Urban Outfitters (URBN) Earnings Report: Q3 2015 Conference Call Transcript

The following Urban Outfitters conference call took place on November 18, 2014, 05:00 PM ET. This is a transcript of that earnings call:

Company Participants

- Oona McCullough; Urban Outfitters; Director - IR
- Frank Conforti; Urban Outfitters; CFO
- Richard Hayne; Urban Outfitters; Chairman, President, CEO
- Ted Marlow; Urban Outfitters; CEO, Urban Outfitters Group
- Dave Hayne; Urban Outfitters; COO, Free People
- David McCreight; Urban Outfitters; CEO, Anthropologie Group
- Meg Hayne; Urban Outfitters; President, Free People, CCO, URBN

Other Participants

- Adrienne Tennant; Janney Montgomery Scott; Analyst
- Kimberly Greenberger; Morgan Stanley; Analyst
- Lorraine Hutchinson; Bank of America Merrill Lynch; Analyst
- Lindsay Drucker Mann; Goldman Sachs; Analyst
- Marni Shapiro; the Retail Tracker; Analyst
- Janet Kloppenburg; JJK Research; Analyst
- Dana Telsey; Telsey Advisory Group; Analyst
- John Morris; BMO Capital Markets; Analyst
- Anna Andreeva; Oppenheimer Capital; Analyst
- Barbara Wyckoff; CLSA Limited; Analyst
- Betty Chen; Mizuho Securities USA; Analyst
- Oliver Chen; Cowen and Company; Analyst
- Ike Boruchow; Sterne, Agee & Leach; Analyst
- Richard Jaffe; Stifel Nicolaus; Analyst
- Mark Altschwager; Robert W. Baird; Analyst
- Simeon Siegel; Nomura Securities; Analyst
- Omar Saad; ISI Group; Analyst

MANAGEMENT DISCUSSION SECTION

Operator:

Good day, ladies and gentlemen. Welcome to the Urban Outfitters third quarter fiscal 2015 earnings call.

(Operator Instructions).

As a reminder, this conference is being recorded.

I would now like to introduce Oona McCullough, Director of Investor Relations. Ms. McCullough, you may begin.

Oona McCullough (Director - IR):

Good afternoon. Welcome to the URBN third quarter fiscal 2015 conference call. Earlier this afternoon the company issued a press release outlining the financial and operating results for the three- and nine-month period ending October 31, 2014.

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

We will begin today's call with Frank Conforti, our Chief Financial Officer, who will provide financial highlights for the third quarter. Richard Hayne, or Chief Executive Officer, will then comment on our broader strategic initiatives. Following that, we will be pleased to address your questions. As usual, the text of today's conference call, along with detailed management commentary, will be posted to our corporate Web site at www.UrbanOutfittersInc.com.

I will now turn the call over to Frank.

Frank Conforti (CFO):

Thank you, Oona, and good afternoon, everyone. I will start my prepared commentary discussing our fiscal year 2015 third quarter results versus the prior comparable quarter. Then I will share our thoughts concerning the remainder of the year.

Total company sales for the quarter increased by 5% to a third quarter record of $814 million. This increase was driven by $34 million increase in non-comparable-store sales, opening 14 net new stores, and a 26% jump in wholesale segment sales.

The retail segment comp rate was minus 1% for the quarter. Within our retail segment comp, the direct-to-consumer channel continued to outperform stores, posting positive gains at all brands. The direct-to-consumer sales growth was driven by increases in average order value and site visitors, which includes web, mobile, and mobile apps. Negative store comp -- store sales resulted from decreased transactions and units per transaction, which were partially offset by higher unit selling prices.

By brand, our retail segment comp rate increase by 15% and 2% as Free People and Anthropologie grew, respectively, and inclined 7% at Urban Outfitters . Free People wholesale delivered another strong quarter as sales surged 26% to $63 million. These results came from double-digit sales growth at department stores and specialty stores domestically, and strong international growth.

Gross profit for the quarter decreased by 3% as compared to the prior comparable quarter to $284 million. Gross profit rate declined by 295 basis points to 34.8%. The deleverage occurred primarily due to lower initial merchandise markup followed by higher markdowns at the stores and store occupancy expense deleverage due to negative store comp net sales, which were all primarily driven by the poor performance at the Urban Outfitters brand.

