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PIR - Q3 2015 Pier 1 Imports Inc Earnings Call

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PRESENTATION

Operator

Good afternoon, ladies and gentlemen, and welcome to the Pier 1 Imports Third-Quarter Fiscal 2015 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 IR*

Thank you, and good afternoon, everyone. Today after market closed, we issued a press release which included the detailed financial results for the third quarter ended November 29, 2014.

In just a few moments, we will hear comments from Alex and Cary about the third-quarter and year-to-date financial results. The Company's full FY15 outlook, and the evolution of the Company's operational and financial model under our omni-channel strategy, 1 Pier 1. This will be followed by a question and answer period.

Before we begin, I need to remind you that certain comments made during this call may contain forward-looking projections or statements within the meaning of Section 27-A of the Securities Act of 1933, and Section 21-E of the Securities and Exchange Act of 1934. And can be identified by the use of words such as may, will, anticipates, believes, expects, estimates, intends, plans, projects and other similar words and phrases.

Our actual results and future financial condition may differ materially from those expressed in any such forward-looking projections or statements as a result of many factors that may be outside of our control. Please refer to our SEC filings, including our annual report on Form 10-K for a complete discussion of the major risks and uncertainties that may affect our business. The forward-looking projections or statements made today are as of the date of this call, and we do not undertake any obligation to update our forward-looking projections or statements.

The Company will also discuss the non-GAAP financial measure on this conference call. Pursuant to the requirements of Regulation G and item 10-E of Regulation SK, the Company has provided a reconciliation of the non-GAAP financial measure to the most directly comparable GAAP financial measure in our earnings press release that was issued this afternoon.

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. Joining me on the call today of course is Cary Turner, our Senior Executive Vice President and Chief Financial Officer, and also with us in the room are members of the senior executive team.

The transformation of Pier 1 Imports from one of the most profitable bricks and mortar home specialty stores into what we fully expect to be one of the most sophisticated and profitable omni-channel retailers continues. We are making profound changes to our business at a speed and in ways not attempted by others in our retail space. As each quarter goes by, we get nearer to the point when we will view our omni-channel capabilities to be sufficient to claim transition is complete.

From that point on, we expect to see progressive improvement in our operating ratios. And although we are only one quarter removed from having set out our multi-year operational and financial model under 1 Pier 1, already some stabilization in our numbers came through.

After a strong start in September, our third-quarter sales were somewhat softer than anticipated, primarily reflecting the weak traffic patterns in October. We saw meaningful improvements in November, which finished particularly strong with our five day event surrounding Thanksgiving. Although it falls just outside of the third quarter, Cyber Monday was a record day online with demand achieving a little over 25% of sales.

Our online assortments continue to grow. We now have over 2,000 online only SKUs, up more than four-fold from last year. And you can expect that online SKU growth to continue.

As you recall, last quarter, we provided you with detailed information regarding our evolution towards omni-channel. Laying out our operational and financial road map for the next two years. The headline today is that the transformation is progressing well.

We have, with our 1 Pier 1 omni-channel strategy, a strong and increasingly productive portfolio of more than 1,000 stores, and an e-commerce business that exceeded 12% of sales in our most recent quarter from a standing start in July of 2012. As e-commerce sales penetration continues to advance rapidly, we are managing the business carefully, and our teams are executing diligently. Most importantly, we are seeing evidence that we can restore our base merchandise margins to historical levels of 58% to 60%.

Our stores and our e-commerce business are interdependent. And it's clear to us that they are much more valuable together than separate. And to that end, we are pleased with the progress we are making against the six guideposts we introduced last quarter.

As a reminder, the six areas of focus are as follows. Brand traffic conversion average ticket, stores of sales and customer experience centers, merchandise margin and gross profit, fulfillment and home delivery, SG&A, and lastly, capital allocation.

First, brand traffic conversion and average ticket. Total brand traffic grew 4.3% in the third quarter, and we achieved increases in conversion significantly online and modestly in stores. The soft store traffic patterns that we saw in Q2 continued into Q3.

As those of you who follow your promotional cadence avidly already know, we cut back our across the board offers significantly in the quarter. This had some impact on store traffic in the short term, but we are confident this is the appropriate long-term strategy for our brand.

Our decision to add more selling tools to our stores, a second PC and swatch stations in all stores, as well as tablets to 600 locations is beginning to pay dividends. Our associates and customers are embracing these additional ways to shop at Pier 1 Imports.

E-commerce orders placed in-store increased from approximately 25% of e-commerce sales last quarter to nearly 30% in Q3. Having said that, our field leadership feels that we have much more potential as the store teams build on their expertise.

The accelerated investment in functionality on Pier1.com, including mobile and tablet optimization, is driving significant increases in conversion. Smartphone traffic surpassed desktop traffic for the first time in pier1.com's history on Thursday and Sunday of the Thanksgiving holiday weekend. And conversion on mobile devices was up 85% over our five day event, with demand from those devices up 150% year-over-year.

We're pleased with the quality of the creative that our marketing team has delivered. Across all media, and our print, TV, digital and on our sites. We believe our more aspirational messaging is resonating well with our customers, and helping us to grow the size of our customer database, especially the omni-channel shopper.

