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Francesca's Holdings Corporation
Second Quarter Fiscal 2016 Earnings Conference Call
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Richard Kunes, *Interim Chairman, President, and Chief Executive Officer*
Erik Lautier, *Senior Vice President of Direct-to-Consumer & Marketing*

CONFERENCE CALL PARTICIPANTS

Randal Konik, *Jefferies & Company*
Simeon Siegel, *Nomura Securities*
Pamela Quintiliano, *SunTrust Robinson Humphrey*
Adrienne Yih, *Wolfe Research*
Susan Anderson, *FBR Capital Markets & Co.*
Betty Chen, *Mizuho Securities USA, Inc.*
Janet Kloppenburg, *JJK Research*
Richard Jaffe, *Stifel Nicolaus & Company, Inc.*

PRESENTATION

Operator:

Good day and welcome to the Francesca's Holdings Corporation Second Quarter 2016 Earnings Conference Call. Today's conference is being recorded.

At this time, I would like to turn the call over to Kelly Dilts, Chief Financial Officer. Please go ahead.

Kelly Dilts:

Thanks, Audra, and good morning, everyone. We appreciate your participation this morning in Francesca's Second Quarter Fiscal Year 2016 Conference Call. Earlier this morning we issued a press release outlining the financial and operating results for the second quarter ended July 30, 2016.

The following discussion may include forward-looking statements. Please note actual results may differ materially from those statements. Additional information concerning factors that could cause actual results to differ materially from projected results are contained in the Company's filings with the Securities and Exchange Commission.

Joining me today are Rick Kunes, Interim Chairman, President, and CEO, and Erik Lautier, our Senior Vice President of Direct-to-Consumer & Marketing. Following our prepared remarks, we will be pleased to address your questions.

As usual, a transcript of today's conference call will be posted on our corporate website.

I'll now turn the call over to Rick.

Richard Kunes:

Thanks, Kelly, and good morning, everyone. I will begin today's call with some brief highlights of the second quarter, including a review of what's working for us, followed by an update on our outlook for the remainder of the year and what we believe is our differentiated market position. Kelly will review details of our financial results, and, finally, Erik Lautier, our SVP of Direct-to-Consumer & Marketing, will highlight some of our key e-commerce branding and marketing initiatives.

We were pleased with our second quarter performance as we exceeded our guidance. The Team was focused and motivated to drive results and execute our strategy despite a difficult retail environment. The quarter started off with a high-single-digit decrease in boutique traffic and mid-single-digit decrease in comparable sales, which led us to guide to a mid-single-digit comp decline for the quarter. However, as the quarter progressed, we saw demand strengthen in both June and July as traffic, while still negative, began to moderate and comparable sales turned positive. As a result, both boutiques and e-commerce came in ahead of plan.

Similar to the first quarter, we saw strength in dresses, shoes, and gifts, offset by weaker results in accessories and tops, although graphic tees were quite strong. Additionally, late in the quarter we began to shift some of the open-to-buy dollars out of lower performing categories to capitalize on our strong selling items while still maintaining tight inventory management, as evidenced by our inventory per boutique decline of 9%. Our results reflect a strong execution by our team, as our strategic initiatives begin to take hold.

For the back-to-school season, our Boutique operations, merchandise, and marketing were all well aligned. We continued to raise the bar on the customer experience and saw another quarter of higher conversion rates year-over-year. Our open-to-buy flexibility is allowing us to buy into the fashion trends, such as cupro dresses, bomber jackets, and the improved jewelry business, while our shortened lead times are getting these hot sellers back into the boutiques within four to six weeks.

In addition, our increased use of predictive tools was instrumental in getting on-trend colors into the boutiques in a timely manner.

Marketing initiatives included some new advertising vehicles for us and we will further test these in the second half of the year. Additionally, we continued momentum in our e-commerce business. Erik will give you details on both marketing and e-commerce shortly.

Based on the better-than-expected results in the second quarter, and with our strategic initiatives beginning to align, we are revising our annual guidance while also accounting for a couple of spending shifts into the back half the year which Kelly will discuss shortly. Our guidance is based on the current traffic pattern continuing for the remainder of the year. As evidenced by our performance, the executive team is very focused on driving gross margin, but we also recently implemented a process improvement and efficiency initiative. We have developed longer-term targeted savings plans and will utilize third-party expertise where appropriate. While we continue to invest in the necessary infrastructure improvements, we will make sure our other areas of spending are efficient and thoughtful as we strive for continuous operating margin expansion. We remain intensely focused on executing our strategic plan to drive long-term success for our business.