Total SG&A expenses for the quarter increased by 11% to $207 million. Total SG&A as a percentage of sales deleveraged by 128 basis points to 25.4%. The SG&A deleverage was primarily due to increased marketing and technology expenses, which were used to drive higher direct-to-consumer traffic. SG&A at the Urban Outfitters brand in North America grew less than 2% during the quarter.

Operating income for the quarter decreased by 27% to $76 million with operating profit margin deleveraging by 423 basis points to 9.4%. Net income was $47 million or $0.35 per diluted share.

Turning to the balance sheet, inventory increased by 15% to $467 million. The growth in inventory was primarily related to the acquisition of inventory to stock new and non-comp stores as well as the comp retail segment. Comparable retail segment inventory increased by 8% at cost while decreasing 7% in units.

We ended the quarter with $358 million in cash and marketable securities. During the quarter the company repurchased and retired 184,000 common shares for approximately $7 million. We have 6.1 million shares remaining on our May 27, 2014, Board of Directors authorization to repurchase 10 million shares.

As we look forward to the fourth quarter of fiscal year 2015, it may be helpful for you to consider the following. We are planning to open approximately 35 to 40 new stores for the year. For the fourth quarter by brand, we are planning approximately 4 new Urban Outfitters stores globally, including one new European store, and six new Anthropologie stores globally, including one new European store.

Due to the current store performance at the Urban Outfitters brand, we believe it is likely that fourth-quarter gross profit margin will continue to deleverage on a year-over-year basis. This gross profit margin deleverage could be similar to the first half of fiscal year 2015. If this deleverage occurs, it would primarily be due to lower merchandise margins and store occupancy expense deleverage and could occur despite continued sales and profitability momentum at the Anthropologie and Free People brands.

We are planning for SG&A to grow at a low double-digit rate for the final quarter of the year. This increase would be driven by increases related to direct and selling support expenses to support our new store growth and continued investment in technology and marketing expenditures utilized to further customer acquisition and retention efforts.

Capital expenditures for fiscal year 2015 are planned at approximately $215 million to $235 million, driven primarily by a new fulfillment center in Gap, Pennsylvania, and the expansion of our home office and new stores.

Our fiscal year 2015 annual effective tax rate is planned to be approximately 36.5%.

As we look forward to fiscal year 2016, we are excited about many of our ongoing and new initiatives. We will continue to invest in technology, specifically around web, mobile, and omni capabilities and the opening of our new fulfillment center in Gap, PA. Within the brand we will continue to invest in product category growth such as shoes at Free People, home at Anthropologie, and beauty at Urban Outfitters . We will also continue to enhance our marketing and imagery capabilities across all of our brands.

We look forward to opening our first large-format Anthropologie and our first Free People store in Europe. We are excited about the many opportunities for Free People to continue their strong international growth. We are planning to moderate our Urban brand store growth in North America and Europe. In order to increase the Urban Outfitters brand profitability, we are taking steps to reduce their base SG&A spend and improve their product margins. The fiscal year 2016 plans are not finalized yet, and we will have more commentary on our plans on our next call in March.

As a reminder, the foregoing does not constitute a forecast but is simply a reflection of our current views. The company disclaims any obligations to update forward-looking statements. Now, it is my pleasure to pass the call over to our Chief Executive Officer, Dick Hayne.

Richard Hayne (Chairman, President, CEO):

Thank you, Frank. And good afternoon, everyone. Let me say at the outset that URBN's overall performance in this year's third quarter was subpar. Disappointing results at the company's namesake brand, Urban Outfitters , deflated what otherwise would have been a powerful company performance. And while we had many successes in the quarter, total performance, namely a 9.4% operating profit, is well below our historic norm and certainly less than what we know our brands are capable of producing.

It is obvious that the environment surrounding apparel retailing over the past year has been challenging.

Many brands have struggled. A few have delivered fair results, and very, very few have showed strength. We are pleased that two of our brands, Anthropologie and Free People, continued to be amongst the strongest performers in the market.

So let me begin with an overview of the total company in the third quarter. Frank has already given most of our total URBN stats, so I won't repeat them here. But I would like to elaborate on our results by channel. I think it's important to note the significant divergence across our channels and speculate on what it means.

In general, direct-to-consumer performed very well while stores fared more poorly. The Free People wholesale channel continued to produce amazing sales gains.

First, let me discuss the stores. Total store comps in the quarter were negative. This was driven by lighter store traffic, which resulted in fewer transactions. AUR was positive while the units per transaction were down. For some reason which we can't explain, September was a particularly poor month, but happily October improved from the September level.

