

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

David, good question. It's still tracking consistent with our earlier research, which is 20%, 25% transfer to the existing stores within the radius, and then good transfer of online. Actually the online business that's in that area actually builds a little bit, we think due to actually the absence of the physical store. I mean, a little more goes online. So those statistics and trends that we saw, we've been seeing, have been consistent. They really haven't changed at all.

David Mann - *Johnson Rice - Analyst*

Thank you. Good luck in the second quarter.

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

Thank you.

Operator

Your next question comes from the line of Michael Lasser from UBS. Your line is open. Please go ahead.

Michael Lasser - *UBS - Analyst*

Good evening. Thanks a lot for taking my question. Alex, so sales were down about $20 million year over year. I think the advertising expense was up $6 million year over year. I recognize that there was only six weeks of TV during the quarter. And it sounded like you said you were happy with it. What sort of return are you expecting over the subsequent next few quarters to generate meaningfully better sales dollars on what seems like will be a consistent level of advertising?

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

Well, thanks for the question. As you know, it's almost impossible to do a sort of direct cause and effect in terms of we spent X on TV and it was a Y impact on sales or traffic. So we rely very heavily on the market research which I alluded to earlier in terms of measuring the effectiveness. And we ask a whole batch of questions, not just about brand awareness but about how customers foresee the brand and our brand health metrics. And we also ask questions around likelihood to visit as a consequence of seeing the ads. So we've got a really good method for tracking it from a research point of view. But I can't say to you it added 0.5% to store traffic. It's just not possible to do that.

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

I would add to that, Michael, that when you think about the marketing spend, at least in the first quarter, a fair amount of that marketing spend increase was due to the production costs. When we do go into production, go to TV, it's a little more expensive. And when we do start to run the TV it does get expensed. So that's a little bit of a timing issue between the quarters. So it's an investment that happens and an expense that happens in the first quarter.

Michael Lasser - *UBS - Analyst*

And maybe I'm -- thank you very much. My follow-up question is, maybe I missed this, but if you back out the margin hit from clearance inventory, what did the pure merch margin do as a result of the promotional activity within the marketplace? Because it does seem like this promotional activity is here to stay and that's going to continue to weigh on the margin.

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

Well, we certainly agree with the statement that the -- and we said on the last call, this is no longer a highly promotional environment. It's just the environment. It's the world that we live in. So our job is -- and by the way, I think I said our promotional activity in Q1 was pretty much in line with what we expected. So our job as merchants and retailers is just to get smarter and smarter about how we use those promotional dollars, make sure that we are only using them on promotional activity that really does drive merchandise margin dollars and not be overexcited by things that drive sales but no margin dollars. As our analytics get better and our thought processes get better, I think we feel pretty confident that we can expand our merchandise margin over time.

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

I would just maybe dimensionalize it a little further. Absolutely spend a little bit more on promotion, but the big issue we had in the first quarter was on clearance. And of that 230 basis point margin decline that we had, 80%, 85% of it was clearance. The vast majority of it was clearance related.

Michael Lasser - *UBS - Analyst*

And just with that being said, do you know what the clearance activity added to your sales for the quarter?

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

I see, that's where you're going. Here is the weird thing. Clearance activity really, unless it's really big ticket and there's a big volume of merchandise like the outdoor furniture we had to move through last year, if it's just regular clearance on your regular merchandise, it moves customers from the full price sort of bucket to the clearance bucket, but it really does very little for average ticket or UPC, or anything. It just gets rid of merchandise.

Michael Lasser - *UBS - Analyst*

Got it. That's helpful, Alex. Thank you so much.

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

Okay. You're welcome.

Operator

Your next question comes from the line of Simeon Gutman from Morgan Stanley. Your line is open. Please go ahead.