We believe that Francesca's model sets us apart from other retailers with a distinctive blend of personal, experiential boutique atmosphere and the unique non-commoditized and consistently fresh and differentiated product assortment. Our positioning helps to insulate us from the big-box retailers' challenges for the market share grab of big e-commerce. We will always strive to surprise and delight every guest every time and in every channel.

I will now turn the call over to Kelly for the financial details.

Kelly Dilts:

Thanks, Rick. Today I'll be discussing our second quarter results, as well as providing some color around our third quarter and updated full-year guidance. As Rick noted, we were pleased with how our second quarter finished and are encouraged with the traffic declines moderating.

With that, let's turn to the numbers. Net sales for the quarter increased 9% to $115.3 million compared to $106 million last year due to the addition of 44 net new boutiques since the end of last year's second quarter and a 37% increase in e-commerce sales. Our comparable sales were flat compared to last year as the increase in the number of transactions offset the slight decrease in the average transaction value. Once again, we saw a strong increase in our conversion rate, which more than offset the reduction in traffic. The slight decrease in average transaction value was driven by lower average unit retail due to sales mix somewhat offset by the higher average units sold per transaction.

On a department basis, Apparel posted total sales growth of 8% with the dress category still driving the department performance. Fashion tops are starting to improve on a unit basis, but because we are mixing more into lower average unit retail graphic tees and tanks, we are not seeing the same dollar increase. In jewelry, total sales grew 8% driven by bracelets and rings. Sales in the gift department posted the highest increase this quarter with 19% growth, led by entertainment, home, stationery, and other miscellaneous gift items. Our accessories department grew 4%. Shoes once again had a significant increase and we were successful in shifting some of our dollars into shoes, offsetting the weakness in the handbag and hair goods categories.

Our e-commerce business remained strong with comparable sales growth of 37% to $4.8 million, driven by increased website traffic and conversion. Erik will touch on our e-commerce business later in his remarks.

During the quarter, we opened 19 new boutiques and closed four. This brings our total boutique count to 652. It consists of 324 mall locations, 328 non-mall locations—and those non-mall locations include 44 outlets. Our 2016 vintage continues to open stronger than both our 2015 and 2014 vintages in large part due to the digital marketing strategy we developed for boutique openings.

Gross profit as a percentage of sales decreased approximately 60 basis points to 46.8% from 47.4% in the prior-year quarter. The decrease was due to a 30 basis point decrease in merchandise margins and 30 basis points of occupancy cost deleverage. The decrease in merchandise margin was principally due to a sales mix change to the lower margin category. Promotions were similar to the prior-year's quarter.

Selling, general and administrative expenses increased 5% to $36.9 million compared to $35.1 million in the prior-year. This increase was largely due to higher boutique and corporate payroll expenses to support a larger boutique base and strategic initiatives, as well as higher marketing and depreciation expenses. Erik will address the marketing expenses. The increase in depreciation was due to continuing investments in technology and infrastructure. These increases were partially offset by a $2 million net benefit or $0.03 of EPS in connection with the CEO resignation. This net benefit consists of a $2.6 million reversal of previously accrued stock-based compensation expense and a $0.6 million of expense primarily related to search fees. Additionally, we had a favorable shift in expense timing primarily due to the POS implementation and marketing. These expenses will be mostly moving to the third quarter.

Our effective tax rate for the second quarter was 37.9% compared to last year's effective tax rate of 38%. Diluted EPS was $0.27. This was above our guidance, primarily due to better-than-expected sales, and compares to diluted EPS of $0.22 in the same period last year. The weighted average diluted shares outstanding were 38.8 million in the second quarter of FY'16 and were 42.4 million in the second quarter of FY'15.

Now let's turn to the balance sheet. We ended the quarter with $26 million in cash. This compares to $48.8 million at the end of second quarter of Fiscal Year '15. The Company had no debt outstanding at the end of the quarter. During the quarter, we repurchased 2.3 million shares of our common stock at a total cost of $27 million. In total, we have repurchased 3.2 million shares for $43.8 million this year and have approximately $73 million remaining to spend under the new program. Despite the increased boutique count, inventory at the end of the quarter decreased by 3% to $32.7 million from $33.6 million at the end of last year's quarter. On a per boutique basis, our ending inventory was approximately $50,000. This is down 9% compared to last year's quarter level to $55,000 and lower than our expectation of a mid-single-digit decrease.

