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JWN - Q2 2019 Nordstrom Inc Earnings Call

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OVERVIEW:

Co. reported 2Q19 results. Expects 2019 sales to decline approx. 2% and EPS to be $3.25-3.50.

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PRESENTATION

Operator

Greetings, and welcome to the Nordstrom Second Quarter Earnings Conference Call. (Operator Instructions) We'll begin with prepared remarks followed by a question-and-answer session. (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 - *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 we'll be referring to slides, which can be viewed by going to the Investor Relations section on nordstrom.com. Our discussion may include forward-looking statements, so please refer to the slides showing our safe harbor language.

Participating in today's call are Erik Nordstrom, Co-President; and Anne Bramman, Chief Financial Officer, who will discuss the company's second quarter performance and outlook for 2019. Joining during the Q&A session will be Pete Nordstrom, Co-President.

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

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

Thank you for joining us today. In the second quarter, we delivered strong bottom line results, demonstrating our inventory and expense execution. We exited the quarter with inventory levels in a favorable position and made significant strides in productivity. We are implementing key learnings from the quarter to drive our top line and deliver bottom line results.

In the second quarter, sales were down 5.1%, which was around the low end of our expectations. Full-Price decreased 6.5% and Off-Price decreased 1.9%. We anticipated first quarter trends to continue, however, we had a slow start to the second quarter and softer results in both Full-Price and Off-Price.

Last quarter, we emphasized our top line focus related to loyalty, digital marketing, and merchandising. We've seen good outcomes from our efforts, including improvement in Nordstrom Note redemptions. From a merchandise perspective, we're improving our in-stock levels and addressing a gap between our opening and higher price points. We ended the quarter in a strong inventory position, giving us the ability to better align our assortment in the second half of the year.

Now I'd like to provide insight into 2 drivers of our business performance, our Full-Price Anniversary Sale and our Off-Price business. Starting with anniversary, this is a unique event featuring new arrivals at reduced prices for a limited time. Our anniversary strategy focused on 3 objectives: increasing customer satisfaction, driving sales, and improving the economics of the event. We're seeing early indications that our event resonated well with customers. That said, we planned anniversary consistent with current trends, but sales were softer than expected.

Based on customer feedback, we curated our Anniversary assortment to highlight their favorite brands, which drove higher sell-through of anniversary product relative to last year. We expect this to benefit merchandise margins in the third quarter, and we'll have a complete assessment of our overall Anniversary results at that time.

While we increased depth in top brands, the event has become even more concentrated around key items. We did not have enough depth in key items, and we are actively addressing this in the second half, particularly with our top gift ideas for the holidays.

During anniversary, we improved our operational metrics around satisfaction scores, delivery times in key markets, and site performance. This includes initial survey feedback from our top loyalty customers who value the enhanced benefits such as earlier access to merchandise. We also leveraged our digital and physical assets through Buy Online, Pick Up in Store, which increases customer engagement and is one of our most profitable transactions. During anniversary, sales from order pickup more than doubled over last year with nearly half coming from customers using this service for the first time. Customers who engage through order pickup tend to double their overall spend.

Turning to Off-Price. We are pleased with our profitability results. However, sales fell short of our expectations. Earlier this year, we made changes to improve our bottom line, which included reducing less profitable flash events. Because these events help drive meaningful traffic to our Nordstrom Rack and HauteLook sites, we are increasing the number of high-quality flash events in the second half. We are also accelerating our marketing efforts to drive traffic, such as the upcoming launch of our Nordstrom Rack television brand campaign.

The Off-Price business ended the quarter in a strong inventory position, improving turns across all merchandise positions. As we head into the second half, we are being opportunistic in the marketplace with plans to accelerate fall receipts.

In this dynamic retail environment, we are evolving our business to create a seamless shopping journey. Historically, we know that more than 1/3 of customers who place an online order will have visited the store to help inform that purchase, and half of our customers who make a purchase in our store will first spent time on one of our digital properties. Our local market strategy leverages our physical and digital assets to provide greater access to merchandise selection with faster delivery and at a lower cost to us. This strategy focuses on gaining market share in our most important markets by leveraging inventory and increasing customer engagement through the services we offer.