Total comp store sales and transactions were down in both North America and Europe. In North America the West Coast stores performed better than those in the East. And in total, we were slightly more promotional in the stores this year than in last year's third quarter. This increase was driven entirely by store promotions at the Urban brand. As Frank pointed out, negative comps caused the total occupancy costs to deleverage and store expenses as a percent of sales to increase.

Inventories at the end of the period were heavier than we would like at the Urban brand but were well controlled at the other two brands.

In contrast to store performance, the direct-to-consumer businesses in Q3 delivered strong double-digit sales increases and robust traffic gains. DTC transactions increased and produced excellent full price sellthroughs across all brands and product categories. Compared to the same period last year, DTC required fewer promotions to drive these sales gains.

The ongoing customer shift from desktop to mobile continued during the quarter with total mobile sessions increasing by 38% over Q3 last year. Even though mobile sessions tend to convert at a lower rate than desktop sessions, our overall DTC conversion rate rose slightly. This is largely due to the growing popularity of our brands' mobile apps, which tend to convert at roughly twice the rate of other mobile sessions.

Total retail segment sales increased by 4% in the third quarter while the Free People wholesale segment continued its stellar growth with Q3 sales jumping 26% above last year's level. Wholesale produced strong gains both domestically and internationally with specialty, department, and e-commerce stores all showing significant increases.

So what have we learned? Clearly, the consumer's growing affinity for direct-to-consumer shopping has somewhat tempered her need to shop in stores. Physical shopping trips, particularly to undifferentiated malls, are becoming less frequent. DTC is more efficient. It allows her to browse more products from many different sources faster, see outfits and styling more clearly, and engage others as part of the social network. She is willing to pay for these advantages but expects consistent quality and prompt service.

And what does this mean for stores? Obviously, it raises the bar for bricks and mortar stores. It is no longer sufficient to build a store, stock it with tables and racks of wares, and open for business. The store experience must become a performance with the energy and precision of a Broadway play. We must permeate the stores with creativity and offer service when and to the degree the customer wants it. Of course, it means offering all the omni bells and whistles they want like in-store pickup, same-day delivery, and mobile point-of-sale. And all of this must be done every hour of every day the store is open. I see this as an exciting opportunity to reinvent the store and the store experience to complement the online experience, not compete with it.

As a company, this is exactly what we are working on. And for those of you who attended our Investor Day in September, you were able to see and experience our ideas for a larger and more compelling Anthropologie store.

Now, returning to our third quarter results, let me give you some color by brand. First is Anthropologie. The Anthropologie brand delivered solid retail segment comp growth which, along with non-comp sales, resulted in record third quarter revenues.

The quality of the sales was excellent as the brand a set a new record for merchandise margins in the quarter. This is on top of record merchandise margins achieved in Q3 of the previous year as well. The Anthropologie brand continues to succeed in emotionally engaging its customers while delivering strong financial results.

During the quarter the brand also made progress on many of their strategic growth initiatives. They successfully launch the Anthro gift registry with over 3,000 customers registering in a little over a month with a total registry value in excess of $5 million. As expected, weddings drove the majority of registries but almost 20% of those signing up were for non-wedding events.

They also mailed a Home Journal which introduced the customer to an expanded Anthropologie home assortment. Response to the Journal was overwhelmingly positive and many items sold out within days. The results definitely strengthen our confidence in the strategy of category expansion that David unveiled during our recent Investor Day.

The brand successfully opened six new stores during the quarter, five in North America and one in the UK. In addition, Anthropologie opened its first concession in Paris, in the Galeries Lafayette department store. This marks the brand's first foray into Continental Europe. Early results have been encouraging and leave us excited about the potential for additional concessions in France and other countries.

And finally, they begin the integration of Terrain into the Anthropologie group. As a way of introducing the Anthro customer to the Terrain brand, the upcoming Anthropologie holiday gift catalog will feature a full page of Terrain products.

I want to thank David and his team for delivering another strong quarter and making wonderful progress on Anthropologie's strategic growth initiatives. I also want to congratulate the Anthro team on winning the Ragan's 2014 Grand Prize for Best Content Marketing Strategy. As the publisher said, in quotes, overall we haven't seen many content marketing strategies that hit all the right notes, are planned so meticulously, and are executed with such class and style, unquote. Those are very nice words indeed coming from a recognized marketing expert.

