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JWN - Q2 2016 Nordstrom Inc Earnings Call

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OVERVIEW:

JWN reported 2Q16 diluted EPS of $0.67. Co. expects FY16 EPS to be $2.60-2.75.

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PRESENTATION

Operator

Greetings, and welcome to the Nordstrom second-quarter 2016 earnings conference call.

(Operator Instructions)

As a reminder, this conference is being recorded. At this time, I will turn the call over to Trina Schurman, Director of Investor Relations for Nordstrom. You may begin.

Trina Schurman - *Nordstrom, Inc. - Director of IR*

Good afternoon, and thank you for joining us. Today's earnings call will last 45 minutes, and will include 30 minutes for your questions. Before we begin, I want to mention that our speakers will be referring to slides, which can be viewed by going to Nordstrom.com in the Investor Relations section. Today's discussion may include forward-looking statements, so please refer to the slides showing our Safe Harbor language.

Participating in today's call are Blake Nordstrom, Co-President, and Mike Koppel, Chief Financial Officer, who will discuss the Company's second-quarter performance and the outlook for fiscal year 2016. Joining during the Q&A session will be Pete and Erik Nordstrom, Co-Presidents. With that, I'll turn the call over to Blake.

Blake Nordstrom - *Nordstrom, Inc. - Co-President*

Thank you, and good afternoon. Over the past several quarters, our team has been actively addressing our inventory, expense, and capital, as we align to current sales trends. In the second quarter, the team made substantial progress by bringing down inventory in line with sales.

We're also pleased with our customers' response to the anniversary sale. This year marked one of the best events we've had in our history, with an all-time high in sales volume. The strength of our anniversary event, along with the team's inventory and expense execution, drove better than expected results for the second quarter.

Our anniversary performance reflected an improvement from our recent sales trends. We had a strong start to the sale, and the momentum continued throughout the event. Our sell-through rates were at record highs, putting us in a clean inventory position for the second half of the year.

Customers responded favorably to newness, with shoes and beauty leading our results. As a reminder, historically, every several years we have a shift in our anniversary event, which moves one week of the event into the third quarter. As a result, our comp decrease of 1.2% was unfavorably impacted by roughly 250 basis points.

On May 18, we achieved an important milestone with the expansion of our loyalty program. Nordstrom Rewards serves as a powerful tool to drive incremental sales and trips. Even more importantly, it gives us an opportunity to strengthen relationships with customers.

In response to feedback for more flexibility in joining our program, we've expanded it so that all of our customers can earn Rewards, regardless of how they choose to pay. We're encouraged with the strong response. We now have around 6 million total Rewards customers who shopped with us over the last year, up significantly from 4.7 million last quarter.

As we head into the second half of the year, we are focused on a number of initiatives to improve the customer experience and drive top-line growth: In our Nordstrom brand, we're expanding our reach to serve more customers. We're building on the success of our Canada expansion, with two full line store openings in Toronto.

On September 16, we will open a flagship at Eaton Center, followed by another store at Yorkdale Shopping Center on October 21. In the US, we will open a second full line store in Austin, Texas, on September 30. In our Nordstrom Rack brand, we plan to open 15 stores this fall, for a total of 215 by the end of the year.

Our merchandise strategy remains focused on providing our customers with newness. Our efforts to grow relevant brands that have limited distribution play an important role in creating excitement, and attracting new customers. They now make up the majority of our top 20 fastest-growing vendors, and we're continuing to expand the most highly sought after brands like IVY PARK, Madewell and Charlotte Tilbury, with new partnerships to come.

In addition to providing a differentiated product offering, we recognize that our customers desire a personalized and convenient experience. To meet their evolving expectations, we are making digital enhancements to better serve customers, no matter how they choose to shop with us. We have several initiatives under way that include new mobile features, improvements to our website, and enhanced selling tools.

In the second quarter, we have made ongoing improvements to our mobile app, including features that enable customers to shop their store of choice, and shop for items based on a visual search. This fall, we are piloting a mobile feature that gives customers the ability to reserve merchandise online, and try in our stores.

In closing, our ability to deliver strong anniversary results, while realigning inventory and expense, speaks volumes to the quality of our team. We're proud of the team's high level of execution, and remain committed to continuing this progress. Next quarter, we look forward to providing further updates on our efforts, including our expanded loyalty program, and performance in Canada.

