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JWN - Q2 2017 Nordstrom Inc Earnings Call

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Co. reported 2Q17 EPS of $0.65.

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PRESENTATION

Operator

Greetings, and welcome to the Nordstrom Second Quarter Earnings Conference Call. (Operator Instructions) As a reminder, this conference is being recorded.

At this time, I'll turn the call over to Trina Schurman, Director of Investor Relations for Nordstrom. You may begin.

Trina Schurman

Good afternoon, and thank you for joining us. Today's earnings call will last 45 minutes and will include 30 minutes for your questions.

I want to mention that we'll be referring to slides, which can be viewed by going to Nordstrom.com in the Investor Relations section. Our discussion may include forward-looking statements, so please refer to the slide showing our safe harbor language.

In regards to the June 8 announcement that members of the Nordstrom family have formed a group to explore the possibility of a going-private transaction. Nordstrom does not plan to comment further on this process, including on today's call, except as and when the special committee of the board otherwise determines to be appropriate.

Participating in today's call are Blake Nordstrom, Co-President; and Anne Bramman, Chief Financial Officer, who will discuss the company's second quarter performance and outlook for fiscal year 2017. Joining during the Q&A session will be Pete and Erik Nordstrom, Co-Presidents; and Jamie Nordstrom, President of Stores.

With that, I'll turn the call over to Blake.

Blake W. Nordstrom - *Nordstrom, Inc. - Co-President & Director*

Good afternoon, and thank you for joining us. As you know, we've just completed our Anniversary Sale. It's a unique event and one that distinguishes us in the industry, as it includes brand-new arrivals that reduce prices for a limited time. Our customers look forward to our Anniversary Sale every year, and its one-of-a-kind element attracts new customers as well. This is our biggest event consistently generating significant volume that rivals the holiday period.

Our Anniversary results outperformed our recent sales trends as customers responded favorably to newness and the ability to shop the way they prefer in stores, with a mobile device and online. Our event continues to generate a strong call to action for our customers, and we increasingly see a higher penetration of digital sales. We delivered online growth of more than 20% compared to last year's sale. We also grew buy-online, pick-up in-store sales by roughly 50%. Our results demonstrated our progress in offering customers a differentiated selection of the best brands and products.

In addition to a strong sell-through rate of our Anniversary product, we had increases in our regular price sales over last year. Beauty and Women's apparel led our results, and 3 of our Nordstrom proprietary labels were among our top 5 selling brands.

Our Nordstrom cardholders, who are among our most loyal customers, highly value the rewards benefit of shopping the sale early. Unfortunately, we had some website performance issues on the first day of Early Access. Our teams responded and resolved these issues within hours. Because our customers are our top priority, we subsequently offered Nordstrom cardholders 10 points per dollar spent on purchases made during the start of Early Access. Our customers appreciate this approach, and we saw a substantial recovery in sales throughout the remainder of the day. In fact, we had the biggest day of online volume in our company's history.

Turning now to our overall sales results. We ended the second quarter with a total sales increase of 3.5% and comp increase of 1.7%. This growth was driven by our digital businesses, with Nordstromrack.com and HauteLook up 27% and Nordstrom.com up 20%.

In our full-price business, the Anniversary Sale contributed to positive gain with total sales increasing 2.4% and comp sales increasing 1.4% in the second quarter. While our full-line stores improved during the sale, the underlying trends outside of this event were consistent with our recent trend. Keep in mind that our Anniversary results won't necessarily inform our second half performance. Recall that last year, after a strong Anniversary Sale, our second half was more reflective of the trends prior to the event.

In our off-price business, total sales increased 9.8%, and comp sales increased 3.1%. This represented an improvement of roughly 100 basis points from last quarter but fell slightly below our expectation.

Looking to the rest of the year. We continue to focus on enhancing the customer experience and reaching new customers by leveraging our digital capabilities and investing in our top market. As part of our customer strategy, we're continually testing and rolling out new ways to connect the physical and digital shopping experiences. We're expanding our Reserve Online and Try In Store service from 6 stores in the Seattle area to 4 more in the Chicago market. We plan to offer this feature in roughly 50 stores by the end of the year. We've been encouraged to find that around 80% of customers who try this service choose to shop this way again.

We're executing on our digital strategy to meet our ambition for continued double-digit online growth. Through our ongoing efforts to elevate the digital experience, we expect our online penetration to exceed 25% by the end of the year. We've modernized our platform, enabling us to increase the speed and agility of enhancements to our product pages, navigation and content. In our efforts to gain market share, we continue to prioritize our investments in the top North American market.