Our business is highly concentrated in our top markets with the top 10 accounting for 60% of our sales. This year, we scaled our local market strategy in Los Angeles, our largest market. We're seeing compelling results and predictive metrics for customer engagement and inventory efficiencies. We're seeing higher customer engagement and spend at our Nordstrom Local neighborhood service hub. Customers spend 2.5x more on average.

These service hubs account for 30% of order pickup, and alterations increased by more than 10%. In addition, product returns are coming in 8 days faster, driving greater inventory efficiencies.

To leverage inventory across the broader L.A. market, we began offering customers up to 7x more selection that's available next day. This contributed to sales from order pickup nearly tripling in July. We are pleased with our results in L.A. and are accelerating key elements of our local market strategy in more of our top markets.

Our next milestone is expanding our presence in New York City, currently our largest market for online sales. This fall, we will significantly expand our presence with the opening of our flagship store and 2 Nordstrom Locals. We anticipate that the combination of our physical and digital assets will drive a meaningful sales lift in this important market. We will also leverage our 7 locations in New York City, including Nordstrom Rack and Trunk Club locations, to take care of our customers through services such as returns, order pickup and alterations.

In closing, we're focused on driving our top and bottom line results, and we are well positioned for the second half. Nordstrom has managed through many cycles, and we will continue to evolve our business to better serve customers on their terms no matter how they choose to shop.

I'll now turn it over to Anne to provide additional color on our financial performance and outlook.

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

Thanks, Erik. Our second quarter earnings demonstrated our continued inventory and expense discipline. We are in a strong position to rebalance our merchandise assortment with customers' demand across price points and key items. We also made significant progress in bending the expense curve, mitigating our sales shortfall.

Second quarter sales reflect a consistent traffic trend while conversion was softer relative to the first quarter. Heading into the second half, we continue to take aggressive actions related to loyalty, digital marketing and merchandise. Our progress in the second quarter and plans for the second half give us confidence in our ability to turn around our current trend.

Beginning with loyalty. We continue to grow the program with 12 million active customers, increasing 12% over last year and making up 64% of second quarter sales. We have addressed the execution related to Nordstrom Notes, and redemptions are in line with expectations. Enrollments are up over last year, and importantly, we saw a significant improvement in customer satisfaction scores during the quarter.

With respect to digital marketing, we increased our level of investment in Full-Price and have further plans to accelerate Off-Price. For example, in the first half, we had a 25% year-over-year reduction of flash events and plan to get back to prior year level with high-quality events. And third, in merchandising, we made initial investments in Women's Apparel to address the gap in our assortment from a price point perspective. We are encouraged by the sell-through performance, and we're accelerating plans for the second half.

In addition, we're applying our anniversary learnings to increase depth in key items. Specifically, for the holidays, we're amplifying our gift assortment across categories and increasing the mix of more accessible price points.

For the second quarter, our gross profit rate decreased 50 basis points from last year due to occupancy deleverage. Q2 merchandise margin rate relative to last year improved sequentially from Q1, and markdown levels were consistent with our expectations. We ended the quarter in a solid inventory position, reflecting 2 consecutive quarters with a positive spread to sales.

Expense performance well exceeded our expectations. Our SG&A rate in Q2 increased modestly by 26 basis points, reflecting fixed-cost deleverage on lower sales volumes. SG&A expense was down 4% compared to the previous year. This was primarily due to our expense savings in addition to performance-related adjustments. To date, we have delivered expense savings of $100 million, tracking ahead of our annual plan for $150 million to $200 million. Our efficiency initiatives include realignment of our support structure in stores, end-to-end process improvement in supply chain and technology and lower discretionary spend. These initiatives represent permanent reductions to our cost structure that position us well for strong EBIT flow-through.

During the second quarter, we also managed variable expenses well in a tough sales environment and maintained flat overhead expenses. Expenses related to digital capabilities, marketing, technology and supply chain were relatively flat to last year. Our 2Q EBIT margin of 5.7% deleveraged by 47 basis points over last year, a meaningful improvement from Q1. EBIT from generational investments met our expectations.