I'll now turn it over to Mike, who will provide additional color on our results and our ongoing efforts to improve our business models.

Michael Koppel - *Nordstrom, Inc. - CFO*

Thanks, Blake. Our second-quarter results are reflective of the ongoing efforts to realign our resources and priorities to customer expectations. This includes the progress we have made adjusting our inventory and expense, which had a positive impact on our second-quarter results. As we evolve our business model, we will continue to aggressively prioritize our resources, to ensure that we can serve customers with high-quality products and services, while achieving profitable growth.

Our earnings per diluted share of $0.67 were ahead of our expectations, driven by our strong execution of the anniversary sale, inventory management, and expense control. We are also continuing to see benefits from the strategic growth investments we've made to fuel growth in new markets and e-commerce. These investments, Hautelook, our expansion into Canada, and Trunk Club, are expected to contribute over $1 billion to our top line in 2016.

Our full line stores, Nordstrom.com, and Trunk Club had a combined comp decrease of 2.3%. This reflected an unfavorable impact of over 250 basis points from the event shift. The momentum of Nordstrom Rack, consisting of stores and online, continued with a comp increase of 5.3%, on top of last year's increase of 6.5%.

Over the last several quarters, we have been aggressively adjusting our inventory plans as consumer demand has changed. We have a complex portfolio of businesses, and combined with the uncertainty of sales trends, our merchant and planning teams were making continuous adjustments. That high level of execution, combined with a compelling product offering for the anniversary sale, drove better than expected results for the second quarter.

Our inventories are well positioned, current and in line with our sales trends. As a result, we are on the offense, focused on bringing in the latest and most compelling product offering, that resonates with our customers.

In terms of our broader efforts to improve profitability, we recognize that the shift towards e-commerce is having an impact to our financial model. As we accelerate investments to support changes in customer expectations, our expenses, particularly in technology, supply chain, and marketing, grew faster than sales. To address this, we are continuing to make operational changes to right size this trajectory.

As we shared last quarter, we identified over $150 million in productivity improvements this year, of which roughly half has been realized to date. We are streamlining corporate headquarters, and executed on a number of initiatives that will enhance the customer experience, and improve our operating model.

In technology, we're on a path to modernize our platform, and increase the productivity of delivering features that will improve the customer experience. For example, this year we implemented new technology solutions that support our expanded loyalty program and online search engine. These modernized platforms enable us to serve customers in a more personalized and relevant way.

In supply chain, we've executed on several initiatives to improve operating performance. This included optimizing our supplier network for both in-bound and out-bound carriers, reducing split shipments through a greater allocation of merchandise to our fulfillment centers, and editing out less profitable items online. A year ago, we opened our East Coast fulfillment center, which has the potential to double our fulfillment capacity, as we scale for growth.

For customers we serve on the East Coast, we've been able to speed up delivery times by over 30%, with lower unit shipping costs, due to the increased proximity to our customers. In continuing these efforts, we are further integrating Trunk Club's operations into the Nordstrom fulfillment network, with completion expected by mid-2017.

In marketing, we are repositioning our organization to better align with the customer journey and our strategic priorities around customer acquisition and retention. This includes strengthening our capabilities around customer analytics and digital engagement, so that we can reach customers in a more efficient and cost-effective manner. Our expanded loyalty program demonstrates our efforts to rebalance our marketing resources, towards a greater focus on personalization. This will help us better serve customers, and increase their lifetime value.

In addition to the adjustments we've made to inventory and expense, we have reprioritized our capital investments, to better align with changing customer expectations, and strengthen our financial position. This resulted in a 10% reduction to our five-year capital plan.

Our reduced CapEx plan of $3.6 billion is appropriately balanced between store and technology investments. We have made a modest reduction to our Rack store expansion plans, given the growth of our online business, which has doubled since the launch of NordstromRack.com, a couple years ago. All of these efforts to improve our productivity will result in a more productive use of financial resources, which is beginning to positively impact our results. During the second quarter, our cash flow from operating activities was $853 million, more than twice what it was last year.

Now, I'd like to address our financial outlook. We have adjusted our earnings per share outlook to $2.60 to $2.75, from our prior outlook of $2.50 to $2.70. As we head into the second half of the year, we believe we are well-positioned to manage our business while also being mindful of uncertainty in retail trends.