In September, we will complete our planned full-line store expansion into Canada with a 6th store at Sherway Gardens in Toronto. And in October, we will relocate 2 full-line stores in California, 1 from Westside Pavilion to Century City in Los Angeles, and the other into a new space at University Towne Center in La Jolla.

Our Rack business is an important way to attract new customers to Nordstrom. We opened 6 stores this spring, with 11 more opening this fall, which will bring our total Rack store count to 232 at year-end.

These stores incorporate our latest store designs with improvements to the layout and fitting room experience. Additionally, we're further integrating the digital and store functionalities to improve speed and convenience for the customer. For example, we enhanced our mobile app so that customers can scan an item in store and buy it online if they want a different color or size.

Through strategic partnerships with our vendors, we continue to focus on providing customers with newness and relevant product. Our efforts to expand product with limited distribution helps us provide customers with the most relevant brand while strengthening our regular-price business.

In closing, we view our business through our Nordstrom and Nordstrom Rack brand rather than through discrete store and online channel. The combination of our physical and digital asset represents a competitive advantage. Our local market assets, our stores, salespeople, products and services, are the core of our brand and play an important role in engaging with our customers. Nearly 80% of customers who shop with us across multiple channels began at our stores. With our customers at the center of everything we do, we're appreciative of the ongoing efforts by our team to better serve them in more ways, which has contributed positively to our second quarter result.

I'd now like to introduce Anne Bramman, who joined our team as Chief Financial Officer on June 2. She is a tremendous addition to our executive team and the company as a whole and has hit the ground running in supporting our various initiatives.

Anne, I'll now turn it over to you.

Anne L. Bramman - *Nordstrom, Inc. - CFO*

Thanks, Blake, and good afternoon, everyone. But before we get started on our results, I'd like to say how excited I am to be part of this company. I've long admired the Nordstrom brand and the management team. Since being in the role for the last couple of months, my appreciation of the company's unique culture and customer-centric philosophy has only grown.

During a time of transformative change in the industry, I consider Nordstrom a leader in strategically investing for the future. In supporting the company's commitment to operating excellence, I'm focusing on evolving our business model to better serve customers and improve our performance.

Moving on to our second quarter results. Our earnings per share of $0.65 achieved our expectations. This reflected our positive Anniversary results, on-going inventory and expense discipline, and continued strength of our financial position.

Now some additional color on the drivers of our earnings. Beginning with merchandise margins. We had an improvement over last year, driven by the strength of our regular-priced selling. This exemplified our ongoing progress of providing customers with newness and limited distribution product. We ended the quarter in a good inventory position, with sales growth of 3.5%, outpacing inventory growth of 2.2%.

Our merchandise performance was more than offset by higher occupancy expenses related to new Rack and Canada stores, in addition to the unplanned 10-point loyalty accommodation that Blake mentioned. We believe this offer contributed to our top line performance, but impacted gross profit by $7 million or 20 basis points.

From an EBIT perspective, we estimate the overall impact was roughly breakeven for the quarter with potential future upside if customers redeem their points. The net impact of all these factors was 25 basis point decline in gross profits from last year.

Moving to our expense performance, we've made meaningful improvement to our operating model. As we've accelerated our investment to fuel growth over the past several years, our technology, supply chain and marketing expenses grew 20% on an annualized basis from 2010 to 2015. Last year, we made a significant step change by making a number of adjustments to increase our efficiencies. As a result, the expense growth of our enterprise capabilities was cut in half to 10%. Throughout this year, we continued to maintain this moderated expense rate for these areas.

For the second quarter, SG&A expense increased 5% from last year or approximately 45 basis points, driven by a couple of items. As we've shared at the beginning of the year, we planned a total technology investment on a cash basis of $540 million or 3.5% of sales. This all-in view captures the changing nature of our investment as we continue to shift to a cloud-based platform. This transition results in an immediate expense impact rather than capitalization.

In the first half of the year, we stayed on track with our plan as we continue to focus on improving our technology productivity. In addition, there is a mixed impact from higher supply chain costs associated with the growth of our online businesses, which accounted for 25% of our sales in the second quarter. In terms of our underlying supply chain performance, on average, cost per unit came in better than planned.