Moving now to our second guidepost, stores as sales and customer experience centers. Our Pier 1 Imports stores are central to our 1 Pier 1 strategy and the successful transformation to omni-channel. Our stores tell us that the frequency with which customers are asking to look at items they have browsed online is increasing.

The website is driving store traffic. The fast growing numbers of customers who shop both online and in-store is very encouraging, as they spend more than online only or store only customers. Also, the fact that 30% of online sales originate in the stores means stores are driving traffic to the web.

Two mutually supportive and independent vehicles. That's the beauty of 1 Pier 1.

We have a number of initiatives in process to drive growth in a number of our omni-channel shoppers. A key focus is our customer data excellence program, which as I told you io our last call, is in its early stages.

A major component of this, our non tender loyalty program, will launch next year. And is fully expected to drive even more momentum in building our customer base in general and our multi-channel customer in particular.

As our omni-channel platform evolves, we'll be making determinations as to the appropriate number of stores in a given market. This year, we now anticipate net closings of approximately six stores, but more on that from Cary in a few minutes.

Next, I'll turn to merchandise margin and gross profit. In the third quarter, we generated gross profit of 42.3% of sales, which is in line with the guidance we provided on our last call. And reflects a sequential improvement in our merchandise margin before fulfillment cost from the second quarter.

This was primarily driven by our refined promotional strategy, which is highlighted by a more targeted approach to promotions. Specifically in the third quarter, we finessed our strategy and cadence to reduce the frequency and debt of all Company coupons, and return to a more balanced mix between full and promotional selling. We're pleased to see progress on this front and believe we can generate more meaningful improvement in our margin rates in the coming quarters, and get back to our historical norms over time.

So here's something you've heard me say repeatedly. Our customer decides how she wants to experience the Pier 1 Imports brand. And from a profitability point of view, that's okay, and here's why.

As a result of our 1 Pier 1 strategy, there are multiple ways that our customer can purchase. Point of sale, order at home pick up in store, order from home parcel service, order from home white glove delivery, order in store pick up in store, order in store parcel service and so on.

Each of the separate ways to purchase carries a different cost to get our wonderful Pier 1 Imports products to their final destination, our customers. What we see with great clarity is that e-commerce in all its forms will improve the level of the Company's profitability over time.

Our fourth guidepost is fulfillment and home delivery. We opened, as you know, our second e-commerce fulfillment center in August, which has enabled us to add capacity and shorten delivery times. The efficiency of both the new Columbus fulfillment center and our Mansfield center have exceeded our expectations, and as I noted earlier, our fulfillment teams have done a terrific job.

By the way, focusing on inventories for a moment. Total inventory is up year-over-year, as we told you it would be, but store level inventory has increased only slightly. Some of the change is due to growth at the distribution and fulfillment centers to support Express Request and online only SKU expansion.

In addition, we have a considerable amount in transit at the moment as we plan for particularly strong floor resets in January and February to ensure we have a high degree of newness in store. Because the inventory growth is not in seasonal goods, we do not see any significant mark down risk.

Looking at selling, general and administrative expenses. Full-year expenditures for marketing and corporate admin costs are tracking to be in line with the guidance we provided last quarter. Marketing expense was up in the third quarter, as planned.

But although SG&A spend has been accelerated in recent quarters to propel our 1 Pier 1 strategy as we discussed on our last call. With top line opportunities we have in the fourth quarter, we are confident we can manage full year SG&A as a percentage of sales back to a point relatively consistent with FY14 levels.

Lastly, I'll speak to capital allocation. Our strong cash generation and balanced allocation strategy have allowed us to consistently return capital to our shareholders over the past several years. We continue to do so.

Although our profitability is currently constrained by investment in 1 Pier 1, we know this is a short-term tradeoff for medium to long-term benefits. Our management and Board remain committed to delivering shareholder value, and we plan to continue to return capital by way of stock repurchases and cash dividends.

In the third quarter, we repurchased approximately 1.8 million shares of Pier 1 Imports' stock, and today declared a quarterly dividend of $0.06 per share. Year-to-date, we've returned $189 million in cash to our shareholders, consisting of $173 million in share repurchases and $16 million in dividends.

Our merchants have done a terrific job putting together a compelling and cohesive product assortment for holiday, which is clearly resonating with our customers, judging by our sell-throughs. We are pleased with the execution of all aspects of our business. We have great associates, impactful marketing and inspirational visual merchandising both in store and on pier1.com.

Our e-commerce and fulfillment groups have managed the increased volumes very effectively. Our new e-commerce fulfillment center is running smoothly, as I've already mentioned.

Ultimately, the success of Pier 1 Imports rests on the quality and passion of our associates. We have a great organization. We have superb people at all levels who approach each day with energy and commitment, as we focus on creating great product, a great customer experience and an efficient infrastructure.

As we enter the home stretch of FY15, I want to thank all our associates for their hard work and enduring commitment to our well loved Company. We wish them a happy holiday and a prosperous new year, and to all of you as well.

Now I'll ask Cary to review our third-quarter financial results and fiscal year guidance. Cary?

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

Thank you, Alex, and good afternoon, everyone.

Total sales in the third quarter rose 4.1% to $485 million, while Company comparable sales increased 2.5%. Company comparable sales increased 3% on a constant currency basis after adjusting for a 50 basis point impact, attributable to the year-over-year devaluation of the Canadian dollar.