Moving to the full year. We lowered the top end of our prior outlook to a revised EPS range of $3.25 to $3.50. We expect a sales decline of approximately 2% for the year versus the prior outlook range between a 2% decrease to flat growth. The impact of tariffs has not been incorporated into our outlook, but we believe it will be relatively immaterial for the year.

Now I'd like to provide color on our assumptions for the second half. Sales are expected to be flat at the midpoint, reflecting roughly a 400 basis point improvement from the first half. This incorporates 4 sales drivers, all of which are weighted equally. First, our merchandise plans include rebalancing our assortment, increasing depth of key items and accelerating opportunistic buys for Off-Price. Second, we are accelerating our marketing efforts, including our Nordstrom Rack television brand campaign and additional flash events in Off-Price while continuing digital marketing investments in Full-Price. Third, we will lap last year's Nordy Club launch with respect to Nordstrom Notes with most of the impact in the fourth quarter. And fourth, sales in the New York flagship opening on October 24 will primarily benefit the fourth quarter.

For the third quarter, we expect sales to improve modestly from the first half. We expect gross profit rate expansion from improved sell-through of anniversary product. We also expect our SG&A rate to deleverage from fixed costs, which includes preopening expenses for our New York flagship. Third quarter EBIT margin is expected to be relatively flat, including last year's estimated credit-related charge. For the fourth quarter, we expect the New York City flagship opening to contribute sales in the fourth quarter as well as occupancy deleverage.

Taking a step back, our framework to drive shareholder value remains consistent: gain market share, improve profitability and returns and maintain a disciplined capital allocation approach. We're focused on driving the top line, leveraging inventory, and bending the expense curve. Over time, we expect our generational investments to further scale and contribute to improved profitability and return on invested capital.

We have a strong balance sheet and maintain a consistent approach to capital allocation. As we exit this year's heavy investment cycle, we expect moderating CapEx and accelerating free cash flow beyond 2019. CapEx levels are expected to moderate from 6% this year to 3% to 4% of sales, an appropriate level to fund our strategic objective. In terms of the long-term financial targets we shared a year ago, we're focused on delivering on our current year expectations and intend to revisit those targets after we finish the year.

In closing, our priorities are to drive our top line, improve profitability and execute key strategies to enhance the customer experience.

I'll now turn it over to Trina for Q&A.

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

Thank you, Anne. (Operator Instructions) Also, as a reminder, the company does not plan to comment on market rumors or speculations. We will now move to the Q&A session.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Our first question comes from Edward Yruma with KeyBanc Capital Markets.

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

I know you indicated that your strategy of kind of deeper in brands that the customer loves seemed to have worked. But just try to help us understand a little bit some of the conversion issues you experienced. And you obviously indicated that the presale did well or at least the customers responded to it. So I guess just kind of what did the consumer not like about anniversary that contributed to the soft top line?

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

This is Erik. Yes. We did go into the event -- go narrow and deeper on brands. We edited out some of the long tail of our brands and went deeper in our customers' favorite brands. That being said, we didn't go far enough. We simply ran out of our top items. Obviously, we have a long history with Anniversary Sale. There was a change this year in customer behavior. Certainly, we always see a highly disproportionate amount of demand on our top items. What was different this year was how deep that disproportionate amount was. We saw more demand on our top items than we've seen previously. And we simply ran out faster of our top items than we had planned.

So we're encouraged that I think our buyers did a great job of picking the right items and putting the dollars in the best items. We just should have, could have done a better job of going deeper on those top items.

And another point, you brought up the Early Access portion. As we mentioned, we had a lot of good customer feedback on the changes we've made this year. But again, I think what could we have done better, we could have had deeper positions on our top items.

Operator

Our next question comes from Omar Saad with Evercore.