Our credit EBIT increased $23 million over last year, driven by a 30% increase in credit card revenues. This was attributable to our successful partnership with TD Bank, which continues to exceed our expectations.

Turning to our financial position. We ended the second quarter with a cash balance of approximately $900 million, essentially flat to a year ago. Year-to-date, we generated operating cash flow of $574 million and free cash flow of $115 million. Our debt leverage remain consistent with our expectation at 2.4x on adjusted debt-to-EBITDAR basis. These metrics reflect our strong financial position, which is supported by a robust e-commerce platform and high-quality store portfolio. Even through this current retail environment, we've demonstrated industry-leading growth, increasing sales by 6% on an annualized basis over the past 3 years. Since 2009, we consistently generated annual operating cash flow in excess of $1 billion while maintaining a solid investment-grade rating.

We are well positioned in the market with our stores generating positive cash flows. As Blake mentioned, we're disproportionately investing in the top market in which we serve customers. Our omnichannel business model provides favorable economics related to the cost of serving customers and strengthening our brand. As we continue to refine our approach, we'll keep you updated on how we're lining our metrics to better reflect the underlying performance of our business.

Turning now to our full year outlook. We've narrowed EPS to the high end of our range, which represents $2.85 to $3. This incorporates our second quarter performance while holding our assumptions for the second half of the year. Our top line expectations are consistent and reflects the trends we've seen over the past 1.5 years. Total sales are expected to increase approximately 4%, including $200 million for the 53rd week, while we expect comp sales to be roughly flat to last year.

Retail gross profit assumes higher new store occupancy expenses and the mix impact from off-price growth. Merchandise margins for the year should be relatively stable.

Our SG&A outlook remains consistent and incorporates higher technology and supply chain expenses associated with our growth initiatives, offset by our continued progress in productivity improvement. Our second quarter income tax rate of roughly 42% was impacted by timing. We expect to end the year with a tax rate of approximately 40%.

In closing, we remain focused on delivering a differentiated customer experience. This enables us to continue creating value for all stakeholders, including our shareholders, customers and employees.

With that, I'll turn the call over to Trina for Q&A.

Trina Schurman

Thank you, Anne. (Operator Instructions) As a reminder, we will not be commenting on the June 8 announcement. We will now move to the Q&A section.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of Ed Yruma with KeyBanc.

Edward James Yruma - *KeyBanc Capital Markets Inc., Research Division - MD & Senior Research Analyst*

Obviously, some really strong results in e-commerce. Which of that is due to kind of a desire for an Anniversary sub customer to purchase something online because out of stock in store versus what you had viewed is kind of organic e-commerce growth rate.

Erik B. Nordstrom - *Nordstrom, Inc. - Co-President & Director*

I'll take it. This is Erik. Well, a couple of comments on it. Number one, we came out of the gate superstrong online, so it wasn't that customers are going to stores and not finding their size and going to online. That being said, our online business has grown faster than our normal regular trends during anniversary for the last several years. Anniversary does seem to lend itself more and more to customers' desires on how to shop that event. And I think having real hot product at great prices that is limited in quantity does -- for many customers they prefer to search for those online. So it's been a continuation of a multiyear trend we've seen.

Operator

Next is Omar Saad with Evercore ISI.

Omar Regis Saad - *Evercore ISI, Research Division - Senior MD, Head of Softlines, Luxury and Dept Stores Team, and Fundamental Research Analyst*

It was interesting to hear how strong beauty is and is one of the best performers in your full-price stores. What do you think you guys are doing differently than the rest of the department store sector in this space which seems to be struggling and losing share to some of the newer channels out there? Your company seems to be doing quite well, which is unique in the space.

Peter E. Nordstrom - *Nordstrom, Inc. - Co-President & Director*

This is Pete. I'm not exactly sure what the other guys are doing, so it's hard for me to tell you. But I can tell you where we had success, and I think that's just with the ongoing work that we do shoulder to shoulder with our key vendor partners. And we've got a really good team in beauty that's been doing this for a while, and we've got good relationships there. I think particularly, when you look at more of the premium sector of that part of the business, we've demonstrated over several years that we have customers that they like. So we're able I think to work on programs that are unique to us and it's paid off great. And it happened the same way with the Anniversary Sale. So we've got a good thing going there, and we've had consistent strength in beauty for a while.

Operator

Next is Christian Buss with Credit Suisse.