Moving to our guidance, for the third quarter of FY'16, as Rick noted, we are encouraged by the recent traffic trends and the response to back-to-school. With the assumption that traffic trends don't deteriorate, we now expect sales of $114 million to $118 million, a 10% to 14% increase compared to the third quarter of FY'15. This assumes a mid-single-digit increase in comparable sales. We expect to open 14 to 20 new boutiques and close one to three underperforming boutiques during the third quarter. We expect gross margin to be up modestly compared to last year's third quarter, mainly due to occupancy leverage, offset by merchandise margins that are expected to decrease slightly due to mix and higher clearance sales than in the prior-year.

Our SG&A spend in the third quarter of 2016 will increase approximately $7 million compared to the second quarter of this year, which had the $2 million net benefit of the CEO resignation. Additionally, the favorable shift in second quarter expense timing will hit the third quarter. The remaining costs are associated with new boutiques, additional professional expenses related to the POS implementation, prior marketing spend, and higher stock-based incentive compensation. Diluted earnings per share for the quarter are expected to be in the range of $0.16 to $0.19 based on 37.7 million diluted shares outstanding and a 37.8% tax rate. We expect our per boutique inventory at the end of the third quarter to decrease in the mid-single-digit range compared to last year.

For the full-year of 2016, we now expect net sales of $473 million to $488 million, representing an 8% to 11% year-over-year growth rate. This assumes a low-single-digit decrease to a low-single-digit increase in comparable sales. We still expect full-year SG&A, excluding the net benefit discussed earlier, to increase in the mid-teens compared to adjusted FY'15. This increase is due to investments related to the POS project, stock compensation incentive programs, marketing expenses, the corporate team build-out, and the impact of the new boutiques. GAAP diluted earnings per share for FY'16 are now expected to be in the range of $0.96 to $1.03 per diluted share. The number of average diluted shares for the full-year assumed in our guidance is 38.6 million shares and our effective tax rate is estimated to be 37.8%.

We now expect to open 55 to 65 new boutiques, of which 15 will be outlets, and we'll close six to 10 underperforming boutiques during this year. Similar to the FY'15 boutique closures, the boutiques are either at the end of their lease term or contain kick-out clauses, allowing us to terminate the leases. Capital expenditures for the year are still expected to be in the range of $28 million to $31 million, primarily for new boutique openings, existing boutique remodels, as well as investments in our IT system.

This concludes the financial review and now I'd like to turn the call over to Erik.

Erik Lautier:

Thanks Kelly and Good morning. I'm Erik Lautier, Senior Vice President of Direct to Consumer & Marketing. By way of background, I joined Francesca's in late November, so I've been at the company almost ten months now, and my main areas of responsibility include marketing, branding and the ecommerce channel.

In the second quarter, ecommerce sales increased 37% thanks to improved traffic, conversion, and average order value. We also increased margin in this channel by 280 basis points versus last year. We were able to achieve this by relying less on clearance and promotions, and more on a broader product assortment, new website functionality, and a number of the marketing initiatives we've optimized or newly launched this fiscal year.

So far in FY16, we've successfully rolled out affiliate marketing, retargeting, influencer and blogger marketing, and social advertising campaigns. We have also made significant improvements in the ROI of existing initiatives, such as Search Engine Marketing and Email, which has enabled us to invest deeper into them. In addition, we are beginning to invest in PR, direct mail, and other more traditional marketing initiatives, generally testing in a localized and targeted way that helps us measure performance.

We have accomplished a lot in the first half of the year, and one of our successes was in how we sequenced our initiatives; for example, retargeting and acquisition are both important, but it made sense to invest in retargeting first so that our acquisition efforts would be more productive, since retargeting gives us the ability to reach that newly acquired visitor again. Abandoned cart recovery emails and a revamped email registration program are also consistent with our intention to drive greater productivity from our marketing efforts to the first-time visitor. So, the way we've sequenced our launches has helped improve the overall yield of our marketing, and we are now working hard to understand how to best attribute revenue across multiple marketing touchpoints so that we can better balance out our investments. While we will continue experimenting and trying new things daily, the first two quarters put us in a position to allocate marketing dollars into the initiatives that are generating the highest returns for us, just as the holiday season begins to get underway.

Most importantly, we plan to build long-term, sustainable, and manageable growth in ecommerce, and in the marketing initiatives that drive all channels, fueled by daily optimization and refinement. In everything that we do, our approach is to test, to measure, and to iterate based upon performance. We've been very fluid with our investment dollars, constantly flowing them into stronger initiatives and out of weaker ones in order to maximize our results.