Omar Regis Saad - *Evercore ISI Institutional Equities, Research Division - Senior MD and Head of Softlines, Luxury & Department Stores Team*

Wanted to follow up on a lot of the detail and commentary you made on the Los Angeles market local. Maybe you can elaborate what it is about this experience where you're seeing your loyal customer who gets free shipping and returns go into the store, order online, pick it up in the store. And how do we make sense of that in an e-commerce shipping world? And then what is it -- what are the inventory implications on the other side, at least within the Los Angeles market, and maybe at least theoretically, thinking about it longer term as you expand this kind of strategy to other markets?

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

Thanks, Omar. Yes. There's clearly -- being able to have the broad selection that customers are coming or accustomed to online, but being able to pick it up in store resonates with lots and lots of customers. Just looking at a lot of retailers results this last couple of weeks, seems to me there's a pretty common thread there of some successes in various categories of probably doing this. We've had BOPUS capabilities for quite some time. We did make some changes. And most impactfully in Los Angeles, we greatly increased the selection that customers have in doing a Buy Online, Pick Up in Store for next day. Specifically, we're able to leverage the entire market's inventory that we have in stores and let the customer choose where they want to pick it up. We're able to move around that inventory very efficiently between our stores in the market, get it there quickly. And customers love it. Our customer satisfaction scores on that service are amongst the highest we have of anything we do.

And you mentioned the inventory implications of that. Part of our local market strategy is getting to a different level of inventory efficiency, in particular, having the capabilities of holding back inventory and allocating it as needed to -- be it stores or be it to customers' home. We haven't done that yet. We're still working on that. We've done some testing. We're getting in a position to do that. But we certainly think that, that's the next step of Nordstrom Local is getting even a bigger selection to customers, having fewer out-of-stocks and, for us, reaching another level of inventory efficiency.

Operator

Our next question comes from Oliver Chen with Cowen and Company.

Oliver Chen - *Cowen and Company, LLC, Research Division - MD & Senior Equity Research Analyst*

Regarding the product opportunity ahead and thinking about rebalancing in key items and the investments you need to make, is it very different on the Full-Price side versus Rack? And how -- as you do approach holiday, a key topic is value as well as recommerce and sustainability. Would love your thoughts.

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

Yes. This is Pete. I think, for us, just being more thoughtful and purposeful about how price impacts our offering. And it's particularly clear with holiday, we've been able to get objective information about how customers purchase gifts and the prices that they're really looking for from us. And we just -- we're going to be much more purposeful at having the proper amount of inventory, first of all, in the gift classification that makes sense, but also at prices that work. And for us, really more of that $50 to $150 or $200 kind of price points, and so we have a pretty broad range of prices that we have to offer. And it doesn't serve us well just to have kind of a democratic approach across every category that we're in. We need to step back and figure out where to invest the money to be a better gift destination for customers. And I can just tell you, in our experience of being around, it feels like the most purposeful attempt for us to improve in terms of being a gift destination. So we think we've learned a lot. And as Erik mentioned, anniversary, I think, was helpful in kind of understanding depth of stuff. So we feel good about our chance to have a good holiday as a result of that.

As you talked about price and what happens in Off-Price and Full-Price, it is a version of it that's applicable in both places, and we're trying to be thoughtful and surgical about how we're doing it. So I just think it puts extra focus on our ability to be good editors and curators, something we've been able to approach with some more objective information. We have better data than we've ever had before. So again, I think from our point of view, it feels like less opinion-based thing and it's much more purposeful around objective information.

Oliver Chen - *Cowen and Company, LLC, Research Division - MD & Senior Equity Research Analyst*

Okay. Great. And would love your thoughts on recommerce. I mean Nordstrom's been really ahead of the curve with what customers want. And I know you have an innovative partnership with Rent The Runway.

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

Yes. Well, thematically, it's abundantly clear that the whole sustainability subject is really important to lots of customers, and so it's important to us. And I think the recommerce thing plays right into that. And there's a bunch of things that we're working on that we're really not in a position to fill you in on right now because a lot of things are in flight. But I think it's fair to assume that as a major theme for our merchandising strategy, that is right at the heart of a lot of it. I mean it gives us a great opportunity to work collaboratively with our brand partners to figure out how to satisfy customers better on that score.