Looking at the cadence of the quarter, brand traffic and sales growth were strong in September, but showed some weakness in October. We finished November on a high note buoyed by the strength of Thanksgiving weekend.

E-commerce sales, including both direct to customer and pick up in store, accounted for 12.3% of total sales in the third quarter. Up sequentially from 9.7% in the second quarter of this year, and 4.2% a year ago.

Year-to-date, e-commerce sales accounted for 10.4% of total sales. This compared to 3.5% of sales during the first nine months of FY14.

As we continue to emphasize, e-commerce and the stores are mutually supportive. In the third quarter, we saw 29% of our e-commerce orders originate in the stores, up sequentially from a little more than 25% of e-commerce orders in the second quarter.

In addition, we continued to see a little more than a third of our e-commerce orders picked up in the store. Combined, over 60% of our e-commerce sales touch a store.

On a trailing 12 month basis at the end of the quarter, sales per retail square foot were $207, up from $205 at the end of last year's third quarter. Sales on the Pier 1 rewards card grew again in the third quarter, accounting for 32% of US store sales on a trailing 12-month basis. This program continues to be an important part of our business, and remains a key driver of growth.

Moving down the income statement, third-quarter gross profit was $205 million, compared to $202 million last year. As a percent of sales, gross profit declined 110 basis points to 42.3%, essentially in line with the expectations we set out on our second-quarter earnings call. The reduction was primarily attributable to the shift in our channel mix, including fulfillment costs.

Our base merchandise margins before fulfillment costs were flat year-over-year, and improved sequentially from the second quarter. We leveraged store occupancy costs by 20 basis points, which came in at $74.7 million or 15.4% of sales, compared to $72.3 million or 15.6% last year.

Looking at expenses, SG&A for the third quarter increased $12 million over the same period last year to $161 million. That's in line with the expected increase of $12 million to $14 million that we noted on our second-quarter earnings call.

As a percent of sales, SG&A increased 110 basis points to 33.2%. On a full year basis, we anticipate that SG&A as a percentage of sales will be relatively flat versus FY14.

Variable expenses were $115 million or 23.7% of sales, compared to $108 million or 23.3% of sales last year. The 40 basis point increase was primarily related to incremental marketing expense, partially offset by the leveraging of store payroll. We continue to expect the full-year marketing expense will be slightly greater than 5% of sales this year, and plan to return to our historical 5% rate next year in FY16.

Fixed expenses during the quarter were $46 million or 9.5% of sales, compared to $41 million or 8.8% of sales last year. The dollar increase is primarily attributable to planned growth in headcount and associated costs to scale e-commerce and expand our organizational capabilities in support of 1 Pier 1.

Third quarter EBITDA was $44.3 million, compared to $53.4 million last year. Depreciation increased to $12 million, up from $10 million a year ago. For the full year, we continue to expect depreciation and amortization to be approximately $47 million.

Operating income was $31.8 million, versus $43.1 million in the same period last year. For the third quarter, interest expense totaled $3 million, compared to $500,000 last year. The increase is primarily attributable to the Company's $200 million senior secured term loan, which closed in this year's first quarter.

Taxes for the third quarter were $11 million, representing a rate of 38.4%. Net income for the third quarter was $17.9 million or $0.20 per share.

Moving to the balance sheet. Inventory at the end of the third quarter totaled $536 million, up about 25% versus a year ago. This growth reflects a combination of factors.

Primarily a year-over-year increase in merchandise in transit, due to earlier deliveries in advance of the Chinese New Year. Merchandise related to the planned increase in online only and Express Request assortments, and additional inventory to support higher sales. If we look at inventory net of in transit year-over-year, they're up only about 12%.

We continue to expect inventories to be up approximately 20% at year-end. Inventory growth is expected to subside and more closely approximate the growth in sales beginning with the FY16 second quarter. Of note, delays at the West Coast ports have had no impact on our sales, but we continue to closely monitor the situation.

The Company paid $5.4 million in cash dividends during the quarter, and utilized $23.3 million to repurchase 1.8 million shares of common stock. Since the end of the third quarter, we have repurchased an additional 371,000 shares at a cost of $5 million.

Under the April 2014 $200 million share repurchase program, $123.2 million remains available for future repurchases. Currently, there are approximately 90 million shares of common stock outstanding. In the third-quarter press release issued earlier this afternoon, the Company also announced a $0.06 per share quarterly cash dividend payable on February 4, 2015.

Capital expenditures in the third quarter totaled $19 million. That spend was evenly deployed towards the opening of new and relocated stores, investments in our distribution network, and lastly, our technology initiatives.

For the first nine months, capital expenditures totaled $61.5 million. We continue to expect capital expenditures for the year to be approximately $80 million.

Turning now to real estate. During the third quarter, we opened nine stores and closed eight. Of the nine new stores, seven were relocations.

We ended the period with 1,074 Pier 1 Imports stores, including 993 locations in the US and 81 in Canada for a total of 8.5 million retail square feet. Our strategy continues to be focused on quality versus quantity.

As Alex noted earlier, we will continue to strategically review each store and each market and determine the appropriate number of stores to maximize market share and optimize our profitability. We are projecting to have approximately 1,066 stores at the end of FY15, down slightly from 1,072 stores a at the end of last year.