Christian Roland Buss - *Credit Suisse AG, Research Division - United States Research Analyst on Apparel, Footwear and Softlines*

You'd indicated earlier in the year that you're expecting your e-commerce business to have a higher margin rate than your full-line stores. Could you provide us an update there?

Erik B. Nordstrom - *Nordstrom, Inc. - Co-President & Director*

Sure, this is Erik. We don't split that out precisely, so we're not going to share specific numbers on that. But I will say that EBIT performance of our online business is growing nicely.

Christian Roland Buss - *Credit Suisse AG, Research Division - United States Research Analyst on Apparel, Footwear and Softlines*

That's great to hear. And could you provide some color on the shift away from a capitalized model from your software? What are the learnings as you implement these new structures and agreements with your technology providers?

Anne L. Bramman - *Nordstrom, Inc. - CFO*

So I think part of what you're seeing is that we're still -- we're modernizing our platform, and it's allowing us to become very agile in making changes that are customer facing. Clearly, we're not quite at that inflection point yet when we look at what's going through operating expense versus what's going through capitalization depreciation. At some point in the future, we'd expect that inflection point. But right now, we're kind of, so to speak, doing both or seeing both pieces to it, but it is allowing us to become very -- much more agile in how we deal with the customer facing software.

Operator

Next is Kimberly Greenberger with Morgan Stanley.

Kimberly Conroy Greenberger - *Morgan Stanley, Research Division - MD*

Blake, I think you mentioned that the performance for the quarter was driven by the Anniversary event. And underlying results, let's say, excluding the Anniversary Sale, showed no change from recent trends. So would we assume outside of the Anniversary Sale that would have -- that the same-store sales results would have been let's say similar to the first quarter? And then secondarily, if you could just give us -- if you have any color available and care to comment any sort of range of performance from the Anniversary Sale event, that would be helpful.

Blake W. Nordstrom - *Nordstrom, Inc. - Co-President & Director*

Well, Kimberly, your first question would be correct. Yes, the separate Anniversary of the overall business was in keeping with my comments with our trends of late. I'm sorry I wasn't clear in your second question. One more time.

Kimberly Conroy Greenberger - *Morgan Stanley, Research Division - MD*

I was wondering if you care to comment on the comp result during the Anniversary period? If they were positive mid-single digit? Or if maybe even double digits?

Blake W. Nordstrom - *Nordstrom, Inc. - Co-President & Director*

We don't break out those numbers. But obviously, for the trend of the last year or 2 to be the way they are for us to have a positive full-line store event means that we had a good solid Anniversary Sale. So we don't break out those figures, but what we're trying to convey to you is that we're very pleased with our team's efforts and most importantly, how the customer responded to our offering.

Operator

Next is Mark Altschwager with Robert W. Baird.

Mark R. Altschwager - *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst*

I wanted to ask about off-price. This is, I think, the third quarter in a row you've had some deceleration in the Rack stores. Just hoping you can update us on your thoughts there. It sounds like you've rolled out some tools that allow the customers to more seamlessly shop in Rack stores but buy online. So curious if just the negative store comp is more that new normal? Or how you're thinking about the channel shift dynamics versus your broader competitive dynamics that maybe pressuring the Rack store business.

Blake W. Nordstrom - *Nordstrom, Inc. - Co-President & Director*

This is Blake. I'll take that. In one of the slides in my remarks, it shows both the full-price and off-price business. And if you look for the last 6 quarters, it's been fairly consistent ranging from on the high 8% to about 11.8% to 12% from a total business, and the comps are pretty similar. We had, in hindsight now, maybe too aggressive a plan for the year. So for this year, we've been running about 200 basis points below our plan, and that's put a little pressure on our business, and so that's why I made the comment that it was running a little bit below our expectation. But the main thing that I tried to convey in 3 or 4 of these calls now is both for the full-price business and the off-price business, we look at as the customer looks at it, both digitally and in the stores. And so though as merchants we're aware of the nuances in each channel, the most important thing is how are we doing from a multichannel point of view in off-price, and we're really pleased with our results. And we think there's a lot of positives taking place, whether that's attracting new customers, whether it's the productivity, that return on that investment, it's still a very strong part of our business, and we're encouraged about the opportunities. We have some opportunities with that plan to manage the inventory a little bit tighter. So overall, the company had good inventory control, and off-price was slightly over, given those plans. So put a little margin pressure on it. But we think that's one of our strengths. We're making those changes, and we hope to demonstrate that for you the balance of this year.