In closing, as our business evolves, we remain confident in our ability to serve customers in an exemplary way, and achieve sustainable, profitable growth. Through our ongoing efforts, we believe Nordstrom will emerge stronger and better positioned for future success. I'll now turn it over to Trina for Q&A.

Trina Schurman - *Nordstrom, Inc. - Director of IR*

Thank you, Mike. (Caller Instructions)

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Thank you. Our first question comes from Lorraine Hutchinson from Bank of America Merrill Lynch.

Lorraine Hutchinson - *BofA Merrill Lynch - Analyst*

Thank you. Good afternoon. I was just hoping that you could give us some clarity on which of the categories you saw the most sequential improvement in during the anniversary sale, and how you're modeling receipts for those specific categories coming into the back half?

Peter Nordstrom - *Nordstrom, Inc. - Co-President*

This is Pete. We experienced some good success in a few categories. You heard us call out beauty and shoes, in particular. I think with the categories within there, boots were particularly good for us in shoes. In apparel, our denim business was strong, as were sweaters.

In terms of how that impacts our inventory plans going forward, I think for us, we're really well served to try to keep our inventory plans conservative. We've been able to prove over the years that we can exceed sales plans, with conservative inventory plans. And when you do that, obviously it creates a good scenario for us in reducing markdowns.

So I think while we're happy about the sales results, we're very cautious not to over-invest either our plans, or just in the way we're allocating inventory. We're still taking a cautious approach here for the second half.

Lorraine Hutchinson - *BofA Merrill Lynch - Analyst*

Thank you.

Operator

Thank you. Our next question comes from Matthew Boss from JPMorgan.

Matthew Boss - *JPMorgan - Analyst*

Thanks. So the Rack seems to be striking a really nice balance with stable brick and mortar and then outsized online growth. But the full line still remains negative. What do you think off-price is delivering, that the full line's missing? And what's the best way to think about initiatives in place to drive better traffic at the full line?

Blake Nordstrom - *Nordstrom, Inc. - Co-President*

Well, Matthew, this is Blake. We don't look at it as the Rack is doing something that the full line store is missing. Those are different businesses. There's some similarities, but we're making terrific progress within the full line stores, and that trend improved greatly in that second quarter.

The Rack's had a more consistent business the last couple of years than the full line stores, but we have a team on the full price business, the Nordstrom brand, and we view it together, both the stores and the online as one business, and it's over time becoming more and more merged. The customer doesn't view that as two different experiences.

That said, there are experiences that put product and experiences in the store or online that the customers desires and deems is good service, and it's a fluid thing, and we're working on a number of initiatives, and we're encouraged about from the anniversary sale the feedback and response we got, and the opportunities we have going forward.

Michael Koppel - *Nordstrom, Inc. - CFO*

Matt, this is Mike. The one thing I would also add to that is, you have to look at the relative maturity of the online channel in full, and the full price sector versus the off price. We're one of the few that actually have an online offering off-price. Most off-price is done in stores. I think there's a little bit of apples and oranges there, in terms of comparing the two.

Matthew Boss - *JPMorgan - Analyst*

Great point. Good luck.

Operator

Our next question comes from Jeff Stein from Northcoast Research.

Jeff Stein - *Northcoast Research - Analyst*

Question on the service levels in the store. If you continue to see drops in same-store sales, are you making adjustments in selling payroll? Because obviously your online business is more of a variable cost model, and you've got that fixed cost in the store, and if it -- we continue to see negative comps, obviously that is going to continue to weigh on your EBIT margins. I guess I'm asking a question, I'm also making a comment. Do you risk -- if that's the case, and if you do adjust payroll on the downside, are you risking service levels, inferior service levels in the store?

Michael Koppel - *Nordstrom, Inc. - CFO*

Sure, this is Mike. The first point I would make there is, certainly a key differentiator for us is our service level. So we're very conscious of assuring that we deliver that high level of service. But keep in mind in our regular price business, in the full line stores, that's 100% commission-based sales force.

So by its very nature, it does adjust to the overall level of sales volume activity. And certainly, we also ensure that we have the right level of staffing there, to ensure that we can deliver the right level of service. So I think that's something that we'd prefer not to compromise.

Jeff Stein - *Northcoast Research - Analyst*

Okay. Thank you.

Operator

Our next question comes from Paul Trussell from Deutsche Bank.

Paul Trussell - *Deutsche Bank - Analyst*

I apologize if I missed it but did you give the actual comp for the anniversary sale? And also, if you can just touch on the narrower spread between comp and overall sales growth this quarter?