Operator

Our next question comes from Jay Sole with UBS.

Jay Daniel Sole - *UBS Investment Bank, Research Division - Executive Director and Equity Research Analyst of Softlines & Luxury*

Erik, I appreciate your comments on the Anniversary Sale. If you take a step back, maybe just help us understand, sales for the company were down 4.3% in the first half. If you could pick out maybe 2 or 3 real big-picture things that explain why the sales growth rate have slowed down so much from where it was historically going back 5 or 10 years, that'd be really helpful.

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

Sure. Well, first, I'd start with what we talked about in first quarter, we identified 3 areas: loyalty program, digital marketing and the balance of our merchandise assortment. We've made good progress on the first 2, the loyalty program and digital marketing. We saw general good traffic across our properties.

As we talked about in the first quarter, the merchandise assortment takes longer. We obviously have buys in place. And around that, we have opportunities in the balance of our price points and we have opportunities in being in stock in these top items that we've been talking about. We've seen some encouraging signs there. That rebalancing is underway, but we expected that to have more traction in the third quarter and the fourth quarter than we did in the second quarter.

Jay Daniel Sole - *UBS Investment Bank, Research Division - Executive Director and Equity Research Analyst of Softlines & Luxury*

Do you feel like that the company organizationally is the right structure? And what do you feel like is the key to sort of driving traffic back into the stores -- I mean driving that store sales growth rate back to a higher level?

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

Well, as you know, we've been working on our local market strategy for a couple of years now, and that is progressing. We started last year in L.A. really to do a lot of testing with customers, a lot of listening of how we can connect our digital and physical assets to better serve customers. This year, it's really been about scaling it in L.A. We started with our 4 stores in L.A. We've now expanded in particular that Buy Online, Pick Up in Store, greater selection for next-day delivery across 16 stores in Los Angeles, Orange County as well as our 3 local stores. And we're seeing really tremendous traction on that service in particular.

But stepping back, it's looking at our physical assets as points of engagement as much as they are points of sale. We really don't care where the sale gets rung up. And we continue to learn that those physical assets that when leveraged really how customers want make a tremendous difference. We've talked about Buy Online, Pick Up in Store. We know our customers who use that service spend double those that don't use it.

I think others talked about alterations before. Alterations is obviously something that can't be done digitally, and it's something we're really good at. We're the largest employer of tailors in North America. I think we have the best tailors that are out there. And we know that customers who are engaged in our alterations area, their spend triples. When a customer engages with a stylist, their spend goes up 5x.

So that engagement is really what we're looking for, be it with services, be it across channels. We know the more engagement we get with the customers, the better it is. And through our local market strategy in particular, we feel really good that we've got some ways to leverage these physical assets that really resonate with customers.

Operator

Our next question comes from Alexandra Walvis with Goldman Sachs.

Alexandra E. Walvis - *Goldman Sachs Group Inc., Research Division - Research Analyst*

I have a question, clarifying the guidance. You helpfully break down what the 4 drivers of the 4 point improvement in comps into the back half likely to be. I was wondering if you could clarify whether the sales from the new New York flagship would all be coming in the fourth quarter given the opening date.

And then a follow-up question there. I think that implies some pretty strong sales per square foot in that new store. Can you talk about the level of confidence there and your, perhaps, expectations on P&L implications of that specifically?

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

Alexandra, I'm going to start with the clarification on the guidance piece to it. So as you mentioned, the store does open October 24. So there will be a very, I mean, tiny amount in Q3. And I would say the significant majority of what you will see would be in Q4, which is how we framed the guidance on this. And as far as, again, how we're looking at New York, and I think Erik and Pete can weigh in on this but -- provide some more color on this. But we're really seeing this as -- we're opening this for positionally entering a market. And I think when Erik went through his slides and we have the slide talking about the 7 points in Manhattan that we're servicing customers, we're really approaching this as not only opening the tower but our local -- leveraging our other touch points between Trunk Club and Rack as well as enhancements in our online with our customers as well.