Anne L. Bramman - *Nordstrom, Inc. - CFO*

Yes. I would just like to add that even though we saw is a little bit below of our plan for the year, we actually saw our merch margins grow year-over-year in off-price.

Operator

Next is Paul Lejuez with Citi.

Paul Lawrence Lejuez - *Citigroup Inc, Research Division - MD and Senior Analyst*

Guys, wondering with your proprietary labels working so well during the Anniversary Sale, does that change how you think about the role that that part of the assortment can play for you guys in the future?

Peter E. Nordstrom - *Nordstrom, Inc. - Co-President & Director*

Yes, this is Pete. I think it really fits with the narrative that we've been sharing around here for quite some time is that, when done right, the proprietary brands can be a real asset for us. And we've had a lot of good success over the years. So I think it's nice to have that play itself out. I think, particularly as time goes on, it's pretty clear that we have to find ways to distinguish ourselves in our offer. It's important that we have strong brands but the brands aren't here to save us. That's not their job, so it's important that we can do what's within our control and we've got a really strong team in terms of product development. And it's definitely part of our plan going forward that we'll find ways to leverage that and grow it.

Paul Lawrence Lejuez - *Citigroup Inc, Research Division - MD and Senior Analyst*

So should we expect that to increase as a percentage of the assortment as we look out to the second half or into next year?

Peter E. Nordstrom - *Nordstrom, Inc. - Co-President & Director*

Well, it takes a while for it to increase much, but I think it is true that it's planned to increase. But you don't see that in very short burst. I mean that kind of happens over time. But yes, that's -- part of our plan is to increase our own label penetration.

Operator

Next is Brian Tunick with RBC.

Brian Jay Tunick - *RBC Capital Markets, LLC, Research Division - MD and Analyst*

I was curious, maybe Anne could comment. As you look at the investment impact on the P&L from, I guess, Trunk Club or the new stores in Canada and preopening in New York City and HauteLook, can you maybe talk about are there opportunities to find additional ways to stem those losses? Anything you bring from your prior companies? And then secondarily, can you maybe talk about where the leverage point is for sales on occupancy in the model going forward?

Anne L. Bramman - *Nordstrom, Inc. - CFO*

Yes, thanks for your question. So I think it's important to have that balance of (inaudible) investing in our key markets and leveraging both our digital and our physical assets, but also find that right blend, that right prioritization between serving the customer and the way they want to shop us as well as driving productivity. So we're continuing to focus on both. There are sometimes some trade-offs along the way, but it's certainly a focus as far as -- from a business model perspective as far as following the customer, but also making sure being as productive as possible in order to help our business model. So it's not a short term -- I'd like to say it's not a sprint, it's a marathon, and it's not a short-term fix. It's something that you continue to evolve. As far as the inflection point, we do have some things coming online and we talked about that as far as the generational investments. We would expect to see that flow through, especially with some of these large generational investments coming online in the future, but we're not giving guidance beyond this year.

Operator

Next is Dylan Carden with William Blair.

Dylan Douglas Carden - *William Blair & Company L.L.C., Research Division - Analyst*

Just on the higher merch margin. Can you speak to the promotional environment? And particularly what you're seeing on price matching out there?

Peter E. Nordstrom - *Nordstrom, Inc. - Co-President & Director*

This is Pete. Our percentage of promotional business is down a little bit from previous years, but a lot of that is not so much what's happening out there in the industry. I think it's been pretty consistent with the promotional activity. But our efforts whether it's our own labor or some of these brands that we've been partnering with to try to find a way to insulate ourselves to some of that. As we talked about pretty much every single quarter, I mean, what really drives our business is newness and regular price flow. And even if you look at Anniversary Sale, we did well with Anniversary product where we did particularly well with regular-priced products during the sale, too. So it's just an ongoing effort for us to be able to collaborate in ways that ensures full-price business.

Operator

Adrienne Yih with Wolfe Research.

Adrienne Eugenia Yih-Tennant - *Wolfe Research, LLC - MD and Senior Analyst Retailing, Department Stores & Specialty Softlines*

Can you discuss your online return rates and the trends there? And whether you see those returns mostly coming back to the fulfillment center? Or do they result in store visit? And if so, how can you recapture kind of the incremental sales when they come back?