As we noted in our press release earlier today, we are reiterating our full year FY15 financial guidance. It's as follows.

Company comparable sales growth, which includes e-commerce in the mid to high single digit range. Gross profit as a percentage of total sales of 40.5% to 41.5%. SG&A expense relatively flat as a percentage of sales, compared to FY14.

EBITDA as a percent of total sales of approximately 11%. Net interest expense of approximately $10 million. And earnings per diluted share in the range of $0.95 to $1.05.

Additionally, for modeling purposes, you should continue to assume an effective annual tax rate of 39%.

Alex and I appreciate your continued support, and wish you all a safe and happy holiday. Now we'd like to turn the call open for questions. Kelly?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Your first question comes from the line of Budd Bugatch from Raymond James. Your line is open.

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

Thank you very much. Good afternoon, Alex, Cary and Bryan, my wishes for a good new year and happy holiday to everyone there.

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

Thank you.

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

Just run through me again what you're seeing in the stores. And you said you were off to a strong start after the Black Friday week. Can you give us maybe a little bit more as to kind of the store sales in the quarter, and what you're seeing so far as you start in the fourth quarter?

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

Well as we said, we had a strong half to the month. But of course, as you know, we're only halfway through December in terms of volume. So we feel good the way we're positioned.

We like our promotional cadence, and that's pretty much all we can say at this time. But I think except that we will as usual -- when? On January 8th, we'll certainly give you the December sales update.

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

Okay. Also, can you talk a little bit about the merchandise margin in the quarter again? Cary, I'm not sure I quite understood the comments you made. If I got right, buying and occupancy was 15.4%, is that correct?

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

Sorry, Budd. Was your question about merchandise margin or gross profit? I think we just --

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

Merchandise margin, which obviously includes both the cost of goods sold minus the cost of buying and occupancy.

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

The store occupancy was 15.4% of sales.

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

Okay. And so did you say merchandise margin was flat from year-over-year? That's what I thought I heard.

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

What you heard us say was that that number we've been sort of talking to you directionally which is merchandise margin before fulfillment center cost, that was pretty much flat year-over-year.

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

Okay. All right. And I guess final from me and I'll cede the questions to others. Cary, for the full year, you've got interest cost at $10 million. Is that about a $3 million, $3.7 million in the fourth quarter then or how does -- ?

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

Yes.

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

Okay. Thank you very much.

NEW SPEAKER

Thanks, Budd.

Operator

Your next question comes from the line of Brian Nagel of Oppenheimer. Your line is open.

Brian Nagel - *Oppenheimer & Co. - Analyst*

Hello, good afternoon.

NEW SPEAKER

Hey, Brian.

NEW SPEAKER

Nice quarter. Definitely some bright spots here. The question I had, maybe bigger picture, we've watched now, and you guys talked a lot about the transformation and omnichannel business and we've seen very, very strong sales online, it's growing now as a percentage of total sales. But as you laid out the merchandise margin back towards historic peaks, 58%, 60%, what needs to happen? What do we basically waiting for on the online sales in order to the pressure to have paid and the merchandise margins to climb back to those levels?

NEW SPEAKER

Did you mean after fulfillment center costs?

NEW SPEAKER

Yes.

NEW SPEAKER

Let me just back up, make sure I'm being really very clear with everybody. When we talk about -- we did this with you on the last call. We talk about merchandise margin before the impact of our fulfillment centers, so that we can give you guys some clarity into the impact of our promotional strategy in terms of markdowns and promotional markdowns. You'll recall, we had a lot of debate about that after the second quarter because we'd taken a big hit. What we told you this quarter, the one that we're just talking about, is that our merchandise margin before fulfillment center cost is broadly speaking the same as last year. So in other words, we've made sequential improvements Q3 over Q2 in terms of our base merchandise margin. And we expect to continue to finesse our promotional strategy going forward so that we can get back -- well, to those previous historical levels. After fulfillment center costs of course the merchandise margin is lower and will continue to be lower. So we're never going of to get to 60%, I'm looking around the table, we're never going to get to 60% after fulfillment center costs.

NEW SPEAKER

I could probably do the math had, but could you just say what -- the number you alluded to, the merchandise margin after fulfillment of cost, what was that here in the quarter?

NEW SPEAKER

Well, we didn't report that out. We just reported as we've been trying to talk to everybody about is really we need to focus on those -- on the gross profit line which you're going to see.

NEW SPEAKER

Brian, if you recall, last quarter press release talked about -- so the guidance we gave you this year is a gross profit of 40.5 to 41.5. Next year will be a little bit higher and in fiscal 2017 we should be able to get back the to thoses historical gross profit levels of 42 to 43% of sales.

NEW SPEAKER

Back to the question I was asking initially, sounds to me like what's changing then is you're getting better again with your promotional strategy and then I assume over time as we look at gross profit they are some leverage of these fulfillment costs.

NEW SPEAKER

Oh, yes, yes, yes. And we talked -- again, we talked about that quite extensively I think on the last call and said that as we go into -- as we move through next year and we see the growth in e-com sales we do expect to see leverage on that. What I also said, if you listened, there's one sentence if my prepared remarks where I said that the fulfillment centers had actually exceeded our expectations in terms of their efficiency for Q3. So we're feeling pretty good about that.