Simeon Gutman - *Morgan Stanley - Analyst*

Thanks. So my first question is on loyalty and the marketing, and I think you mentioned the data. You mentioned you're going to try to personalize some discounts. And I think that then would be premised that not every shopping trip the customer is coming in to seek a discount, and that makes sense. But do you have the data that proves it? And then connected to it, is the data, the systems that you have built, does that mean you've analyzed it and the offers are ready to go in the back half? Not offers, but let's say more personalization, or does it going to take time for you to analyze the data to develop the behaviors and then start to solicit earlier next year?

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

There's a lot of good questions in there, Simeon. So the answer is, at the moment we're building our database of our Pearl level customers. We can obviously track their spend in terms of what they're spending, when they're spending. They have the opportunity when they come into a store to check in so that we know that they're visiting the store, and we can start to reward behaviors.

Now, all the things that we do are somewhat iterative. So yes, we can do an element of personalization today, but in truth, we are going to build more and more functionality behind the scenes over the next sort of year or so. So we'll be able to get more and more granular in that. You asked a question about testing. I'm not quite sure what that was. Can you say that again?

Simeon Gutman - *Morgan Stanley - Analyst*

Yes. I think you answered it, in that does it take time to understand how the customers react before you could go and get in the marketplace and drive some of the offers?

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

I see what you mean. Yes, but the good thing about this is that you start doing something rather than nothing. So the minute you have a few thousand customers in your new database, you can start playing with it and start testing stuff.

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

I'll just add to that. We already with our database and our segmentation, we already do a lot of specific offers to different customers. So the segmentation, we know some customers respond better to a sale offer or a clearance offer. So our direct mail, many of our pieces are already segmented. So I would say we're fairly well along on that learning curve. We have a lot to go still on that learning curve. So personalization takes it to yet another level, but segmentation, we're well down that curve right now, Simeon.

Simeon Gutman - *Morgan Stanley - Analyst*

My follow-up is on product. I guess what gives you confidence that some of the new products you're working on is going to resonate? Maybe you could share with us, if you're taking bigger risk in your portfolio in terms of product? And then how do you ensure that you don't drift outside of what the comfort zone is for your key customers?

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

What was the risk question? I didn't quite get that.

Simeon Gutman - *Morgan Stanley - Analyst*

I guess in every product portfolio that you probably have a group of product that's stable, that's consistent. And then I'm guessing you're always testing either new product or new items or design that -- I meant that you might take some risk on product, not in terms of inventory but in terms of style. And you mentioned trying to differentiate.

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

I see what you're saying. Yes, well, approximately half our business comes from our reorder SKUs. So that business sort of evolves over time. New SKUs come into our reorder base and old SKUs drop out. In terms of testing, you're right. And now we have the web, which is a wonderful way that we can test new products, particularly those that may be a little outside what we've normally done. And we have many examples of where we bought merchandise into the stores that we've tested online first. So all that is true.

Our job as merchants is to take sensible business risks. You can't buy everything so vanilla that you never have the opportunity to exploit things. And frankly, that's what we pay our merchants to do, which is to be trend right and get the right balance between quality and selling price and design aesthetics. That's kind of what we do all day every day.

Simeon Gutman - *Morgan Stanley - Analyst*

Okay, thanks. Good luck.

Operator

Your next question comes from the line of Seth Basham from Wedbush Securities. Your line is open. Please go ahead.

Seth Basham - *Wedbush Securities - Analyst*

Thanks a lot, and good afternoon. My question first is around --

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

Hi how you doing?

Seth Basham - *Wedbush Securities - Analyst*

Very good. My first question is just around dimensionalizing the comp in terms of traffic and ticket. Could you give us a little bit more color on that?

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

Do you want to take that. Jeff?

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

Yes. Our practice is not to go into detail on kind of those drivers. What we do typically comment on is that it has been just generally traffic. It's been a traffic issue as much as other retailers have had. It's a traffic (technical difficulties).

Seth Basham - *Wedbush Securities - Analyst*

Got it. And are you seeing any change in the behavior of the casual shopper coming into your stores?

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

Not that we would say, no.

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

And when you look at -- if you look at our average transaction value and our units per transaction and our conversion rates, do you know they -- I mean, they move seasonally, but they really don't bounce around all that much at all. They are remarkably steady.