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

Yes. I would just add on to that. We think it's really important that with opening of the tower, that we have these other assets and services coming online around the same time. So we've announced that we'd be opening 2 Nordstrom Local service hubs, 1 in the Upper East side, 1 in the village. And we are also able to execute and deliver the most popular services that our customers have that we've seen in Los Angeles with our Locals, which is returns, online returns in particular, order pickup and alterations at our 2 Rack locations in Manhattan as well as the Trunk Club clubhouse. So we will have 7 locations on Manhattan to be able to take care of customers. And there's really a synergy between those assets, the inventory we have there, the people we have there, services we're able to provide. And we had a lot of proof points in Los Angeles. We're set up well to leverage that for New York. But I would -- to reiterate Anne's point and we had that 1 slide in my section, which showed the map and the 7 locations and really emphasize that we are opening a market. We have assets, physical and services that we're excited to bring to the New York City customer.

Operator

Our next question comes from Paul Trussell with Deutsche Bank.

Paul Trussell - *Deutsche Bank AG, Research Division - Research Analyst*

On margins, SG&A dollars were nicely managed. Could you highlight some of the areas of savings? And do you now expect to deliver above the original $150 million to $200 million of savings you originally outlined?

And also, on gross margins, can you just talk about the puts and takes, please, both in regards to what you experienced in the second quarter but also your level of confidence in terms of expecting expansion in the third quarter?

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

Paul, so let me take the SG&A piece as well. We've talked about we had 3 particular drivers driving our SG&A. One is realigning our support structure and costs more on the store. The second was really driving end-to-end productivity initiatives, the supply chain and technology and, I would say, to a lesser degree, is more discretionary spend across the board. And I would say that's a small piece of all the things that we've been doing. That was the -- those are the 3 levers we've been pulling and working through. And as you mentioned, we are ahead of our plan. So when you look at our overall guidance for the year, we basically (inaudible) 2, kept our plan for the second half and [banked the beat we had]. So we are exceeding what we originally had thought in Q1. So that's how you get to the reconciliation (inaudible).

On gross margin, as we mentioned, merch margins were actually in line with our expectations as far as markdowns. The only thing we had was deleverage on our occupancy expenses given our sales volume. As we go through the rest of the year, we really didn't change any of our guidance assumptions on margins. As Erik had talked about how we thought about Anniversary Sale as far as having better margins in the third quarter, the anniversary product, we are -- that was the plan that we made, and we're continuing to progress on that. So the only thing that's changed in our overall guidance is basically the top line.

Operator

Our next question comes from the line of Mark Altschwager with Baird.

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

Nice job on the expense savings. I was hoping you could dig a bit more into how the operating model is really changing at the store level and just really what you're doing differently. I think that's a big component of the cost savings that you've outlined. And I also think this is the first Anniversary Sale period since you put some of these operational changes into play. So just curious how that all played out during the higher-volume period and then any key learnings as you move forward to the holiday.

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

Mark, yes, the implications on the operating model, especially in our store, are really profound. Our stores -- if we're going to leverage the inventory we have in our stores to better serve customers, it means our stores are increasingly becoming fulfillment centers as well as selling directly to the customers. So we have had changes in our model and our store there to do that. We need more people handling both online orders that are being built as well as returns coming back, getting that inventory sellable as quickly as possible. That's gone really well. And in particular, our Anniversary was such an intense period of demand. We saw significant improvement in our fulfillment rates in our stores as well as the speed of delivery to customers in our key markets. So we feel really good about that.

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

And if I could just quickly follow up on a previous question. The implied sales guidance is quite a bit stronger for Q4 versus Q3. Is there anything beyond the Manhattan store coming online that's driving that difference? If you could just talk about some of the drivers there, that would be helpful.

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

Yes. So for -- what we try to do is give you full year and then give you the Q3 assumptions that you can -- and we talk about how we expect sales to moderate -- moderately getting better in Q3 and then some of the big drivers -- the biggest driver, outstanding driver in Q4. So what I would assume as the 4 levers that we laid out, you're going to continue to see some improvement, particularly as we go through the second half of the year.