NEW SPEAKER

Got it. Just one more question, then I'll turn it over to someone else. Gas prices is a question I'm getting from a lot of our clients. How do you think about the impact on your business from lower gas prices either with respect to consumer demand or even the shipping costs?

NEW SPEAKER

Well, I think in terms of consumer demand there's so many factors go into consumer demand, it's hard to put a number on that. But of course, lower gas prices will certainly have an impact on the cost of moving goods from our distribution centers to the stores. So that is a good thing. And ultimately, it will feed through into the cost of diesel for the cost of shipping from overseas.

NEW SPEAKER

Thank you. Happy holidays.

NEW SPEAKER

Okay. Many thanks.

NEW SPEAKER

Your next question comes from the line of Jessica Mace of Nomura Securities. Your lines is open.

NEW SPEAKER

Hi. Good afternoon.

NEW SPEAKER

Hey, Jessica.

NEW SPEAKER

My first question is about that 60% of online or e-commerce sales that touch the store in some way. Is there any way that you can measure and/or drive the amount of those sales that turn into increased sales across the store as well? How can we think about that?

NEW SPEAKER

I think that's a very nice question. Unfortunately, I don't have a very nice answer for you because that's not something we can easily quantify. Having said that, the stores are very focused and it's part of the way that we discuss it with them. For those customers who come in to pick up in store and that's a good percentage of our online business, when those customers come in clearly we have an opportunity to sell them something in addition to what they've ordered online. So we're very cognizant of that. But I can't give you a sort of thumb better and say here it is.

NEW SPEAKER

Understood. On your initial expectations for about roughly 10% of sales to be online for the year, is there any way you're thinking about increased penetration in the fourth quarter or kind of updated expectations for where that will be in fiscal 2015?

NEW SPEAKER

I think our expectation of 10% actually was not for this year. It was for next year. So we're a year -- at least a year ahead in terms of participation of online. So what it's going to be for fourth quarter I'm not sure yet. As you know, as we build our business and scale it out, what I suspect we're going to see over the next few days is customers needs become more immediate, we'll see the power of our stores take over again and that more of the sales will go through the stores and online. But that's something that --

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NEW SPEAKER

see a pickup.

NEW SPEAKER

That's something we'll certainly update you on in the fourth quarter call.

NEW SPEAKER

Great. Thank you so much for taking the questions.

NEW SPEAKER

You're very welcome.

NEW SPEAKER

Your next question comes from the line of Simeon Gutman p of Morgan Stanley. Your line is open.

NEW SPEAKER

Good afternoon. This is Joshua on for Simeon. Hello. Just would you guys say the promotional environment in the last three months in the entire category has changed from earlier this year? And if so, how has the customer responded to these changes?

NEW SPEAKER

Well, I think the answer to that is it depends which part of the market you're looking at. I don't think you can say in general home furnishings, this is the environment. I think you have to look at what the different parts of the business are doing, what the big box store guys are doing, what the specialty retailers are doing and so on and so forth. So I think the conversation is more specific than that. P if I try to give it a sort of vanilla answer, I'd say we don't see anything very significantly different than we've seen in the last number of years, frankly. It became a while ago a very promotional environment and there's no sign yet that the customer's retreating from that.

NEW SPEAKER

Okay. And just on another topic, does the pickup in e-commerce sales and greater penetration imply a pickup in future investments in that channel?

NEW SPEAKER

Well, that's what we've been doing. And so if you think about the history of the Company over the last year and just to very quickly recap, we had a crawl, walk, run strategy for e-com where we were going to match the investment with the he growth of the e-com sales. But we got such an amazing response to our pier1.com and our e-com capabilities that we. Board approved acceleration of our 1 Pier 1 strategy which is why you've seen the big growth in incremental cost that we've had over the last little while. What we've also said to you is that when we go into the next fiscal year, we expect that investment to moderate as we seek to reap the benefits of the accelerated investments that we've made in this fiscal year.

NEW SPEAKER

That's reflected not just in SG&A but also our capital expenditures should decrease next year from $80 million down to $60 million to $70 million.

NEW SPEAKER

Okay. Thank you guys.

NEW SPEAKER

Okay. You're welcome.

NEW SPEAKER

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

NEW SPEAKER

Yes, good afternoon everyon. I want to follow up on this. On Jessica's question, about the 10% of sales, in the second quarter you guys did guide to $200 million this year, $400 million next year. That would be 10% of sales this year. The original guidance was 10% next year. But I just want to reaffirm that you are still guiding to $200 million. And you are well on track to that this year which would be 10%. $400million based on our sales number would be close to 20% next year.

NEW SPEAKER

You're absolutely right. I was referring to our original strategy when we --

NEW SPEAKER

okay.

NEW SPEAKER

That's all.

NEW SPEAKER

Perfect. More importantly, I wanted to talk about the loyalty program. You touched upon in your prepared comments which will launch next year. How is that different? Obviously for competitive reasons as much as you can talk about maybe, what are some new aspects of that and why it should be such a good driver.

NEW SPEAKER

Well, you're right, for competitive reasons I'm not going to say very much, except this, which is not -- everybody knows this. The more customers who we have in our database, the more we are able to market specifically to them. And the more segmented our database, the more we are able to send them targeted messaging. So non tender loyalty is a vehicle for us to get more and more customers into our database.