Beyond these marketing investments, we've also made significant enhancements to our site experience. We recently improved our navigation in mobile, which dominates traffic; we've allowed customers to favorite items, which helps tie together the browsing experience across devices; and, we've begun offering more user-generated content to deepen customer engagement.

On the creative side, we have focused on telling an authentic and relatable story in our lifestyle imagery and messaging that we believe will resonate strongly with our target audience. We plan to engage in an updated brand health and customer survey to deepen our understanding of our customer and brand DNA. Through it all, we are maintaining our focus on creating a differentiated, personalized experience for our guest to ensure that her interaction with the brand is always authentic, unique and boutique.

Francesca's ecommerce channel is underpenetrated, but we expect significant growth to continue, and as its penetration to the total increases, so too will its impact on full chain comp figures. But we're not investing in digital just to grow ecommerce; we're investing in digital to grow everything. We began engaging in digital advertising to drive our new boutique openings for the first time in Q1, and those results were so successful that we've committed to do more in "click to brick" advertising. Ultimately, we care only about serving our customer in the channel she has affinity for, and our investments in systems leading toward omnichannel solutions are reflective of the importance we are placing in this area.

I'm very pleased with our results and with the work my team has done to drive ecommerce and marketing initiatives forward. I'm also very proud of the partnership we've developed at the executive level to ensure continued execution of our strategic plan. I look forward to the balance of the fiscal year and beyond, and to continued growth for the brand. I'll now turn the call back over to Kelly.

Kelly Dilts:

Thanks, Erik. We would now like to open up the call for questions. Operator?

Operator:

Thank you. The question-and-answer session will be conducted electronically. To ask a question, please press star, one on your touchtone telephone. If you are using a speakerphone, please make sure your mute function is turned off to allow the signal to reach our equipment. Additionally, we ask that you please limit yourself to one question and one follow-up. Again, that is star, one to ask a question.

We'll take our first question from Randy Konik at Jefferies.

Randal Konik:

Yes. Thanks a lot. Good job on the quarter. I wanted to really kind of expand upon the open-to-buy flexibility first and the shortening of the lead times. Kind of, can you give us a little bit more perspective on how much it can broaden that out; how much we can shorten the lead times on a more sustainable basis; and with the inventories very well controlled, could we expect that kind of type of inventory control over the next two to four quarters? Just kind of trying to pull it all together there. Thanks.

Richard Kunes:

Sure. So regarding our open-to-buy, I mean, I think an easy illustration would be that in June, looking into the third quarter we had about 73% of our open-to-buy available to us. That compares to a year before where we were probably 85% to 90% committed. So, we've done a terrific job and the Team has done a terrific job in keeping that flexibility going into the quarter to be able to react quickly. In addition, we've reduced our vendor base. To some extent, we've also reduced our SKUs, so that gives us a little bit more of a focused business with our vendors and allows us to be a little bit more flexible, if you will, in the timing of when we receive things. So that's how we've helped bring that weeks to replenish down to like four to six weeks on many items versus the longer time period before.

Looking at inventory, it's really a disciplined effort. So we went through, as you know, in the first quarter and into the second quarter in clearance—in season, rather, clearance activity, so we reduced our inventory rather substantially and we are sort of having a doubling effect of reducing what historically used to be a little bit of out-of-season clearance in that time period, as well as the spring season clearance. The combination of those two was a little bit of a greater activity, but helped bring down our inventory. Then along with the open-to-buy that I mentioned, that's another fact that it has.

So going forward, we're looking for a mid-single-digit decline year-over-year in our inventory levels per store, on a per store basis and we think that's going to continue for the rest of this fiscal year certainly.

Randal Konik:

That's super helpful. Just the follow-up question would be—you talked about the idea of the gross margin getting less worse obviously and about to inflect. The occupancy deleverage, if we assume comps get better, should kind of go away. You should get obviously leverage. How do you think about the mix item on merchandise margin that's impacting the business? When do you kind of start to potentially see the mix detriment kind of change from impacting the merchandise margins, assuming that we can get lower markdown rates given this better open-to-buy flexibility in the shortened lead times? Thanks.

Richard Kunes:

Sure. So we're not going to walk away from business because the margin is a little bit lower. I mean, if we have a category business that's growing quite fast, like Shoes, we'll do what we can to improve that. Honestly, our Shoe merchant—Shoe margin, rather, year-over-year is up more than 10 points, so we're doing what we can in those categories that have a lower margin to improve that margin and we're certainly going to continue to focus on things that the customer wants, and if that happens to be a little bit lower margin than our overall business, well, so be it.