Operator

Our next question comes from Dana Telsey with Telsey Advisory Group.

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

Two quick things. As you think of the Women's Apparel market and what you've been seeing there, how did it -- did anything from the Anniversary Sale inform you for what should be in the store or other brands, what's happening with some of the existing innovative brands that you have to expand or to contract and bring in others? And lastly, what does success mean to you for the New York store? Are there any metrics around it that you can place?

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

Dana, this is Pete. We've made some strides in Women's Apparel. There's not a lot that you can easily quantify at this point, but I think certainly creating a road map for the future for us to bend the curve there. As Erik mentioned, I think we did a good job of identifying the key items and brands and styles that, that customers are responding to. So we've always had a pretty aggressive program on trying to identify and amplify emerging brands.

I guess what I can tell you is change is -- the cycle on all that stuff is shorter than it's ever been. So one of the things we need to do is identify new emerging brands and amplify them quickly. It isn't a matter of test and learn over a couple of years, a couple of stores in time. So I guess what I can say just more broadly is that I think we have more confidence in our ability to be able to pour on the gaps when things are working well. And the same holds true for, perhaps, some legacy brands that are declining. And we have some very big, built-up, established businesses with some legacy brands where it's going the wrong way. So I just -- our teams have to be really good editors. They've got to be curious and they can't really use last year so much as a guide.

So the other thing I would say is thematically, really understanding the way price impacts classifications and just getting sharper about that has helped. So it's been kind of a tough goal for a while in Women's Apparel, but I think it's fair to say that we have optimism about our ability to make some improvements there, particularly starting in the back half of the year.

And then the other one was about -- I'm sorry, about New York specifically, Dana?

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

Yes. How do you quantify success in the New York store? What would you be looking at in a year? Or how do you think of the New York store? What would make it in your mind a success? Do the volumes match Seattle? Or how do you think about it?

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

Yes. There's obviously a way of quantifying it. We don't break out those numbers by store. But I think what Anne mentioned, really, the way that we look at it is by market. I think as we mentioned all the way long, already it's our largest online market. And we know when we have physical assets to a market like that, that we grow our online business considerably as well adding stores -- the sales in the physical stores as well. So we'll probably have more to say about that as we get -- but I think ultimately, the way you guys should be keeping score at is looking for us to -- look at it in terms of a market.

I would say, though, if you're asking us particularly in the near term how we're going to view the success, I think it's really along the lines of can we deliver a great customer experience there in all the ways that I think customers would expect from Nordstrom entering a market. There's plenty of places to buy things in New York. And if we're really successful there, it's because we do the little things better and the little things that are actually big things, just the way that we serve customers, a more relevant, a more convenient way, and we've heard that theme a lot. And we've got a good team of leaders that are ready to take that challenge on. So I think we'll be getting a lot of indications about our ultimate ability to be successful there based on the reaction that we get from customers and our ability to step up and do -- and deliver something that's (inaudible).

Operator

Our next question comes from the line of Matthew Boss with JPMorgan.

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

So at Off-Price, this was the weakest quarter on the top line, I think, in 5-plus years. I guess what's driving the magnitude of the slowdown? What's the time line to stabilize the concept? And any change in your view regarding the long-term size of the brick-and-mortar fleet for Rack?

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

Yes. I would mainly point to those issues we've had across our Full-Price business, in fact, our Off-Price business as well: the loyalty, digital marketing and merchandise assortment. The loyalty, as we mentioned, we have good progress over the quarter. So we like the direction that we're there. The digital marketing, we're a little further behind in Off-Price than we are in Full-Price. We do have still some traffic opportunities in Off-Price. We feel much better about that.

In particular, what's unique about Off-Price, as we touched on our comments, is flash. We did a deep dive at the end of last year in all our flash events. We had a number of flash events that were, one, categories that we don't carry in our stores. And with the majority of our online returns coming back to our stores, that creates issues. But number two, they were unprofitable events. So we did a lot of editing, these flash events.