Seth Basham - *Wedbush Securities - Analyst*

Got it. Lastly from a financial standpoint looking at some of your online offers, we notice that there's a bit of an increase in free shipping offers. How are you thinking about free shipping and shipping fees in general as part of the promotional equation?

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

Well, I think you just answered your own question, which is we look at free shipping as just being one of the promotional offers which we can use. And we try and balance free shipping along with all of the other -- free shipping is just another discount. And we just look at it alongside all of the other discounts opportunities that we have.

Seth Basham - *Wedbush Securities - Analyst*

Okay. Thank you very much.

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

Okay. So thank you.

Operator

Your next question comes from the line of Brad Thomas from KeyBanc Capital. Your line is open. Please go ahead.

Brad Thomas - *KeyBanc Capital Markets - Analyst*

Hey, guys. To follow-up on the last topic of the DTC segment, could you give us an update on the profitability? One of the interesting tidbits that you gave out here, it sounds like the revenue was up 40% in DTC. And if you do the math on the growth of the fulfillment costs, those are up about 24%. Any more color on that would be great.

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

We just hate the backwards math that you guys always do. It drives us crazy. So what I can tell you is that if we look at the DCs in terms of the -- sorry, the fulfillment centers in terms of their cost as a percentage of the fulfilled sales, they're doing a really nice job. So we're very pleased with all of that. But as you rightly point out, because our direct-to-customer business has grown faster than the rest of the e-comm business, then that number has grown as well.

But I always like to take everybody back to our contribution from operations, non-GAAP table that you've got in the press release. We are not focused on channels. We are focused on, as best we can be, on just sales, and the customer is going to choose. She's going to shop how she wants to shop and she's going to get delivery as she wants it. So she's either going to deliver it herself by picking it up in store, or we're have to deliver it to her. Our job is to manage the cost of the fulfillment centers on the one hand and the cost of running the stores, both in terms of fixed costs and payroll and the other. And that's really what we sort of spend our time thinking about, is to how we juggle those two sets of numbers.

Brad Thomas - *KeyBanc Capital Markets - Analyst*

Great. And maybe a question for Jeff on occupancy costs. Maybe could you just give us a little update on how the dialogue is going with landlords when you bring up the subject of leaving the location or looking for rent reduction?

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

Obviously the landlords are never thrilled. But I will tell you they recognize the challenges out there in the retail environment and we are a very good tenant. We have a very good draw with the female customers in particular. So they enjoy having us as part of their retail mix overall. So they've been working with us. I would say working with us constructively on finding the right opportunity.

So oftentimes we will have rent increases scheduled from an option standpoint. Oftentimes we can take those back. At times we can even take our rent below what we're currently paying. And that's all through the negotiation process. And it's one of the reasons you're seeing some of the store occupancy costs come down. It's a combination of closures and rent reductions.

Brad Thomas - *KeyBanc Capital Markets - Analyst*

Great. Thanks, Alex. Thank you, Jeff.

Operator

Your next question comes from the line of Adam Sindler from Deutsche Bank. Your line is open. Please go ahead.

Adam Sindler - *Deutsche Bank - Analyst*

Yes, thank you. So I just wanted to confirm that the merchandise margin was about 55% in the second quarter last year. And if that's the case, then you are guiding to a 100 to 200 basis points year-on-year improvement versus down 230 basis points this year. So that's a pretty sharp acceleration very quickly. You sort of commented to the fact that the environment remains promotional.

Understandably the impact from clearance and everything from last year gets much more difficult in the second quarter giving you a much more easier compare, but it's not 400 basis points easier. So I'm wondering what drives your sort of confidence in guiding to that type of number, given that you sort of just missed here and that the comparison is maybe 200 and some odd basis points easier, not 300 or 400?