But having said that, we're not ignorant or ignoring the fact that we want to maintain our margins. So we're doing other things, like being more thoughtful in the way we handle promotions; we're being more thoughtful in the inventory now that we've got our position well controlled. We want to be sure that we don't have the mark of the stock in the same level going forward. So we'll continue to focus on what the customer wants. We'll try to drive business into the higher-margin categories, but, we will sell what the customer wants, and we're not allowing—you know, on a category by category basis, we're very focused on not allowing that margin to deteriorate and we'll do everything we can to maintain it going forward.

Randal Konik:

Very helpful. Thank you.

Operator:

We'll go next to Simeon Siegel at Nomura Securities.

Simeon Siegel:

Thanks. Good morning, guys, and congrats on the improvement. Just, so in light of the recent volatility and the positive comps ending the quarter, can you just provide any color on the current trends and maybe talk to comfort around expectations for the fourth quarter given the challenging compare? Thanks.

Richard Kunes:

Sure. So, I mean, the volatility that we saw in the second quarter was really a traffic-driven volatility. I mean, that's the main thing that affected our business. As we started the quarter, traffic was down, I think almost 9% in the month of—in the first month of the quarter. So, what we saw over the course of the quarter was an improvement in that and an improvement in our comps, and improvement in our conversion rates. So those three things kind of led us to where we are today and the results that we just announced.

Looking forward, we're hoping that the traffic patterns that we see today will continue for the rest of the year. There are certain things that we can control and things that we can't. If there's some sort of macro reason that the shopper all of a sudden decides to stop shopping, like happened in the first quarter of this year, those are tough for us to overcome. But, generally, we're doing better than most. We're positive about the outlook going forward and we don't see anything affecting us from a deterioration point of view in the traffic levels that we see today.

Simeon Siegel:

Okay. Thanks. Then just given the internal changes, did anything change with regard to the long-term store counts and can you just remind us where you stand there, maybe full-price and outlets?

Richard Kunes:

Yes. No; nothing has changed. Actually, we're using—we use a third-party to help us lookout in the marketplace and decide how many store locations there are and how many geographic opportunities there are for us, and we're actually refreshing that study as we speak today, but we don't really see a tremendously different number than we see today, or the mix of mall versus non-mall, the mix of outlets versus those two channels may deviate slightly over the next few years and that's something that we're keeping an eye on. We're not going to open stores that don't make sense to us, so we're being very diligent, if you will, in the evaluation the store locations, and our real estate team is doing a great job of presenting us with locations that we feel will be financially justifiable, and those are the only ones we're going to open, quite honestly.

Simeon Siegel:

Great. Thanks a lot. Best of luck for the rest of the year.

Richard Kunes:

Thank you.

Kelly Dilts:

Thanks.

Operator:

We'll move next to Pam Quintiliano at SunTrust.

Pamela Quintiliano:

Great. Thanks so much for taking my questions and congratulations on the quarter. So, if we could talk a little bit more about that traffic improving and how you think about your customer and how she's feeling; so, there's a lot of talk about new trends in the marketplace, so better product—do you think the shopping experience is better? We've seen some other sectors within consumer not doing as well. Do you think maybe she's re-shifting her spend away from footwear or away from going out to eat as much exclusively going more towards apparel? Just any visibility on that?

Richard Kunes:

Well, it's hard to predict exactly what the shopper is going to do, but I think that for us, in particular, we offer a variety of categories and merchandise in our stores. We have that merchandise in great shape, quite honestly. It's very relevant and it's very new, it's fresh. Our stores are not overcrowded with merchandise. We offer, as I say, a variety of categories and merchandise, and we're executing that point-of-sale in a terrific way. So our in-store boutique salespeople are doing a great job with our guests and all of those things seem to be working very well for us.

We're doing a pretty good job on buy now, wear now, and you'll see a lot of that in our stores, and that's going quite well for us. So, as far as us executing, we think we're doing a great job. As far as us being able to predict exactly when that consumer will continue to buy clothing versus electronics or whatever, those are a little bit tougher for us to handle, but we were quite happy with our back-to-school activities and those programs, so those went very well for us.

So, again, I think that from our perspective and from a strategic perspective, we're running pretty good right now and we're executing against all of our initiatives and the Leadership Team is doing a great job in making those things come to life. So we're comfortable with what we're doing for sure.