Michael Koppel - *Nordstrom, Inc. - CFO*

Yes, Paul. We didn't break out the actual anniversary sale comp. In terms of the difference between the total sales and the comp sales, the reason it was so -- the spread was so narrow is at the end of every quarter, we're required to make a number of adjustments that primarily relate to the timing of sales and the timing of returns at the end of every quarter.

And because of the high volume of anniversary, that tends to be a higher adjustment at the end of the second quarter. It's basically timing, and it's a GAAP adjustment, and that will reappear next quarter.

Paul Trussell - *Deutsche Bank - Analyst*

Got it. That's helpful. And then just a very quick follow-up. Could you just speak to merchandise margins in the second quarter versus your expectations coming in, and given where inventories are now, how should we think about that line item in the second half?

Michael Koppel - *Nordstrom, Inc. - CFO*

Well, the line item that we report is gross profit. And interestingly enough, our overall merchandise margins in our Nordstrom brand, our full price business, were roughly equal to last year.

Most of the impact we had in negative merchandise margins came through the off-price business. We also had some deterioration in the gross profit as a result of increased occupancy costs with the opening of new Rack stores. But basically, the regular price business was roughly better than expectations, but equal to last year.

Operator

Thank you. Our next question comes from Lindsay Drucker Mann from Goldman Sachs.

Lindsay Drucker Mann - *Goldman Sachs - Analyst*

Thanks. Good afternoon, everyone. I was -- is the big delta versus your expectation in 2Q the stronger execution in anniversary sale? And if so, could you talk about maybe some of the things that you might have done differently this anniversary sale versus prior sales, besides just moving the date?

Peter Nordstrom - *Nordstrom, Inc. - Co-President*

Yes, it's Pete. I think it's fair to say anniversary was a good catalyst for us, in terms of getting some positive top-line results. But I think what really made it happen for us is the way that we manage inventories, and we went in very conservative plan. At the beginning of the year, when we recognized that the sales momentum and trends were tough, we made the adjustments necessary for the sale, given the current reality of the sales trends.

Once we got that down, what happened is we ended up having very good sell-through on our anniversary product, which puts us in a great position for the fall. So that's probably what contributes to the bottom line the most, is just the efficient application and deployment of inventory.

Erik Nordstrom - *Nordstrom, Inc. - Co-President*

And I would add, this is Erik, just mainly as is usually the case, it's a product that drives -- especially anniversary. But I think we did get some lift from the enhancement of our Rewards program, launching the non-tender part of our Rewards program allowed us to connect with customers in a more direct way.

Lindsay Drucker Mann - *Goldman Sachs - Analyst*

Great. And I was hoping I could just follow up on traffic. Could you comment on sequential changes in traffic?

Michael Koppel - *Nordstrom, Inc. - CFO*

Well, we really don't track traffic within our stores. I would say generally speaking it was roughly -- for the quarter, roughly equivalent to what it has been. I don't think there was any big news there.

Operator

Thank you. Our next question comes from Kimberly Greenberger from Morgan Stanley.

Kimberly Greenberger - *Morgan Stanley - Analyst*

Okay. Thank you so much. Mike, I just wanted to follow up on the merchandise margin comments. I thought you said that the pressure in merchandise margin is coming from the off-price business.

Could you just talk about that a little bit? Is that related to returns? Is it the off-price e-commerce business that's pressuring that margin? And did you see any increased markdowns in the full-price business?

Michael Koppel - *Nordstrom, Inc. - CFO*

Okay. Yes, Kimberly, I would say the markdown pressure that we were having in off-price is primarily related to the fact that we're still working through the operational challenges of operating an integrated in-store and online business. We still don't have all our systems fully aligned. We're still working through the challenges of taking online returns in the stores and finding the right way to balance our inventories based on that kind of flow.

And so that caused us to take some more markdowns. Now, that being said, we continue to make progress there, and we're narrowing the gap, and I think as we go forward, that should continue to be a better news story for us. In terms of full line, the markdowns -- I wouldn't say the markdowns are necessarily better than they were last year, but they were certainly better than our plan for the second quarter.

Operator

Thank you. Our next question comes from Omar Saad from Evercore ISI.