Erik B. Nordstrom - *Nordstrom, Inc. - Co-President & Director*

Sure, Adrienne. This is Erik. Our online return rates, we don't break out specifically. It's come down a bit the last -- it's been over a year now that we've made some progress there. It's high, online business is high-return rate. We get over -- for full price, over 60% of our online purchase returns do come to stores. For off-price, it's over 80%, which is a real positive for us. It's an example we use a lot internally, especially in full price, because it is free for customers to mail back the returns, yet over 60% of our customers choose to do the returns in a store and because that's what they want to do. It's good for the customer and by the way, it's good for us. It's more economical for us to take the return that way. And also as you can imagine, having a store -- customer in the store is beneficial, and we really don't focus on trying to turn around that return and make a sale immediately with it. What we've learned is, a customer comes in with a return, that's their errand they have to do. And the more efficient, the faster we are in doing that, the more free time we're giving back to the customer and often times, they take that free time and start shopping. So we're really looking to take care of the customer on their terms. And if they have a great experience in our stores with a return, we certainly believe that ends up in good news for us.

Operator

Next is Lindsay Drucker Mann with Goldman Sachs.

Lindsay Drucker Mann - *Goldman Sachs Group Inc., Research Division - MD*

I wanted to ask about -- Blake, I think you said we think about these rather than stores and online as omnichannel brands. So in that context, are you comfortable -- are you guys generally comfortable with the idea that store comps could be sort of declining ongoing? And if that's the case, how do you think about managing investments into the store fleet? And also whether you have -- you've talked about some really big bold online initiatives to drive digital. What are the -- what do you consider your sort of biggest store facing initiatives to drive productivity there?

Blake W. Nordstrom - *Nordstrom, Inc. - Co-President & Director*

So Lindsay, this is Blake. I'll take part of that, then I might at the end on what's happening on the full-line stores productivity, have Jamie comment a little bit about that. But yes, in your opening comment, we do look at it in total like that. And we're mindful of, as Anne talked about earlier, how we're deploying the shareholders' capital and it needs to be balanced in stores and digitally. And our board works closely with us close on that, and that's a very fluid subject. You can't starve the stores. You need to maintain them. And so we have a fleet of 123 stores. And we think we're in good locations. All of our stores contribute and are profitable. And so when we think about that investment, it's gone from a very democratic approach to all stores kind of being the same to being more strategic and targeted. And so as we think about from a DMA point of view, the top markets are getting more of those funds. And we think that's appropriate and we think balanced with the digital offering. That's how the customer's shopping. So where we have success is looking at by the customer, by the community, by the market, how they want to shop, whether it's online, in-store and it's up to us to make sure we're deploying those resources talent and capital appropriately. In terms of some of the things we're doing in the store, I think maybe, Jamie, you can give a couple of examples there.

James F. Nordstrom - *Nordstrom, Inc. - Executive VP & President of Stores*

Sure. I think a lot of it falls under the umbrella further integrating the story and digital experience. We've been talking for a while now about our store reserve launch, which I think just this week, we've rolled out to -- we're now in 50 stores across the company. That's purely a mobile experience for customers. It can only be done through the app on their phone. And it's really, really encouraging, mostly because about 80% of the customers who try it, do it again. The repeat rate is really high, which means customers like it. Customers like having more ability to shop on their terms. The store plays a huge role in that and they're really important and they're going to be the hub of a lot of things that we do over time, which is why we want to continue investing in our most important markets. But a lot of I think the advancements in our service is going to be the things that we allow customers to do mostly via their phones to be able to shop those stores in a more efficient and in a more, frankly, enjoyable manner, which we believe is best service. Our focus is on improving service, and this is one of the chief ways we're going to be delivering on that in years to come.

Operator

Next is Max Rakhlenko with Cowen.

Maksim Rakhlenko - *Cowen and Company, LLC, Research Division - Associate*

Can you update us on handbags? How did this category perform during the quarter? And what are your expectations for back half of the year?

Peter E. Nordstrom - *Nordstrom, Inc. - Co-President & Director*

Yes, this is Pete. Handbags for us has improved some and particularly, look, over the last, I think, 1.5 years where we had some challenges, we made good progress there, and the momentum is going the right way and in particular the strongest part of our handbag has been the designer part of it. And So we're -- I think we're on a good track there, and we anticipate that, that will continue to improve. There's a little bit of a cycle to these things, but we do have some pocket success, and I think we're investing in the right way it's going forward.

Operator

Our next question comes from the line of Bob Drbul with Guggenheim.