Pamela Quintiliano:

That was very helpful. Then just one follow-up if I can. Regarding your online customer—and that was great detail you gave with it—can you give a little bit more regarding is it a new customer coming, is it the same age, socioeconomics, anything to think about who's shopping online versus who's been going into your traditional brick-and-mortar stores?

Erik Lautier:

Yes. Hi. So we're doing an updated brand and customer engagement survey that's going to give us a little more color around that. I would say that given that a lot of what we're doing in terms of digital marketing is brand new for us, right, we might see some divergence between the online customer and the traditional retail customer that we would not have seen before. I'm not in a position to give any specifics around that at this time, but we can follow up and I can give a little more information around that later.

Pamela Quintiliano:

Great. Thanks so much. Best of luck.

Erik Lautier:

Thanks.

Operator:

We'll go next to Adrienne Yih at Wolf Research.

Adrienne Yih:

Good morning. Nice job on the upside to the quarter. My first question is going to be on—can you give any more color the positive mid-single-digit comp guidance for the 3Q? Last year, it looks like clothing was kind of the tougher compare and then jewelry an easier compare. Any color on trends that are happening in Jewelry now and the nice recovery we've seen there? Then also, gift and home seems like it's leading, at least in 2Q had a nice upside surprise there as well, so if you can talk about that. Then very quickly, are you sensing any exposure to the Hanjin's shipping issue through your vendor base? If you could just address that. Thank you.

Richard Kunes:

Sure. So I'll let Kelly talk a little bit about some of our category performance. Regarding the shipping issues, we buy from vendors which are based here pretty much in the US, and so they are responsible for bringing our merchandise into the country. So we're going out and surveying them and trying to understand who they use. To date, we have not seen anything that would indicate that that is going to be an issue for us. We don't get a lot of merchandise that comes out of Korea and we haven't found any vendor yet that has said this is going to be an issue for the merchandise that we receive. So far we're cautiously optimistic that it's not really going to affect us.

Adrienne Yih:

Okay.

Kelly Dilts:

Looking to Q3 to the positive mid-single-digit comp, our back-to-school was really successful, and while Clothing is tougher, we've seen really good response to some of our clothing, including those cupro dresses, the bomber jackets are really popular right now, and vests are working for us, the puffer vests. Then with the jewelry being an easier compare, that certainly is helpful and the choker trend is one we have taken full advantage of. So we're seeing real positive comps in that trend and feel like we are really well-inventoried to take advantage of it. So, we're really pleased so far with the Q3 comps as it's running.

As far as the Q2 upside, it was really a traffic story. So, as Rick kind of noted, the traffic was really down and depressed in May. When we went out with our guidance we were at a mid-single-digit comp decline as we were going in and didn't see how that was necessarily going to turn around without traffic improvement, and, luckily, we did see it. Traffic improved sequentially, so June was definitely better than May and July was better than June. So, since July, we've kind of been holding the traffic steady. While it's still a decline, it's certainly favorable to what we were experiencing in April and May.

Adrienne Yih:

Great. Best of luck.

Kelly Dilts:

Thanks so much.

Richard Kunes:

Thank you.

Operator:

Our next question comes from Susan Anderson at FBR Capital Markets.

Susan Anderson:

Hi. Good morning. Nice job on the quarter. I wanted to maybe touch on e-commerce a little bit more on the color with the investments that you're making there and in omnichannel. Where do you think you're at in those investments, and, I guess, as you look out kind of over the next five years, when do you think you'll kind of be at the level of operation that you want to be at?

Erik Lautier:

Yes. So, we're still very much in the early stages and we're in the early stages of a lot of things that we're doing in e-commerce. Our approach really is to do a little of something, measure, see how it performs, and if it's working, well, then we go broader, we go deeper, we invest further. So we're being very conscientious about how we spend our dollars and scaling it up in a way that's organic and a way that I think is a very good fit for the business.

So, with regards to the omnichannel investments, specifically, yes, we are implementing OMS, CRM, POS. That rollout will happen over the months to come. Of course, we have to put the data into the system, so we have to interpret the data. A lot of this, it's a process, right. We'll never be done, and it's going to evolve over time. So, in terms of when we're going to be caught up, I think it's a little early to say that at this point, but we're investing as opportunities arise, and we're improving our platforms, we're improving our website, we're improving our marketing. As things grow, we invest further into them and hopefully they'll grow further.