Omar Saad - *Evercore ISI - Analyst*

I wanted to follow up on some of the comments you just made about the loyalty program, the tender-agnostic version, I think you rolled out in May. What you're seeing there, are you getting a lot of sign-ups from new customers, and how much you're able to expand that program in terms of members?

Is the program, from the consumer side, the same sort of benefits, whether you're participating in the credit card or whether you're a tender agnostic loyalty member, what kind of information you can get from that program as you build out that base? It seems pretty interesting from our perspective. Thanks.

Erik Nordstrom - *Nordstrom, Inc. - Co-President*

This is Erik. The program works for a non-tender, the Rewards are 1 point for every dollar spent, where it's 2 points for every dollar spent if a customer has our card. So it's a little different level of reward there.

The real appeal, the one for customers, there's just no barrier to sign up. It's an e-mail. The identifier is a customer's mobile number, and it takes a few seconds to sign up, and anyone can participate in it. So it's been received really well by customers who just see it as a very friction-free way of enhancing and being rewarded for their shopping experience.

For us, as you know, our reward program's long been one of the main drivers of our business, our retention, our loyalty, and it helps. Getting those reward notes out to customers really helps. The second piece, which I think is what you're touching on, is the information.

Having a lot more customers involved in our program, and we've signed up through the quarter about 1.5 million customers into our non-tender program. It allows us to, number one, connect with them, and number two, deliver a much more personalized experience for them. So that's the longer-term unlock that we're particularly excited about.

Operator

Thank you. Our next question comes from Paul Lejuez from Citi.

Paul Lejuez - *Citigroup - Analyst*

Just going back to the merchandise margin pressure at Rack, just curious, can you just remind us what percent of Rack's product comes from the full-line stores, and has that changed over the last couple of quarters, is that having any an impact on merch margin at Rack? When you talk about merch margins, how do you account for the product that transfers from full price to Rack that would count against full price merch margins or Rack? Where do you see that mix going forward, in terms of what percent of Rack's product comes from full price? Thanks.

Blake Nordstrom - *Nordstrom, Inc. - Co-President*

Paul, this is Blake. It's been fairly consistent for some time. Where it does change very slightly is if we change in any material way the amount of Racks we have, because the full line stores have been fairly consistent. It's approximately 15% of the merchandise at this point comes from the full line stores. And then the rest of the merchandise are with our top vendors, their close-outs and that merchandise allows us to be very current, and have a good offering in sizes and balance.

In terms of the margin, and Mike alluded to it earlier, there's different components that affect the markdowns, and part of it is the merchandise that comes from the full line stores. We're dealing with immediate impact today, but there's also a tail to it. So as we're addressing merchandise over the last -- first half of the year, it has to go through our system, both the full line stores and online and then through our Racks.

Some of that stuff that didn't sell well at full price has been challenged a little bit at off-price, and so we're taking the necessary markdowns in all of our businesses upfront, to try to address what is the right price to clear these goods. And I think overall the most important thing is whether it's the Rack or our stores, we're in one of the best inventory positions we've been in, in many years. We're able to respond to the customer, partner with our vendors, and have good flow, and a lot of good things come from that.

Operator

Thank you. Our next question comes from Brian Tunick from RBC Capital Markets.

Brian Tunick - *RBC Capital Markets - Analyst*

I think last quarter you talked about a big delta between your sale customer and your full price customer. So just wondering, prior to the anniversary sale, if you were seeing any change in customer shopping patterns? And then, as far as your gross margin opportunity to recover, price matching, I know has been a big issue, and now we talk about some of the vendors wanting to pull back themselves from the friends and family, and couponing.

Just, have you changed your perspective on what price matching means to your customer, now that it seems like every client out there is already looking at transparency?

Erik Nordstrom - *Nordstrom, Inc. - Co-President*

I'll take the first one, this is Erik, and Pete will take the second. As far as comparing our regular price customer to our sale customers, the first thing to understand is anniversary is unlike any other sale we have. I think unlike any sale out there.

It's not a clearance sale. It's not older merchandise that's priced to clear out, or broken size runs. It's brand-new merchandise that -- full size runs, that we mark back up after the sale.

So the behavior we've long seen from customers around anniversary is much more around a regular price customer who is motivated by newness, than it is a sale customer that's motivated by price promotion. So in that regard, I would say our trends have really been unchanged, that our business continues to be driven by customers who are looking for newness, as opposed to customers looking for a one-day sale.