Now, Anthropologie was not alone with successes in the quarter. The Free People brand produced yet another outstanding quarterly performance with both sales and operating profit reaching new highs. This feat is more impressive given the extremely difficult comparisons established over the prior two years.

All channels excelled in the quarter. The retail segment produced a comp increase of 15% and wholesale grew by 26%. During the quarter the brand celebrated the opening of its 100th Free People store and total revenue growth at the brand exceeded 25% for the 10th consecutive quarter.

Free People has done an outstanding job in executing its strategy of expanding product categories. Footwear continued to gain momentum across all channels and is performing well above planned. And the intimates category drove especially strong revenue growth during the quarter.

However, of all the Free People initiatives, international expansion is delivering the fastest growth. During the quarter revenues from Asia increased by more than 100%, driven by strong sales in Japan, Hong Kong, and now China. In October, Free People wholesale in partnership with the Hong Kong-based I.T group launched the first to Free People shop-in-shop inside mainland China. Plans are to open four more shop-in-shops with the I.T group next year, two in mainland China and two in Hong Kong.

In Europe, Free People's third quarter revenues grew by more than 200%, driven by successes in the UK and Germany. As is true in Asia, the European customer is just beginning to become familiar with the Free People brand and the lifestyle it represents. We believe as brand awareness and product demand multiply, as they did in the third quarter, Free People will become a premier global lifestyle brand, enabling it to expand all of its channels of distribution around the world.

I extend my congratulations to Meg and her team for delivering another terrific quarter. Additionally, I would like to congratulate the Free People store design and merchandising team that recently won the coveted VMSD Excellence in Visual Merchandising Award for 2014.

Now, finally, let me discuss results at the Urban Outfitters brand. As I mentioned earlier, the Urban brand contributed far less to our overall profitability than we have come to expect, given its historic performance levels. Some of this shortfall I attribute to market conditions, some to the fashion cycle. But some is definitely result of poor execution. Let me explain.

Urban's total retail segment comp sales decreased by 7% in the quarter. On a total retail basis average selling price was up, units per transaction were down slightly but total transactions were down.

Looking deeper once again, we see that it was a tale of two channels. The Urban customer shopping electronically responded very nicely to Urban's fashion offerings and price points. The brand's online marketing was far superior relative to last year. Traffic was up, as was the average order value.

Urban's mobile app, called Urban On, grew its number of users by more than 150% in the third quarter over the corresponding quarter last year. Most importantly, full price sales including full price apparel were strongly positive. This isn't business that Urban bought through markdowns and promotions. As a matter of fact, markdowns in the DTC channel were actually lower in the third quarter, and we saw no price resistance to higher-priced merchandise.

The story in the stores couldn't have been more different. Traffic was down and transactions were down. The sales penetration of accessories, intimates, and home products grew while apparel shrank. This change in mix is partly responsible for an overall drop in merchandise margins. That combined with lower IMUs, higher markdowns, and occupancy deleverage caused by negative comp store sales caused significant deterioration in gross margins in the quarter.

A number of these store issues were self inflicted. Obviously, the Urban team controls IMU and they are making adjustments going forward to bring it back to historic levels. The team did a poor job of designing the architecture of the store buy and creating different assortments for different type stores.

In the women's apparel area there were too many redundant styles and the buy was not properly distorted. The result was that many of our stores were needlessly over assorted and piecey, which made the shopping experience more difficult and less appealing. The merchant and planning teams are working diligently to resolve these problems.

Clearly, the teams still have work to do and it may take more quarters to fix. But they also have made significant progress. The fashion offering and the inventory and marketing are much better than last year. For this reason, even though I am disappointed in many aspects of the team's execution, I am actually much more confident in the brand's position today than last year at this time.

The most positive sign, in my opinion, is that the Urban customer is back. She is definitely online and she is buying. But she's also coming back into the stores -- perhaps a little less regularly than in prior years but, unlike last year, our hip young adult customer is shopping in stores once again. The teams now need to execute and align the stores so they are telling the same compelling stories as direct and telling them with clarity, conviction, and creativity.

I want to thank Ted and Meg and their teams for the many, many extra hours they have worked to get this turnaround underway. Repositioning a brand is never easy and rarely without pain. I believe the Urban brand is making the necessary changes that will allow it to more fully engage its traditional customer and return to solid profitability.