NEW SPEAKER

Okay. Interesting. And then just on the merchandise margins -- I'm sorry.

NEW SPEAKER

Carry on.

NEW SPEAKER

On the drag from shipping and fulfillment, would you be able to provide what that was as you have in past quarters or maybe say directionally if it was more or less than the 100 basis points from last quarter?

NEW SPEAKER

No, I think we said it was primarily attributable, about 110 basis points.

NEW SPEAKER

About 110. Okay. Okay. I appreciate it. Thank you so much.

NEW SPEAKER

Okay. Thank you.

NEW SPEAKER

Your next question comes from the line Seth Basham from Wedbush. Your line is open.

NEW SPEAKER

Hi.

NEW SPEAKER

Hi.

NEW SPEAKER

First question for you regarding sales trends, you talked about the strength of the Black Friday holiday period. Can you talk about any changes you made to promotional cadence through that period? We notice that you put some holiday decor on sale like you haven't done in the past.

NEW SPEAKER

Well, yes, we -- so let's set this in the context of our promotional cadence for the quarter. Actually, I think we have talked about is that we -- in general, we pulled back on our all store couponing and that we made our promotions much more targeted in terms of categories and departments. So that's the big picture. Underneath that of course, we did a lot of things differently on a sort of week by week basis. And certainly we had a very, very strong offer over the Thanksgiving weekend.

NEW SPEAKER

Got you. You don't think you pulled sales forward from the fourth quarter as a result of that type of strategy?

NEW SPEAKER

Well, you never know the answer to that question. I mean, we had -- what can I tell you? We had a great Thanksgiving weekend and we'll take it.

NEW SPEAKER

Good to hear. As relates to clearance levels, how do you feel about current clearance levels?

NEW SPEAKER

Well, clearance levels are a little higher than last year as we talked about on our previous call but they're well within the realms of acceptability. And again, as you can tell from the conversation about merchandise margin, we've done -- the team have done a really good job at managing the balance between mark down and promotional activity so that our net discounts, if you like, are in line with what we want.

NEW SPEAKER

Got it. And then the last question is relating to the gross margin, a little bit longer term. You talked about expectations for improvement of a couple hundred basis points over the next two years. When you break that down you're expecting merchandise margins. Occupancy to be a driver. Do you expect fulfillment costs to be positive as well? In other words what I'm asking is with e-commerce sales penetration increasing, will that be a drag on your gross margins?

NEW SPEAKER

Want to answer that, Cary?

NEW SPEAKER

As we get scale, we continue to see more and more efficiency. So it's going to come from all three.

NEW SPEAKER

Very good. Thank you.

NEW SPEAKER

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

NEW SPEAKER

Thanks. Hey, guys, it's arum, thanks for taking the question. I no he there's a lot of talk around the financial relationship between e-commerce and in-store and I know you're agnostic between those. What about from a customer experience standpoint? Want to make sure your customer's equally satisfied and that you put your best foot forward with the customer at all times, are you agnostic there too or is there room to move?

NEW SPEAKER

I'm not quite sure what you mean by that. Of course, our intention is that the customer experience is seamless and whether she visits and shops online or whether she visits and shops in-store, that she has -- that we surprise and delight her at all times.

NEW SPEAKER

The question isn't about your intention. It's just about that customer experience and how satisfied your customer is as you migrate from one channel to the next to make sure that customer's continuing to be delighted with you at the same rate as they've historically been.

NEW SPEAKER

Well, I think the fact that we're getting such great traction online really speaks to the fact that she likes that online experience and --

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NEW SPEAKER

remember, it's her who's choosing how she wants to shop.

NEW SPEAKER

Right. But you don't score customer service score in one channel versus the other or repeat customer buy in one channel versus the other to answer that which is fine.

NEW SPEAKER

Well, I didn't say that at all. We do have customer satisfaction scores which we measure all the time and clearly we measure in our matched sales those customers who repeat. And yes, we get a lot of repeat customers in stores and yes, we get a lot of repeat customers online. So I think we're pretty happy with the experience in both the stores and online at this point.

NEW SPEAKER

Thanks. And just to follow-up, the average ticket, is that held about steady between -- that spread between in-store and online during that third quarter?

NEW SPEAKER

Absolutely.

NEW SPEAKER

Thanks, guys. Have a happy season and good luck.

NEW SPEAKER

Thank you very much.

NEW SPEAKER

Your next question comes are from the line of Seth Sigman of Credit Suisse. Your line is open.

NEW SPEAKER

Thanks very much. Hey, guys. If I could just follow up on the changes that you made to the promotional strategy, obviously that helped a little bit on the gross margin from a sequential perspective. But can you just elaborate on the consumer response you saw initially. I think you indicated that maybe you saw some impact on sales from that. Just trying to understand maybe how much you gave on the top line, give up on the top line, as you shifted that strategy, even if just initially.

NEW SPEAKER

I think that's a very fair question and of course if you're anniversarying an event where you're offering 20% across the board and you're not offering 20% across the board, then clearly it makes a difference. That's why we've been very careful as we said in the last quarter, this is not something we could stop doing overnight. So what we've done is gradually reduced the number of days so that we've been as careful as we can to balance what we forego, potentially forego in sales to make sure as we always talked to you about, to maximize the margin dollars. This is very much a work in progress. We're pleased with what we've done so far but we still have some work to do.