Kevin Patrick Heenan - *Guggenheim Securities, LLC, Research Division - Associate*

This is Kevin Heenan on for Bob. I was just wondering if you could comment on how the active segment performed in the quarter? And sort of any margin or discounting trends to be mindful of in the (inaudible) in particular.

Peter E. Nordstrom - *Nordstrom, Inc. - Co-President & Director*

This is Pete again. Active, our business is very good, and that's been that way for a while as well. I mean, it's not unique because I think that's just in terms of the sensibility of how people shop, [the casual in relation to America] how Active is really a driving force in fashion trend. It's a big part of it. So that's been really good. There is some promotional activity, but we do a big business, for example, with our Zella label in women's active. It's big part of it. That's proprietary label, and we don't have price promotion pressure there. So that's really helpful. I think it's a foundational brand. On the sale, in particular, it was very successful. We're very, very pleased with that. And then it's back to the things I said earlier, even with the big brands that you may find in other places. We're finding ways to differentiate ourselves through the offer, and we've got good relationships there. So yes, there's some promotional pressure, but I think we're moving in the right direction.

Operator

Next is Matthew Boss with JPMorgan.

Matthew Robert Boss - *JP Morgan Chase & Co, Research Division - MD and Senior Analyst*

So at brick-and-mortar, outside of the Anniversary Sale, was it traffic? Or was it average unit retail that you saw continuing to impact the comp? And then just larger picture, as you think about the competition online in apparel and some new players, what do you see separating the Nordstrom experience today? And any changes to think about?

James F. Nordstrom - *Nordstrom, Inc. - Executive VP & President of Stores*

I'll take the first part. This is Jamie. With regards to traffic, we actually don't measure traffic. We use transactions as a proxy for traffic, and it was slightly improved in the second quarter relative to the trend over the last few quarters, which is to say roughly in line with our comp sales and probably pretty aligned with what we all see in terms of the reported mall traffic numbers that are out there. So a slight improvement but nothing real material.

Erik B. Nordstrom - *Nordstrom, Inc. - Co-President & Director*

This is Erik. I'll take the online question. We're focused on, which we talked about for the last number of quarters, a couple of paths you can go down there. One is around taking friction out and being convenient in a more transactional way. I think our site performed faster, page load, how many clicks to check out, those things. And a lot of that goes to the underlying architecture of our site. We've been investing to modernize our site. It's almost completely modernized. The other part of that enables, which is the other path we have to go down, is differentiating our online experience, which for us I think the right place is in addition to being a convenient, friction-free transaction is that were to be a richer experience, a place for discovery. As Pete talked about, long been the driver of our business has been newness, and we think we should have the fashion authority, the curated assortment with the customers to be a place where they come for something new and update their wardrobes. We've been investing, as you know, for quite some time, and some of those investments are starting to mature and some are in early stages. But I'd point out around technology data where we're investing, in particular around supply chain, marketing and personalization. And we're starting to see progress in all those areas and Anniversary was part of that. And supply chain, there's a reference that our cost per unit delivering was reduced year-over-year. Just from a customer experience, we delivered package faster at a lower cost this Anniversary and while also reducing the number of orders that canceled due to inventory latency in the system. So there's been good progress there that we think is really important to customers.

Operator

Next is Lorraine Hutchinson with Bank of America.

Lorraine Corrine Maikis Hutchinson - *BofA Merrill Lynch, Research Division - MD in Equity Research and Consumer Sector Head in Equity Research*

I was hoping to get an update on the New York stores. Any change to the timing of openings? And then where are we on both expense and capital outlay for the group of stores?

Peter E. Nordstrom - *Nordstrom, Inc. - Co-President & Director*

This is Pete. Regarding the timing of our opening in New York, we are on track from what we've been talking about for a while. So we're opening in March of '18, our men's store. We're opening up in fall of '19, the main tower, which will house women's. That is on track.

Anne L. Bramman - *Nordstrom, Inc. - CFO*

As far as the investment, I think we gave guidance that there was a ramp-up this year of around $30 million. And we're still on track with that for this year as well.

Operator

Our next question comes from the line of Dana Telsey with Telsey Advisory Group.

Dana Lauren Telsey - *Telsey Advisory Group LLC - CEO & Chief Research Officer*

As you think about the Rack and also the full-line, what did you see in terms of traffic trends, full price versus the Rack? And as with some new assortments coming in the Rack like the MAC Cosmetics, what else should we be looking forward to as you expand the assortment there?