Now, before I turn the call over for your questions, I would like to announce the retirement of a senior member of our executive team and a good friend of mine, Glen Bodzy. Glen, who currently serves as the company's General Counsel and Secretary, plans to retire effective June 15, 2015. Mr. Bodzy, who is 62 years old, has overseen leasing and general corporate matters since joined the company in 1997. He is credited with making many contributions to the success and growth of the company during his 17-year tenure and has been an invaluable advisor to me. I thank you, Glen. And I wish you and Linda the very best in your retirement years.

In addition, I want to recognize and thank our 22,000 associates worldwide, including all of our teams in Europe and our shared service teams. I thank our wholesale partners, domestic and abroad, and our many vendors and suppliers. Lastly, I extend my thanks to our many shareholders for their continued support. I'm grateful for the opportunity to lead the URBN community. Thank you.

I will now turn the call over for your questions.

QUESTIONS & ANSWERS

Operator:

(Operator Instructions) Adrienne Tennant of Janney Capital Markets.

Adrienne Tennant (Analyst - Janney Montgomery Scott):

Good afternoon, everybody. And Glen, congratulations on the retirement. Dick, I was wondering if you can talk about the ongoing dynamics that you talked about between brick-and-mortar and DTC. Does it philosophically make you rethink the store count potential for either UO or Anthropologie both domestically and abroad? Thank you.

Richard Hayne (Chairman, President, CEO):

Thanks, Adrienne. Well, you know that we have said 200 to 250 both Urban and Anthropologie stores in North America, and we sure are starting to bump up against that upper limit. And so, I don't think I'm going to have to rethink too much.

Naturally, we would have started to slow the number of stores that we are opening per year. You know, since you were here in September, that we do have a plan, especially for the Anthropologie brand, of increasing the size of each store. And we still are very bullish on that plan. But as far as decreasing the store count, since we are already at about 200, I don't think it makes a heck of a lot of sense.

Operator:

Kimberly Greenberger of Morgan Stanley.

Kimberly Greenberger (Analyst - Morgan Stanley):

Great. Thanks so much. Dick, the comments you made about the Urban Outfitters e-commerce business left me with the impression that your e-commerce business at Urban is positive. I know it's all getting mix between the channels at this point. But is that a sort of fair takeaway?

And what -- maybe you could help us understand the timeline that you think is possible or achievable in terms of translating the story that the Urban team is able to tell online to in-store, and when we might see that show up in the store financials. Thanks.

Richard Hayne (Chairman, President, CEO):

Sure, Kimberly. Thank you very much. It is indeed correct that the direct-to-consumer business at the Urban brand in the third quarter was positive, and I would go even further and say that the apparel division, the women's apparel division, was positive and actually very strong in full-priced merchandise. So, we are very pleased with that.

We are obviously trying to get our arms around the difference between the store and the online experiences. And I think that the biggest thing that we have come up with and think has to be fixed is just the clarity with which the in-store assortments are planned; the conviction with which the buyers and merchants place their buys, meaning how they distort the buys; and then to a lesser degree, the creativity that is employed in the stores themselves.

Of course, there could be some other issues like the amount of service that's in the stores might not be appropriate. I think you know from covering us for so long that Urban has always felt that the Urban customer wanted to sort of be left alone when they come in the store. And that may no longer be appropriate.

So, we are addressing a bunch of these things and are going to make some changes in the way we do things, and would hope to start to see some of these results next year. And we are very bullish on trying to get things turned into the third and fourth quarter of next year.

Operator:

Lorraine Hutchinson of Bank of America.

Lorraine Hutchinson (Analyst - Bank of America Merrill Lynch):

Did all brands pick up in October? And can you give us a little bit of color on what drove that improvement?

Richard Hayne (Chairman, President, CEO):

Yes, they all picked up in the month of October. As I said in my prepared remarks, September seemed to be an anomaly. August was reasonably strong, and then September all brands had a problem. And then we saw a pickup in October.

So, we don't know what caused it. I'm at a loss. If you have any suggestions, I'd love to hear it. But no, don't have any idea what caused it.

Operator:

Lindsay Drucker Mann of Goldman Sachs.

Lindsay Drucker Mann (Analyst - Goldman Sachs):

I was hoping you could go into a little bit more detail on the SG&A focus at UO. What areas do you expect you can start to rationalize cost?

And does that reflect a perhaps new view of the long-term kind of merchandise margin for the concept, whether it's from less apparel mix or whether it's from a lower IMU as you are putting more makes back into the garments? Maybe just some color on where you are rationalizing costs and why?

Richard Hayne (Chairman, President, CEO):

Sure, Lindsay. I'm going to ask Frank to talk about that.