Peter Nordstrom - *Nordstrom, Inc. - Co-President*

With regard to price matching, this is Pete. Our practice has remained the same. But I think it's fair to say that the promotional activity has stabilized a bit, here in the last quarter or so.

To the point you made, there's vendors out there choosing to participate in different ways than they may have in the past with our competitors. What we're trying to do is put ourselves in a real favorable position with vendors, to be the retailer of choice for them, and what that means for most of the vendors we deal with is our desire, strong desire to sell at full price. So we focus a lot on flow and newness and all that.

So I think in terms of the price matching thing, we've had a lot of success and growth with brands, again, that are aligned with us, and trying to sell at full price, and where you see the growth by brand at some of these brands that maybe aren't entirely ubiquitously distributed, but have good growth prospects, and we try to identify those brands early on in that trajectory. So we can partner with them to grow a really healthy business together.

Operator

Our next question comes from Richard Jaffe from Stifel.

Richard Jaffe - *Stifel Nicolaus - Analyst*

Congratulations. Really lots of good news in the call.

Blake Nordstrom - *Nordstrom, Inc. - Co-President*

Thanks, Richard.

Richard Jaffe - *Stifel Nicolaus - Analyst*

It's my pleasure. The Canadian business I know has a different leasing structure, and you're ending up paying rent before you generate sales to offset that rent. Wondering where that process stands? I know you've opened a few Canadian stores. Are you now paying rent on the next wave of Canadian stores?

And the size of that liability, if you will? And then a second question, if you would. Thank you.

Michael Koppel - *Nordstrom, Inc. - CFO*

Sure. Richard, this is Mike. As you may recall, we have shared and I think we shared directionally on one of the slides, the impact that our investment in Canada is having on our P&L. And some of that does relate to how we need to recognize rent. Right now, we have three full line stores that are yet to open that are in process, two that will open this fall, that will start to get some sales, and the third store, [Sherway Gardens in Toronto, is scheduled to open on September 15, 2017] (corrected by company after the call). So in 2017, we should start to see the overall volumes of the six stores we'll have there, start to move forward, and mitigate the loss impact from all those investments.

Richard Jaffe - *Stifel Nicolaus - Analyst*

And I read somewhere that Canada -- I'm sorry, New York City is 2019, is that in time for the holiday season, 2019, or still a work in progress?

Michael Koppel - *Nordstrom, Inc. - CFO*

Well, I would say overall it's still a work in progress. But we'd love to be open by holiday 2019.

Blake Nordstrom - *Nordstrom, Inc. - Co-President*

That's our plan, yes.

Operator

Thank you. Our next question comes from Ed Yruma from KeyBanc.

Ed Yruma - *KeyBanc Capital Markets - Analyst*

Real quickly on Trunk Club, and looking at the slide you have on 10, it looks like you've been able to point to minimization of some of the other costs of Canada and Rack.com. How should we think about the cost trajectory at Trunk Club? And then as a follow-up, I notice you tweaked your credit income guidance there a little bit. Any insight on the drivers there would be helpful. Thank you.

Erik Nordstrom - *Nordstrom, Inc. - Co-President*

It's Erik, I'll take the Trunk Club question. Trunk Club is -- we've had it for two years. It's still, I think, very much a start-up business that's having high growth. Our results have been aligned with our expectations.

But it's a business that is increasingly getting integrated in our business. The merchandising and supply chain would be the biggest examples. So it certainly helps from leveraging cost, but more it's leveraging capabilities to deliver a better customer experience. So I think you'll see us continue to find ways to integrate and leverage the strengths of our businesses, to serve customers across those channels.

Michael Koppel - *Nordstrom, Inc. - CFO*

In terms of the credit side of the business, there's a couple things in there. One is that we've made some very good progress on improving our fraud results and that has shown a better than planned performance. And in addition, we're starting to see some early signs of some benefits from our

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partnership in the revenue sharing agreement we have. We had a little good news on the top line there, and some good news within the expense and credit.

Operator

Thank you. Our next question comes from Michael Binetti from UBS.

Michael Binetti - *UBS - Analyst*

Congrats on a nice quarter. Could you help us just reconcile a couple things, really quickly? From a position of strength, I suppose as you've accelerated the Rack a little bit now, and you sound much more positive on the outlook there than you have in the last few quarters, but you did lower your long-term store outlook for Rack. I think it was part of a bigger capital tightening plan.