Blake W. Nordstrom - *Nordstrom, Inc. - Co-President & Director*

Well, Dana, this is Blake. I'll start with that. You're very astute. You've been out in our stores. You see the MAC in there and it's a great example of a terrific vendor partnership and they had a unique opportunity, and our team was able to partner with MAC here not too long ago. And obviously, it's been really well received by the customer. That is the nature of that business, is being able to be opportunistic to work with our key vendors and to be able to take advantage of things like that. And obviously, we want to keep doing more of things along those line. It's why we're very sensitive to the inventory management because it's really important in that business even maybe more so than the full-price business that we're opportunistic in our buys and that we have open to buy and can be aggressive in that. To date, I can't think of something materially that have passed on, but we just want to stay in that mode. In terms of foot traffic in the stores, Jamie talked earlier, we don't have traffic counters, we look at transaction. We are seeing a very -- continues to be a very healthy movement of customers between the channels, and in many cases, their first experiences in the Rack and then off-price and online and they migrate into a full-price offering. And it's a great way for us to attract an aspirational customer that we're anxious to have part of our portfolio. So I don't know, Jamie, is there anything for you to add on full price?

James F. Nordstrom - *Nordstrom, Inc. - Executive VP & President of Stores*

Yes. You heard what I said earlier about full-price traffic. One way to think about it -- actually, the way we think about it is that our most profitable customers shop in multiple channels. And the better job we do for our customers in the Rack store, the more loyal they are to us across our entire fleet. So our ability to have flow of new product in those stores directly commensurate with the smile on people's face when they're working out the stores. If we do a good job of that, we start seeing them in our full-line store pretty soon, and so we've got a long track record of seeing that work and our entire team is really focus on doing that in the future.

Operator

Next is Erinn Murphy with Piper Jaffray.

Erinn Elisabeth Murphy - *Piper Jaffray Companies, Research Division - MD and Senior Research Analyst*

I guess, my question for you guys was on your loyalty comment that you made 56% of your sales are now made up from loyal members in the second quarter. That's up pretty substantially from last year and from the first quarter. So I'm curious now that you kind of lapped the broadening of your loyalty reward criterion is how much more room do you see the run on this metric? And then, Anne, just if I can on the SG&A. Retail SG&A is up , I think, $60 million-ish year-over-year a little bit higher than the trailing average of like $30 million. Just what's driving that?

Erik B. Nordstrom - *Nordstrom, Inc. - Co-President & Director*

Well, I'll take the first one. You're right, we've anniversaried our nontender launch from last year. Our professional works program continues to be very important to us and shows a lot of strength. We're encouraged that the addition of the nontender portion of the loyalty program did not erode our tender base. Our tender base has stayed pretty flat there, and we've been able to add 5 million new net members to the nontender part. So we think there is more growth there. The onus is on us to put value into the program. It's not something to set up and then forget about it. We've got to continue to find ways to make it compelling for customers and there's a number of ideas that we think are worth exploring, and again, I would say we should grow that.

Anne L. Bramman - *Nordstrom, Inc. - CFO*

As far as your question on SG&A, if you go back to the opening comment that I had, there were really 2 big drivers of that. First is the fact that our technology spend is in line with our plan on cash, but the mix between what's capitalized versus what's going through the operating expense has shifted. That's driven a little bit of increase year-over-year. And then the other big piece of it is the fact that we have higher penetration of online which drove our supply chain costs.

Operator

Next is Charles Grom with Gordon Haskett.

Charles P. Grom - *Gordon Haskett Research Advisors - MD and Senior Analyst, Retail*

Could you guys touch on the complexion of gross profit margins going forward in light of the -- any movement towards more full-price selling along with more proprietary labels and could you remind us the penetration of both those in the most recent quarter?

Anne L. Bramman - *Nordstrom, Inc. - CFO*

Okay, so I'll just give you some broad commentary in gross margin that we laid out in the guidance for the year that we really believe this to be pretty comparable or pretty stable throughout the year. I think -- if you think about we're exiting the quarter with a very good inventory position and we're continuing to be very disciplined on that going forward in the second half. And when you think about gross margin in general, just keep in mind that the higher mix of off-price does impact the overall margins.

Trina Schurman

Great, again thank you for joining today's call. A replay along with the slide presentation and prepared remarks will be available for 1 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.