The flip side is what's really a plus about the flash model is the traffic generation, engagement mainly through e-mail that we give our customers who sign up at these flash events is terrific and helps us not only on the flash side, but helps us on our Rack.com site as well. So we felt the reduction in traffic from cutting back on those events. We started the last about 3 weeks back on more of our normal cadence there of flash events. And the key to there is not just quantity of flash events, it's the quality of flash events. And we feel really good about that. So feel good about flash events going forward that it's going to be differentiated in the first half. We feel good about the marketing that it's going to be differentiated in the first half.

The other point that should not go unnoticed is the inventory position. I mean we're sitting here midway through the year with lots of open to buy across our company, but particularly in Off-Price. In Off-Price, the biggest driver of Off-Price business is having great merchandise and being opportunistic, especially in times like now that are tough for the industry. We're really excited about the position we're in to really pick up some compelling merchandise for our customers and get them into our Rack brand.

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

And Anne, quick follow-up. Any reason for the lack of share buyback this quarter and how best to think about capital allocation in the back half?

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

Yes. Matt, so as we've always been really consistent about how we approach capital allocation, so first and foremost, we look at investing in the business, and we talk about this as a very heavy investment cycle year for us as we complete the payments, the investments we're making in New York. And as we exit out of the year, that CapEx investment should come -- be coming down, more moderated than we've seen in the past, 3%, 4%.

And then the second piece to it is, of course, our dividend and also staying -- we are very focused on investment grade. So the way we've looked at share buyback in the past is we need excess cash for that. And so that's kind of the priority, that's how we look at our capital allocation.

Operator

Our last question comes from Chuck Grom with Gordon Haskett.

Charles P. Grom - *Gordon Haskett Research Advisors - MD & Senior Analyst of Retail*

Just a few housekeeping things. I guess, first, on the third quarter guide, can you quantify how much gross margin expansion you're anticipating? Second would be on the second quarter, could you perhaps walk us through categories that either outperformed or underperformed? And then third, on the note redemption issue, is there a way you can speak to how much this improved or maybe quantify how much of a drag it was in the fourth quarter of last year given that you're going to be cycling that? And I think that's part of your equation for an acceleration in sales later this year.

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

Pete, do you want to take the assortment questions?

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

Yes. Sure. In the second quarter, we had pretty significant improvement in the beauty area. I think we mentioned that before that we had some out-of-stock issues that, at the beginning of the year, hurt us. And so we bent the curve there, and beauty improved quite a bit. To me, it's been a consistent story for quite some time as our Designer business across all categories, positive, continues to be a good growth opportunity for us. Our NPG area did very well, our own product, that showed some improvement. That's good to see. And then lastly, I'd say that the lingerie and active areas in women's performed relatively better.

The tougher areas for us is we had some slowdown in shoes. I think that represented a moment in time. We shall see. But that was a bit of a dip from where it was -- that shoes have been performing strongly. Men's had some challenges. I would say the biggest driver there that we've noticed, and this is not a surprise to those who follow our industry, but the continued kind of casualization of America. That impacts the men's business quite a bit. And so while we're still serving a lot of men and selling them things, the average price of what we're selling them oftentimes is less than it was when they were buying suits and ties and things of that nature. So there's adjustments we need to continue to make, but I think that those kind of represent the stronger-performing categories relative to the -- performance from last quarter.

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

And as far as your question on margin, the guidance we gave that we thought gross profit at the end of the year would have slight deleverage really driven on deleverage in occupancy based on our sales volume. And so when we talked about Q3, what we said was that we thought given -- we thought merch margin will actually be an improvement year-over-year because of the Anniversary Sale sell-through that we're expecting from how we planned the anniversary. I mean -- and just to remind you, Q4 will actually have the occupancy from New York City baked into it. So I think from that, you can kind of baked it into your model.

As far as the Nordstrom Note, we gave that split roughly evenly for the second half. You can probably imagine if you are anniversary-ing that note redemption and the time it takes for people to accumulate and redeem, there's a cumulative effect. So it's not going to be completely even across the 2 quarters. But for the second half, it's roughly about 400 basis points.

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 1 year on our website. Thank you for your interest in Nordstrom.

Operator

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