Richard Kunes:

Yes. Erik brings up a very good point for us in our e-commerce business and that is that we have the advantage in a sense. So we are a little bit underdeveloped relative to the percentage of business that it represents, but the way that we're investing, as Erik's described, is very thoughtfully. So one of the reasons that we get a pretty good return on our e-commerce business and a high level of profitability is that fact that we have the flexibility to test and then to spend money in things that work and don't spend money on things that don't. We're not throwing money at e-commerce and just seeing what works. We're actually doing it pretty thoughtfully.

Regarding the investment in omnichannel or our project which is moving us in that direction at least, we have a pretty high level of investment in this fiscal year. We have that same higher-level of investment next fiscal year, and then that starts to even itself out, and at that same time, some of the benefits, as Erik was describing, starts to kick in. So we're pretty optimistic the way that's going to unfold.

Susan Anderson:

Great. That's helpful. Then just one follow-up on the real estate strategy. I know you guys continue to rigorously test the new and existing boutiques. Maybe if you could just give us a bit of an update on how you feel about the expansion going forward. Any changes in mindset there, especially as your E-commerce continues to grow? Thanks.

Richard Kunes:

I think the key for us is flexibility, that we're not committed to any one channel of distribution, that we're not committed to any one location, be it mall or non-mall, or outlets, that we have a variety of investment opportunities and we invest the money in the ones that we think give us the best opportunity to be successful. So we are being a little bit more thoughtful in our real estate negotiations. We're being a little bit more thoughtful in the locations that we open. We've raised our thresholds, if you will, from a performance perspective to make sure that the ones we open are going to deliver the return that we believe they should. So, other than being more thoughtful and diligent in some of the work that we do, we'll see how the opportunities present themselves and how it unfolds over time.

Susan Anderson:

Great. That's good to hear. Good luck next quarter.

Richard Kunes:

Thank you.

Erik Lautier:

Thanks.

Operator:

We'll go next to Betty Chen of Mizuho Securities.

Betty Chen:

Thank you. Good morning for thank you for taking our question. Thank you and congratulations on the nice improvement. I was wondering kind of related to the earlier question, Rick, you mentioned that this year you're planning to close about 6 to 10 underperforming stores. Can you remind us how many stores may qualify as underperforming, because I think typically you guys have a pretty healthy fleet? Also related to that, how many leases may be coming due for the next few years to give you some of that real estate flexibility? Then my second question is in regard to the merchandise margin. Kelly, I believe you mentioned that we should look for that to be improving in the third quarter. Any color on sort of how we should kind of model that out; and as we go into the fourth quarter, should we also think about some merch margin opportunity as well? Thank you.

Richard Kunes:

Great. So, as far as do we have underperforming stores, from an accounting perspective, the answer is really no. We earn money in our stores. But from a performance perspective, we want to earn a certain level of profitability, and if we come to a store that's not meeting our thresholds, we actually have—we actually have a real estate meeting every month as a minimum and we go through any stores that are coming up and decide whether the performance of that store is sufficient for our longer-term profitability. If it isn't, luckily for us, these stores, generally every five years, have the opportunity, either from a kick-out clause or other—or renewal of lease that we can walk away from that lease. So we don't close stores and take big expenses related to that closing. We just actually close the store.

If you wanted to know how many of those are coming up, if you went back roughly five years, you'd see the number of stores we opened, which was like 70 or 80 stores a year. So every year, if you will, over the course of the year, those 80 stores, roughly, come up for that 5-year renewal and/or kick-out kind of opportunity, and we evaluate those routinely every month and decide which ones stay open which ones close.

Regarding the margin, I'll pass that over to Kelly.

Kelly Dilts:

Yes. So for the merchandise margin, we're actually going to look for a slight decrease in Q3 in the merchandise margin, and that's going to be offset by some occupancy leverage in Q3. We don't expect to see that in Q4. I would say the best way to look at merchandise margins right now is to kind of take a look at Q2 and what happened, and you'll see a similar trend in merchandise margins through Q3 and Q4. Just as Rick talked about, as we start to increase penetration a little bit into the lower margin items, we're getting a little pressure, and also as E-commerce starts to increase the penetration of total sales, there's some pressure on the gross margin there. So that is what I'd look for.

Betty Chen:

Okay. Great. Thank you so much. Best of luck.

Kelly Dilts:

Thanks, Betty.

Richard Kunes:

Thank you.

Operator:

We'll go next to Janet Kloppenburg at JJK Research.