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

Yes, what does happen is two factors. Actually it started happening in the second quarter for us from a comparison standpoint. One factor is the fact that we are up against a significant level of clearance last year. Remember we had about $100 million more inventory. So really the last three quarters of the year we had to move through that. So you started to see that penalty last year. So the comparison does get quite a bit easier because we're down so much on inventory, down 16% and down quite a bit on the outdoor piece of that liability goes away.

At the same time in the quarter last year the supply chain issue started to hit us in the second quarter and for the rest of the year. And we're in good shape on the supply chain costs as we start getting into the second quarter and beyond. So the combination of those two things together actually gave us a fairly sizeable, I almost say structural opportunity to do much better. If you think about it, our 55% margin we had last year was down off a FY15 number, and I hate to say this, 59%. So we did go down 400 basis points on that overall. So we have quite a bit of opportunity given the degradation we had last year.

Adam Sindler - *Deutsche Bank - Analyst*

You usually get back about half of what you lost last year, more or less?

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

Yes, actually not even half.

Adam Sindler - *Deutsche Bank - Analyst*

Okay, perfect. I appreciate it. Thank you.

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

Okay.

Operator

Your next question comes from the line of Denise Chai from Bank of America. Your line is open. Please go ahead.

Denise Chai - *BofA Merrill Lynch - Analyst*

Great. Thank you very much. You made a comment about your higher priced outdoor furniture not selling as well as you had expected. So I'm just wondering, are you seeing pressure on opening price points? And therefore do you think you need to perhaps widen your price offering?

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

Hi, Denise. No, I think you're extrapolating that too far. I think this was a specific decision we made to test some higher price points in a specific category. And it's not that it didn't sell, it just didn't sell at the velocity that we would have wanted it to. So I don't think you can take that thought to the rest of the assortment.

Denise Chai - *BofA Merrill Lynch - Analyst*

Okay, got it. And then in terms of the competitive environment, do you see predominantly online companies as opposed to predominantly offline as the larger threat at this point? And do you see that changing at all?

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

Well, I don't think I would use the word threat, in the first place. As we've always talked about, this is a highly, highly fragmented market in terms of home furnishings. Our market share is 1% to 2% depending on what you look at the total addressable market as being. And so we gain and lose market share by just taking or giving little bits of market share to many different retailers.

Having said all that, I think the discounters have certainly set the tone. There's no doubt about that. And the marketing activities of the deep discounters, be they online or be they brick and mortar, their voice is very loud. And that is one of the reasons why we're so pleased to be back on TV because we believe that we have a great story and great product, and we just need to shout a little louder.

Denise Chai - *BofA Merrill Lynch - Analyst*

Okay, understood. If I could slip one more in. So online this quarter was 19% of revenue and I think your target previously was 20%. So do you think that it's about to stabilize at these levels?

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

No. No, I don't. I think we're going to see continued growth in e-comm, and particularly the trend in our direct-to-consumer business is very strong. And as we said in our prepared remarks, we're keeping our foot on the gas there and building out additional functionality, continuing to work on the look of the site and the mechanics of the site so that we can drive our conversion rates even higher. We talked about registry which comes online. That's an online-only activity. We've just introduced a month or so ago the ability to use gift cards online. So no, it's going to continue to grow, most definitely.

Denise Chai - *BofA Merrill Lynch - Analyst*

Thank you very much.

Operator

Your next question comes from the line of Cristina Fernandez from Telsey Advisory. Your line is open. Please go ahead.

Cristina Fernandez - *Telsey Advisory Group - Analyst*

Hi. Good afternoon.

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

Hi, Cristina.

Cristina Fernandez - *Telsey Advisory Group - Analyst*

Hi. So on the three markets where you've tested the loyalty program, are there any metrics or learnings that you can share with us with regard to the benefit you're seeing on traffic or conversions, whether it's in store or online from rolling out the program?

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

I don't think there's any -- what can I tell you that I think would be helpful? I mean, I can tell you that the response we've got from the stores is, of course, it's a much easier -- it's an easy sell because customers are not having to sign up for credit. So that has been very popular. When we talk about the benefits in terms of what they are going to get and you can either see it online or pick up a little brochure in store and it lists all of the features and benefits of the Pearl entry level.