But is the bigger picture relatively -- this is a relatively low store count chain at this point. Can you help us think about how you see the store opportunity longer term here, if the reduction that you did was make was done more out of necessity during some fairly high volatility around the P&L that the industry saw over the last few quarters?

Blake Nordstrom - *Nordstrom, Inc. - Co-President*

Michael, it's Blake. We shared a couple quarters back that we had an estimate that we thought we could be around 300 stores by 2020. We are sensitive to the capital deployment, but as we have said, the Rack stores have been a good return on the shareholders' investment. I think what we said in our remarks, and what we're mindful of, is just the terrific growth online that's coming.

We want to be sensitive with our resources, and what we're short-term committing to. So we didn't have, when we talked about 300 stores to be exact, that include Canada. We think Canada could have roughly 15 Racks, when we're done. We start with our first Rack in 2018, I believe.

And so when we put the 15 with the reduced number, we're just shy of 300 at this point. But it's not a linear thing. When these opportunities come forward in key locations, we take advantage of that, and that could go up a little bit or it could come down. To the best of our knowledge today, we think it's just under 300 at this point by 2020.

Operator

Thank you. Our next question comes from Tom Forte from Maxim Group.

Tom Forte - *Maxim Group - Analyst*

So two things. On the East Coast fulfillment center, should we think of the benefits on shorter ship miles as immediate, or something that ramps up over time? And then on mobile e-commerce, can you talk at all about either conversion or mix of e-commerce sales that's coming from mobile e-commerce? Seems like you made some adjustments to your app and improvements there. Thank you.

Blake Nordstrom - *Nordstrom, Inc. - Co-President*

Tom, this is Blake. On the East Coast fulfillment center, it's relatively new. We opened it last fall, and it's ramping up. The first test was the holidays last year, and then our anniversary event. It hasn't gotten to full capacity.

What we're saying is that we're well positioned where a good portion of our customers live. And so we're able to improve the delivery times and our execution. But it's not at full operating strength like our Cedar Rapids facility, that's been open for some time. I think the main thing is that we're on track at this early point, one year in, and it's providing a meaningful way to service our customers, with opportunities to be more efficient down the road.

Erik Nordstrom - *Nordstrom, Inc. - Co-President*

This is Erik. On the split between mobile, desktop or e-commerce business, certainly mobile is outpacing desktop. It has been for some time. We continue to see quite a delta between those channels.

Just to clarify, we have two ways of conducting mobile commerce. One's through a mobile browser, the other's through our app. Both, we're seeing quite outsized gains in.

Operator

Thank you. Our next question comes from Neely Tamminga from Piper Jaffray.

Neely Tamminga - *Piper Jaffray & Co. - Analyst*

Congratulations on a great result here. Erik, for you, I think I remember hearing 5 million sign-ups for the Rewards of non-tender base. Did I hear that right? Is that still on track? And more importantly, anniversary sale's a great catalyst to get people to sign up. Are there incremental events planned in the back half to drive that?

And Mike, for you, a housekeeping question on SG&A. When you take that big, large anniversary sale week and move it into Q3, I think back in 2012, it actually did drive some interesting and outsized leverage on SG&A. Could you give us any sort of contextualization to guidance around like how we should be thinking about the SG&A leverage in Q3 this year, because of the shift? Thank you.

Erik Nordstrom - *Nordstrom, Inc. - Co-President*

Neely, we look at it as one program. It's our Fashion Rewards program and there's two ways for customers to participate in it. Overall, we're up to 6 million participants in the program, and we're clearly in the early stages of the non-tender offer there.

Anniversary provides a tremendous opportunity to sign up customers for our Rewards program. It always has. It's been a big driver of opening our credit accounts, previously. Now it does provide the opportunity to additionally add the non-tender portion of it. So we're very pleased with the rate of sign-ups in both the card and the non-tender, and have a lot of plans to continue that.

Michael Koppel - *Nordstrom, Inc. - CFO*

Neely, in terms of the SG&A, we haven't broken that out by quarter. Those assumptions are included in our guidance for the year. But that being said, it's probably a relatively consistent, directionally accurate relationship between what happened in 2012.

Operator

Thank you. Our next question comes from Oliver Chen from Cowen.

Oliver Chen - *Cowen and Company - Analyst*

I was curious about your customer research. On your customer research, what would you say customers really want, that you don't yet offer? What are the longer-term implications for how you allocate CapEx towards IT, to address what's evolving there? Also, related to the future, just on a long-term basis, how do you see your brand composition evolving, in terms of ensuring that you have the specialness that is required in this new version of retail that we're in now?