Frank Conforti (CFO):

Where we have done a great job and where Ted and team have done a great job and I think will continue to as we head into next year is looking at the overall spend related to the stores. And that's more specific to what's going on in the field than the product itself. This is more specifically towards controlling your direct store controllable expenses related to store payroll as well as other store-related expenses.

As it relates to if there's a new view on merchandise margins for the brand, that's not the case. We continue to look at category expansion for the brand, and exactly where that shakes out for merchandise margins will depend on how each category ends up performing when all is said and done. And that will be an iterative process and that will be the same for all of the brands. But as of right now, no; we don't see any difference in where the merchandise margins for the brand can recover to.

Richard Hayne (Chairman, President, CEO):

I think it might be appropriate, Lindsay, for me to just talk about the drop in IMU at Urban and where it came from. About a third of it was a mix issue with higher penetration in the home product and lower in women's apparel.

Some of it was centered around the planning and buying group buying more product from the market. And that was a planned buy, and the market is lower than what we do internally. And the third was in the women's apparel area, because it was not the kind of distortion there was the year before, we had more smaller buys and therefore paid more for those buys and decreasing IMU.

So those three things were the main reason that IMU went down at the Urban brand. And we think each of those three can be reversed, and we are hard at work doing just that.

Operator:

Paul Lejuez from Wells Fargo.

Unidentified Participant:

It's (Tracy) filling in for Paul. Two questions -- first I was wondering if you've -- within the Urban Outfitters price increases you put into place, so I guess really next changes, if you are seeing more price resistance in some categories versus others.

And then just a follow-up on a previous question -- you mentioned slowing growth at the Urban division next year, and I was wondering if you thought you might actually need to close any stores. Thank you.

Richard Hayne (Chairman, President, CEO):

I'm going to ask Ted to take the first part of your question and then I'll try the second.

Ted Marlow (CEO, Urban Outfitters Group):

In regard to any resistance related to price, both in retail and direct, across the business we've seen really no resistance and that we've had categories performing strongly in the women's area and the men's area, in the home area and in our accessories offer with each of those categories delivering growth in AUR as we came through the year and even more specifically as we just came through this quarter.

Despite the challenges that we've had at retail in the women's business, we do have categories that have had nice AUR growth in women's at retail that have, as well, delivered a good comp performance in the quarter.

Our biggest challenge in retail in the women's area coming through the quarter really was in the bottoms piece of the business. Our tops business delivered nice comp improvement, and along with that AUR growth. The same can be said for the dress and outerwear piece of the business.

Richard Hayne (Chairman, President, CEO):

And as to closing stores, I think in my 44 years, I think we may have closed three or four stores, with the exception of those stores that we relocated. So, it's not a very common thing. And while I wouldn't say never and I wouldn't say that it would be impossible for next year, we are certainly not planning any and I wouldn't expect many, if any.

Operator:

Marni Shapiro of The Retail Tracker.

Marni Shapiro (Analyst - the Retail Tracker):

Congratulations on the brands that are doing well and on the DTC business, which looks amazing. Just a couple of just -- Ted, if you could just clarify, you said the bottoms business is tough. Is that because we are not in a particularly strong denim cycle and so your denim business is weak? Could you just clarify that?

And if you guys could also talk more broadly about Urban Outfitters , are you seeing a different in-store performance between a mall store versus a downtown location versus a lifestyle location?

Ted Marlow (CEO, Urban Outfitters Group):

Surely, Marni. Related to the bottoms business, interestingly, not a denim cycle. But that is the strongest piece of our bottoms mix, actually, on the direct side of things. Denim has been contributing decently as we've come through the quarter.

We really had a very weak pants offer. And although we had an offer in skirts, we really haven't found anything in regard to that offer that the customer connects with, whether that's retail or direct. So, it has equated to really a significant shortfall in retail in bottoms. And that shortfall has been somewhat offset by denim holding up on the direct side.

In regard to location, type of location and performance, as we have come through this year and more specifically through third quarter, that business that we are up against last year had stronger performance in the mall piece of our real estate mix. And that has been the weaker segment in regard to performance as we came through the year and, as well, during the third quarter.

Richard Hayne (Chairman, President, CEO):

The only difference that we saw, as I said in my commentary, was the West Coast stores tended to be better than the East Coast stores. And other than that it was pretty much across the board.

Operator:

Janet Kloppenburg of JJK Research.