Janet Kloppenburg:

Hi, everybody. Congrats on a good quarter. Kelly, just a point of clarification—two points of clarification: gross margin is to be up in the third quarter, but down in the fourth quarter? I'm not clear on that. Also, did you modify your comp outlook for the year slightly from flat to plus low-single to minus low-single-digit, and does that indicate that you expect comps to moderate in the fourth quarter? Maybe everybody can join in on this, Rick, maybe because you're up against a very challenging comp in the fourth quarter and your inventory levels are squeaky clean right now, so I'm just wondering how we should think about comps in the fourth quarter and what's implicit in your guidance.

Also, just on the inventory content, I know dresses are doing very well, some parts of tops. When do you—or are you assuming that the tops category does turn positive, or is there not enough clarity on the trend there in the business? Thank you.

Kelly Dilts:

Sure. So Janet, I'll just start with growth margins. So we are expecting a total growth margin increase in the third quarter, but that's primarily due to some occupancy leverage not to merchandise margins. So the decline of merchandise margin should be similar to Q2. In Q4 we're actually expecting total growth margin to decrease. We won't get that occupancy leverage in Q4 and that's really based on what we're kind of inherently implying as your comps for Q4. As you know, we're going up against plus 11 comps in Q4, and so we're being pretty conservative about our Q4 estimates. It's flattish to a low-single-digit decrease. It's kind of what we're looking at for Q4 just so that we have that two-year comparative that makes sense. I think that addresses the comps.

As far as dresses and tops and just tops turn, we hope tops turn positive. Right now the units are very close to turning positive, but the dollars are not just because, like we said, we're mixing more into graphic tees than we are the other tops. We'll have to take a look and see if there's a trend that comes that has a little bit better AUR, and if so, then we'll turn comp positive.

Janet Kloppenburg:

Okay. Last, I wondered if you could talk a little bit about merchandising initiatives within the store. I think you had been successful with some table presentations and I'm wondering what you're thinking about in terms of reconfiguring the presentations. Thanks.

Richard Kunes:

Yes. So that's a process which is kind of ongoing every day is to look at the way our merchandise is presented. Each store for us is a little bit unique. The sizes and shapes are a little bit different, so they're merchandized slightly differently with that location. But having said that, we think that because of the tight inventory levels that we have now in store, it gives us a lot more flexibility to manage that merchandising activity within store. We're doing a great job, I think, and our Store Operations Team is doing a great job of communicating our latest thoughts in that out to the field and we're doing some great programs around getting that stuff out in a timely fashion, not only on the merchandising part but also on instructing our sales force, if you will, that talk to our guests in a certain way and how to present and describe certain fashion trends that are out there. So I think our in-store execution is really hitting on all cylinders, if you will, at the moment, and we're quite pleased with it.

Janet Kloppenburg:

Good luck.

Kelly Dilts:

Thanks, Janet.

Richard Kunes:

Thanks, Janet.

Erik Lautier:

Thanks.

Operator:

We'll take our final question from Richard Jaffe at Stifel.

Richard Jaffe:

Thanks very much. I wonder if you could go into the marketing initiatives for the second half, spend a little more time on what'll be both the traditional initiatives you mentioned, if could be more specific, and then the successes you've seen in the first half through the electronic mediums particularly and how those will carry forward. Thank you.

Erik Lautier:

Sure thing. So, the first half is really a lot of blocking and tackling, setting up a lot of things that we really should have a retailer online, things like affiliate marketing and retargeting and improving our SCM. There's a lot of stuff that we just needed to do a lot more of or to optimize the performance of, and so we've done that and we've seen some improvements in the ROI of things that we were doing and we have improved the ROI of things that we started, going back a few months ago. The ROI is better now than it was when we first started them. So we're happy to see all that improvement.

We are going to be doing a test with some direct mail and we're going to start doing a little bit of PR as well. Beyond that, with the holiday coming, right, and with some, I think, strong results that we've seen so far in the initiatives that we've launched, it's really about going a little deeper into the things that we're already doing as opposed to going even broader at this point. I think we've not hit a point of diminishing returns in terms of the ROI. I think there's still a lot of low-hanging-fruit to be picked, and we're going to pick it going into the holiday.

Richard Jaffe:

I look forward to it. Thank you.

Erik Lautier:

Thank you.

Operator:

That concludes the question-and-answer session. I would like to turn the conference back to Rick Kunes for closing remarks.

Richard Kunes:

Thank you. Before we end our call I want to thank obviously the Francesca's employees, both in boutique and in the office, for their hard work and dedication. I really look forward to working with them to make the back half of our year a very successful one. Thanks for participating in our call today and have a great day.

Operator:

That does conclude today's conference. Again, thank you for your participation.