We are getting a great response from the customers. They like the idea that they can come back into the store and check in. And that, of course, is great. So we have started to see the rewards that we put out to those Pearl customers. We are getting those bounce back. So it is having an impact on store traffic in that sense. But it's only three states, and it's --

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

It's probably a little too soon with probably the big, big benefit is almost internal to us right now in helping us with known customers. But from that then we can build upon going back out to them and driving traffic. But right now it's more of a maybe a data collection piece of it with the benefits yet to come. We're only about three months in -- two or three months into it. So the first phase is getting the known customers and then being able to go back to them, Cristina, as you say with coupons and events to get them back in.

Cristina Fernandez - *Telsey Advisory Group - Analyst*

Then as we think about the second-half sales guidance, it implies that the benefit from TV advertising would be the bigger driver as opposed to rolling out this loyalty program to the rest of the store base.

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

I see what you're saying. Yes, we have not planned in any sales growth specifically as a result of the Pearl loyalty.

Cristina Fernandez - *Telsey Advisory Group - Analyst*

Okay, understood. And then in the past you've talked about your loyal customer, the credit card customer, how is that -- how is penetration for that consumer as a percent of sales now versus a year ago? And how has behavior changed, if any, for that consumer?

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

I don't think her behavior has changed. I mean, those customers love her. In terms of a percentage of business, I think that its gone up a little bit. The guys are just checking as we're talking.

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

Kind of low 30%s but its been climbing up a little bit.

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

It's been climbing, yes. So those customers, they love us.

Cristina Fernandez - *Telsey Advisory Group - Analyst*

Thank you.

Operator

Your final question comes from the line of Budd Bugatch from Raymond James. Your line is open. Please go ahead.

David Vargas - *Raymond James & Associates, Inc. - Analyst*

Good evening. This is David on for Budd. Thanks for taking my question.

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

Hey, David.

David Vargas - *Raymond James & Associates, Inc. - Analyst*

Alex, just a quick question for you. A lot of mine have been touched upon. But in terms of your product, are there any categories that have -- the performance of that category has changed significantly at this point compared to the same point last year? Are there any that are doing better, doing worse? Anything that you can comment on there?

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

Well, I think we highlighted in the prepared remarks, we singled out table toppers as a stand-out. What I would say is we have also changed our assortment a little bit. In the recession we built a business of women's accessories and bath product, very low ticket products. But it really helps conversions during those dark days. Over the last year we have been moving out of those two departments, which has freed up floor space to allow us to expand some other higher ticket, more home furnishings business. We didn't speak to this in the prepared remarks. It seemed a bit trivial, but that also impacted our sales in the first half of the year.

David Vargas - *Raymond James & Associates, Inc. - Analyst*

Okay. And -- go ahead.

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

David, to your point kind of what we're seeing in trends, I would comment that one of the encouraging parts of the business that we see is on our seasonal events, when we run Easter events and we run July, they're not big, they're not big enough in this part of the year to drive it, but that newness and freshness as we look to Holiday and Harvest and Halloween, those are big parts of our business.

And to Alex's point about what our customers like, they really like that seasonal product on it. So we feel good about what's happened in the early part of the year and are optimistic about what can happen in the Holiday/Harvest season as we get into the bulk of our business.

David Vargas - *Raymond James & Associates, Inc. - Analyst*

Okay, thanks. And one final clarification on the guidance. I think you talked about merchandise margin, the dollars and the SG&A dollars. SG&A dollars flat to down in the back half of the year. Is that versus the same period last year that you were making the referring to?

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

Yes.

David Vargas - *Raymond James & Associates, Inc. - Analyst*

Okay. All right. Appreciate it. Thank you very much.

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

Thanks. Well, thank you everybody. Great questions today. We've enjoyed talking to you. And we'll be back in about three months. Thank you.

Operator

This concludes today's conference call. You may now disconnect.