Blake Nordstrom - *Nordstrom, Inc. - Co-President*

I'll take the first part. I guess what do we not have that customers want? I would say --

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Oliver Chen - *Cowen and Company - Analyst*

I think you've been on top of it. You're like a case study for knowing the customer. That's what you do best. And you were ahead of the curve like five years ago with Rack and free shipping. So I'm sure like, what's 5G and Generation Z, what are they asking you for?

Peter Nordstrom - *Nordstrom, Inc. - Co-President*

This is Pete. I would say probably the evergreen subject there is, any enabler to service. Technology's been the best enabler to improving customer service that we have, and integrating multiple channels, and all that stuff. I think that's going to be an ongoing deal for us.

Outside of that, if you look at it more in the bigger picture, it has so much to do with what we have to offer, the products we have to offer. A big part of our success online, is we were able to add to our selection there, that was really helpful. Customers like that a lot.

And I think one of the things that happens slightly on the downside of that is the context it creates for some stores. There's so much more available online than there might be at any given store. Our ongoing challenge is just to do the best we can to make sure each store has the best possible product offer that it has, and the stuff that customers ask about are the things that are hard to get.

They ask for that everywhere. That has to do with some of the limited distribution stuff that's usually connected to designer, what have you. Knowing we can't get that everywhere, we do the best we can to put it in places we think it will be successful. That's been an ongoing subject for us, forever. It's just retailing, stuff that we work on every day.

Michael Koppel - *Nordstrom, Inc. - CFO*

Oliver, this is Mike. In terms of the IT, if you look at our allocation of capital today, we've got over a third of our capital focused on IT investment, and post the completion of Manhattan and Canada, it will be even a larger proportion. So we're highly committed there.

If you ask what that's going to mean to the future and what we're trying to do, so much of the investment we're making today is to build a platform that's going to allow us to, in a much more frictionless way, develop applications for the customer, to make the experience with us very dynamic and very easy. And so we're highly committed to making those investments, and the path we're on is not only are we moving very fast to make those investments, but we're also learning as we go. So we're going to continue to move down that path.

Blake Nordstrom - *Nordstrom, Inc. - Co-President*

Oliver, this is Blake. Your last question, as I recall was on brand composition, composition and level, degree of specialness. As I mentioned, both Mike and I did, we look at it from the Nordstrom brand, which is our full price stores and dot-com and Trunk Club business, and our Nordstrom Rack brand, which is inclusive of Hautelook and NordstramRack.com, as well.

We think the customer views it that way, and there's an opportunity to be current and relevant, and to ensure that the experience they have, whether online or in our stores, through our people and through our product, is meeting and exceeding their expectations, and it's a very fluid thing, and we need to keep testing and trying things and evolve, to be in lock step with our customer.

Trina Schurman - *Nordstrom, Inc. - Director of IR*

We'll now take one more question.

Operator

Our last question comes from Mark Altschwager from Robert W. Baird.

Mark Altschwager - *Robert W. Baird & Co. - Analyst*

Congrats on a nice quarter. Just wanted to dig into inventory one more time. Could you just talk about the trends you're seeing in the full line, versus the Rack? And really, are there any constraints in procuring the inventory that's needed to fuel growth in off-price?

Peter Nordstrom - *Nordstrom, Inc. - Co-President*

This is Pete. At this time, we don't really see that. Part of what Blake mentioned, in terms of what we think is a reasonable growth plan for the Rack business, we have to contemplate that, getting the supply that we need from vendors. To this point, that's not really been a challenge.

Again, if we could position ourselves as the retailer of choice, based on the type of business we're trying to do with full price, doing it at a high service, quality level, and being able to present brands in the best possible way, with all the customers that we serve, that's a compelling -- it's a compelling formula, I think, for vendors. So we just -- it's not really been a challenge for us at this point. It's ongoing. This stuff evolves. But at this point, we feel good about our plans going forward.

Trina Schurman - *Nordstrom, Inc. - Director of IR*

Again, thank you for joining today's call. A replay, along with the slide presentation and prepared remarks, will be available for one year on our website. Thank you for your interest in Nordstrom.

Operator

This concludes today's teleconference. You may disconnect your lines at this time. Thank you for your participation.