NEW SPEAKER

I think you heard in his prepared remarks, this is really more of a finessing and we're being very surgical where we try to get that right balance of promotional activity and traffic.

NEW SPEAKER

Okay. That's very helpful. Just a follow-up question on the improvement in November and I think it may have been asked but just any more color on what do you actually think was driving that? It doesn't sound like the promotional cadence changed that much but what do you think changed there, what's resonateing with the consumer that led to that acceleration in as you think about what's embedded for the fourth quarter, just kind of walk us through how that momentum continues versus what was a little bit of a slowdown intraquarter here.

NEW SPEAKER

October was a difficult month I think across most of the retail sector. We know we certainly weren't immune from that and as we've already chatted, we didn't anniversary our promotional activity. So we felt an impact from that as well. The good news is October is the least important month of the year. November, things, again some of it was us and some of it was external.

NEW SPEAKER

Consumer.

NEW SPEAKER

It just picked up. It picked up generally, which we were pleased about. As far as December's concerned, I really can only say what I said to Budd, which is we've got 50% of our revenue still to do in December but we'll be back to you in January with an update.

NEW SPEAKER

Okay. And just one final one from he me. Clearly there's an emphasis here on some of the initiatives in the store such as the swatch station. What are you learning from that? How meaningful can that be? Do you feel like maybe there's an opportunity to capture an incremental customer there?

NEW SPEAKER

What the swatch station is allowing us to do is to expose our customers more fully to not only the SKUs that we have in-store, but also those many, many XR only SKUs which you've heard us talk about where we're offering additional fabric covers or additional finishes to cabinet furniture. And those all have swatch stations all have a PC at them as well or a tablet. So at the same time, the customers can sort of browse online, look at the options and then look at the fabric in-store. We think it's a very you powerful tool. We're pleased with the initial response. But again, I want to just take you back to something I said in the prepared remarks. When I talked to our field leadership about it, they say it's great but we're only just beginning because frankly we're still rookies at it and we need to really continue to build on our expertise into next year.

NEW SPEAKER

I do believe that one of the reasons the amount of orders that originate in the store from around the 25% to the 30%, the swatch stations, the tablets and the PC were definitely part of that.

NEW SPEAKER

Okay. Thanks, guys. Good luck.

NEW SPEAKER

Thank you very much.

NEW SPEAKER

Your next question comes from the line of Alan Rifkin of Barclays. Your line is open.

NEW SPEAKER

Thank you very much. First, just a point of --

NEW SPEAKER

hi, Alan.

NEW SPEAKER

Just a point of clarification, if I may.

NEW SPEAKER

Can you hear me?

NEW SPEAKER

Yes.

NEW SPEAKER

If total gross margin's. Before fulfillment are flat and occupancy costs are down, wouldn't that imply that fulfillment costs are down more than 110 basis points or is my math incorrect?

NEW SPEAKER

Okay, it's just a little. It's more rounding, Alan,.

NEW SPEAKER

Okay. So Cary, can you help us understand. As a percent of your costs, what do fulfillment costs represent?

NEW SPEAKER

Well, it's the merchandising, it's the fulfillment cost, it's the packaging cost, it's free delivery and also the delivery expense.

NEW SPEAKER

Okay. As a percent of costs, are you at liberty to just give us a broad range as to where that is today and where you think it might go, which will get your overall merch margins back up to 58 to 60?

NEW SPEAKER

No, Alan. So two things. First of all, we're not -- the merchandise margins after fulfillment are not going back to 58 to 60 which is really why we're doing two things. Trying to he focus on the merchandise -- directionally two things, focus on the merchandise margin before fulfillment centers so you guys have a good sense of the efficiency of our buying and merchandising organizations. And then really focusing on the growth profit, because that's where you're going to see the leverage over time.

NEW SPEAKER

Okay. Thank you. And just one more if I may. So your e-commerce revenues in the last three quarters, you were up 400 basis points sequentially in Q1, you were up 80 basis points in Q2 and now you've almost split the difference, you're up 260 basis points sequentially in Q3. And I realize that obviously the business is just growing at a very, very fast rate but with such volatility in the growth from one quarter to the next, how do you go about budgeting your expense structure on the e-commerce side? Are we planning for -- do you think like 250 basis points sequential improvement is a good run rate for what we should expect going forward or will it be more like what we saw if Q1 or more like Q2? If you could just provide a little color there, that would be great.

NEW SPEAKER

I think it will be more like Q3. The more we get into this -- remember, we're just --s this -- this is the first quarter the second fulfillment p center was fully operational. Before we start giving you numbers we want to anniversary that and get for scale.

NEW SPEAKER

A lot of those costs are variable costs. Yes, we have the fixed cost of the buildings and the materialses handling equipment and so on and so forth. But a lot of the other costs will just flex with the sales. So those are variable. And in terms of our costs in the home office, those are pretty much fixed in terms of the fact we have -- we built out the e-com team.

NEW SPEAKER

Thank you. And the capacity of the Columbus fulfillment center is what?

NEW SPEAKER

The capacity of both fulfillment centers and next year once we add the additional functionality that we'll be fulfilling furniture out of all six distribution centers, at that point we're saying we can handle 6 to $700 million.