Janet Kloppenburg (Analyst - JJK Research):

Hi, everybody. And congratulations to Glen on his retirement. Just a couple of quick questions on Urban -- I was wondering if, Dick, you have done any analysis of the demographic of the mall customer. Perhaps you are getting an older customer online, that customer you wanted to bring back to the brand? Maybe the younger customer is -- or the older customer is not frequenting you at the mall? I love you to talk a little bit about that.

And also, Frank, it sounds like you are pulling back on SG&A spend for UO, which is understandable, yet the overall spend remains up at a low double-digit level. So are you devoting more to the Free People and Anthropologie brands? And can we expect that to continue next year? Thank you.

Richard Hayne (Chairman, President, CEO):

I think that in the stores where we have some information we really don't see that big a difference between the age groups of the customers in the store and the customers online. I can't tell you that's true of all 180-some, 190 stores. But of the ones we know, there's not a big difference.

And I don't think that there's really -- I think that there has been a change versus last year. I think we aren't getting as many young kids on either channel. But that's by design and we set out to do that. And I think we've actually been very successful at that. And if that were to be what's driving the difference in the stores, I'm actually okay with it because we don't want the young teen that we started catering to several years ago.

Frank Conforti (CFO):

No, we are not diverting funds from Urban to the other brands as it relates to the SG&A. So there's no reallocation there. As noted, in the quarter both Anthropologie and Free People had several initiatives go live. At Anthropologie we launched, very successfully launched the gift registry program as well as, their first time in over five years, released a home catalog which drove SG&A for the quarter.

As it relates to next year, we did provide some commentary around our thoughts for SG&A next year. We're in the process of finalizing our plans for next year right now, and so we will have some more commentary as we come through the fourth quarter next year.

Operator:

Dana Telsey of Telsey Advisory Group.

Dana Telsey (Analyst - Telsey Advisory Group):

Dick, as you think about the Urban division, how much of it to you think is the Urban division versus the change in the competitive environment with price led by fast fashion and speed to market with trend? The timeline of the back half of next year for improvement -- what should we be watching for as we get there? Thank you.

Richard Hayne (Chairman, President, CEO):

Yes, Dana. I know that there has been a lot of discussion around fast fashion, and I think we've talked about this in the past. If you are talking about fast fashion as a supply chain discipline, then I think the answer is yes, it makes a difference. And we are in the process of adapting to that change. We have significantly decreased the weeks between -- the number of weeks between when we start to put our fashion to bed and deliver it.

So, I believe very much and fast fashion. But when you start talking about fast fashion as a price point, that's where you lose me. We think that our customer is much more driven by style fashion and brand equity than they are by price point. And I think this is a split that is not as well recognized in the investment community as it should be.

Operator:

John Morris of BMO Capital Markets.

John Morris (Analyst - BMO Capital Markets):

A question for Ted and then possibly also Dick -- talking a little bit about looking into the fourth quarter, into holiday here in terms of product and the opportunity versus last year both for Urban, Ted, and then also Anthro, Dick -- or if David is there, whoever wants to take that.

And then just also a quick question about the home category growth as a percent of the mix. Where is that currently for Urban and Anthro, and where would that head to over the next year? Thanks.

Richard Hayne (Chairman, President, CEO):

Okay, John, I'm going to take it very quickly on the last point. We don't release the penetration by category or division. And then I'll let Ted take what he sees on the fourth quarter. And David, if you would like to, you can give a little color on your fourth-quarter expectations.

Ted Marlow (CEO, Urban Outfitters Group):

Related to fourth quarter and the Urban brand, the campaign that we've put together for marketing the business -- we are optimistic in regard to the traction that we plan on delivering off that program through the direct side. And I, as well, expressed my confidence that I hope that that is felt in the store community as the customer gets into more of a store shopping mode going through Black Friday into the holiday shopping season.

We've seen good traction as we've turned the corner into the month of November from October. Some of the healthier business we saw in the month of October has held up nicely for us as we have turned the corner with fresh deliveries for holiday. And I'm looking forward to that playing out in both channels to a larger degree. We will have to wait and see as the volumes are substantial. But I wouldn't necessarily say we were at our best last year.

Operator:

Anna Andreeva of Oppenheimer.

Anna Andreeva (Analyst - Oppenheimer Capital):

A question for Frank -- just on the gross margin guidance for the fourth quarter, just to make sure, are you guys embedding gross margin expansion at Anthropologie and Free People as momentum there continues and the entire decline is being driven by challenges at Urban? So that's my first question.