NEW SPEAKER

Okay. Thank you very much. That's very helpful.

NEW SPEAKER

Okay.

NEW SPEAKER

Best of luck going forward.

NEW SPEAKER

Thanks, Alan, appreciate it.

NEW SPEAKER

Your next question comes from the line of Christina Hernandez of Telsey Advisory Group. Your line is open.

NEW SPEAKER

Hi, good afternoon. I wanted to ask about the fourth quarter guidance. The difference between the low and high end, the $0.10, it's a little bit wider than in the past. I know there's a lot of to go, but can you talk about what -- where do you see the biggest variability between achieving the low end versus the high end?

NEW SPEAKER

Well, I mean, the biggest variable is sales. That's kind of -- that's it.

NEW SPEAKER

We gave you the sales is a wide range and I would say the promotional cadence that gross profit between the 40.5 and the 41.5, those are the primary things.

NEW SPEAKER

And then secondly, with regard to the real estate strategy, you spoke today about closing six stores for the year. I think before you had talked about stores being up 8 to 10. Should we see this as a precursor to more store closings next year.

NEW SPEAKER

I think what you see it as a precursor to us thinking differently about our store base as we get to really understand the whole ramifications of our omnichannel strategy. And you're going to have to bear with us on this because we're learning every day. By the end of the fourth quarter, we'll be a lot smarter. I think we have told you we're looking at our multistore, some of our multistore markets and seeing if we can reduce the number of stores there. But we're not going to make any hasty decisionses, we're not going to make any near jerk decisions. But as we get clearer about all of this, we will make sure you are as well.

NEW SPEAKER

And remember, we have the flexibility where in each of the next five years about 150 stores are coming up for some type of lease evidence event and we're just looking at each store that's coming up for renewal very, very hard.

NEW SPEAKER

Thank you and good luck in the fourth quarter.

NEW SPEAKER

Okay. Many thanks.

NEW SPEAKER

And our last question comes from the line of Matt Nemer from Wells Fargo Securities. Your line is open.

NEW SPEAKER

Good afternoon everyone.

NEW SPEAKER

Hey, Matt.

NEW SPEAKER

So first, I guess sort of a bigger picture question, but if we think about the cost to fulfill to home, which is clearly I would think more on a per order basis than to ship to the store, does that get less dilutive over time because you end up charging the customer the real -- the fulfillment cost or you factored in your product price? How do we think about the spread, not on a percentage basis but on a dollar basis to fulfill to the store versus fulfill to the home?

NEW SPEAKER

Well, fulfilling to the home is obviously more expensive than fulfilling to the store. You're absolutely right on that. But we expect the fulfillment cost per item to the home also to decrease over time because we're going to get the efficiencies of throughput in the fulfillment center, number one. And we'll get smarter about all those costs. So -- and then we have to offset that, what we get in delivery revenue for each of those orders that we fulfilled to the home. Does that make sense?

NEW SPEAKER

Yes, that does. I guess I'm just trying to understand if you -- what you baked into your long range outlook. Do you think that -- do you expect there to be a day where that cost is a lot closer to the fulfill the store cost because you put it back into the product or you sort of raise shipping prices. Is that part of your expectation or no?

NEW SPEAKER

I don't think so, not at this stage.

NEW SPEAKER

Okay. And then secondly, just regarding the promo cadence, it was good to see that come down as you had forecasted. I'm just wondering if in the third quarter and kind of what we've seen in the fourth quarter if this is sort of a new -- is this the new baseline and you're sort of happy here? Should we look to see that start to come down even little bit more from here?

NEW SPEAKER

No, it's certainly not the baseline yet. We still, as we go through the rest of this fiscal year, we still have some big 20% offs to cover and some big markdowns, particularly in the back end of January and February. So we're not there yet by any means.

NEW SPEAKER

Okay. That's helpful. And then just lastly, on the inventory growth, is there any way to parts out how much is related to the Chinese New Year versus the product changes that you talked about in January and February and what specifically is driving that growth for those product changes?

NEW SPEAKER

I said, Matt, that most of the stuff that we're going to be set up in January and Feb are on the water at the end of November. So if you want to look at it this way, I gave you the number that net of merchandise in transit was up about 12%.

NEW SPEAKER

Okay. And does any of that, because of some of this port stuff potentially get stuck on the water a little longer than expected or do you feel good about that pg being on time.

NEW SPEAKER

Right now we're managing it and we're monitoring the containers that we have and we're having it come through.

NEW SPEAKER

Don't forget, we don't bring everything in through the West Coast. We bring in a lot in other parts of the country. And you know we have very deep relationships with the people who ship our goods for us. So we're just working very closely with them and it's not a great situation but we're managing it I think pretty effectively.

NEW SPEAKER

Understood. He very helpful and happy holidays, guys.

NEW SPEAKER

Happy holidays to you. Thank you.

NEW SPEAKER

So I think that was our last question. Thanks, everybody, for your questions and your interest today. Once again, merry Christmas, happy holidays. We'll send you a little press release in early January and then we'll talk to you again --

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NEW SPEAKER

in April.

NEW SPEAKER

-- in April. Thank you.

NEW SPEAKER

Thank you for attending Pier 1 Imports' third quarter fiscal 2015 earnings call. You may now disconnect.