And on the quarter-to-date trend, I guess Ted just mentioned some improvement into November. What are you seeing quarter to date at the other businesses? Thanks.

Frank Conforti (CFO):

Yes, as we look forward to the gross profit margin for the fourth quarter, we do believe that it can decline similar to what we saw in the first half of the year. That does take into consideration the continued strong results from both Anthropologie and Free People brand.

We believe the rest of the fourth quarter is the Urban brand will still be facing the IMU challenges that they have had through the first three quarters of the year, as well as potentially high markdowns related to their store performance and possibly some property deleverage there. So, yes, that does take into consideration all three of our brands.

I guess I don't know if Dick wanted to comment on November's performance quarter to date.

Richard Hayne (Chairman, President, CEO):

Well, I think it's fair to say, just to follow up on what Ted said, that last year was not our best moment at the Urban brand. And we are up against much easier comparisons through November and then December and then intensifying, actually, in January.

So in that respect I think that we would anticipate doing better against the prior year. Internally, we are looking at it against two years ago because we don't want the distortion.

Operator:

Barbara Wyckoff, CLSA Americas.

Barbara Wyckoff (Analyst - CLSA Limited):

Thanks for the elaboration on the share, the results of the Urban Outfitter apps. Could you share the results on apps in Anthro and Free People?

Richard Hayne (Chairman, President, CEO):

Barbara, I did talk about the apps on Anthropologie with their registry, and I would be more than happy to share those with you again off-line. I'll as Dave to talk about the Free People app.

Dave Hayne (COO, Free People):

We've been very pleased with our Free People -- the Free People FP Me app. We have been continuing to see the penetration of customers onto the app, away from the web. This is an experience that we are supportive of. Depending on where the customer chooses to shop with us, we want to support it.

In the third quarter we launched five app revisions or new versions of the app. So it's a channel that we are continuing to support technically. And it continues to be a content creator for our overall e-commerce and brand experience as customers continue to upload photos of themselves in our photography -- or their photography and our clothing. So, it's a valuable piece of the business.

David McCreight (CEO, Anthropologie Group):

We've had a successful launch. We had a soft launch early on. We've had 40,000 downloads in very short order. And like the other statistics shared earlier, we are following the rest of the brands in that conversion rates are higher and average order values are also higher on our app. We look forward to seeing that grow.

Operator:

Betty Chen of Mizuho Securities.

Betty Chen (Analyst - Mizuho Securities USA):

Thank you. Good afternoon, everyone.

Richard Hayne (Chairman, President, CEO):

Good afternoon.

Betty Chen (Analyst - Mizuho Securities USA):

I was wondering if you or Frank can talk a little bit about the inventory composition. The dollar seems to be a little bit higher; we assume that due to the increased make into the merchandise but wanted to clarify that. And then in terms of the units being down 7%, how is that spread across the brand? And are we comfortable that we have adequate inventory level at Anthro and Free People to support the business? Thanks.

Frank Conforti (CFO):

We believe that both Free People and Anthropologie have adequate inventory to support the business. I believe the inventory was well controlled coming into the quarter. We do believe that the inventory cost that was up plus 8% for the quarter was largely driven by the Urban Outfitters brand.

And if you remember, as we came through the end of the second quarter and into the third quarter we had some very strong reads in the direct-to-consumer side of the business from a product perspective. We chased into some of that inventory and brought that inventory and funded that inventory into the stores, and the stores did not perform as well as we would have liked into the third quarter. So, we are facing a little bit of an overhang there on the Urban stores.

With that said, please keep in mind that units are negative at the Urban Outfitters brand and inventory at retail is only very low single-digit positive. So despite the fact that the cost is up, units are down and retail is only up low single digits.

Operator:

Oliver Chen of Cowen and Company.

Oliver Chen (Analyst - Cowen and Company):

Regarding the strategy and what you are thinking of the Urban Outfitters brand, how do you contrast the store experience, potential edits there versus product? And also, as you look at product and you look at redundant styles in the assortment, is there a story there in terms of your composition of good, better, best, and how you feel about that?

Richard Hayne (Chairman, President, CEO):

I don't think there's a story that we want to tell. I think what happened was that we just put too many styles into work and the styles were overlapping needlessly. And I believe that it caused the stores to get over assorted. And because there wasn't the depth of buy in some of the styles, there was then the piecey aspect. Piecey is, I guess, a term of art.

So, I think that it wasn't anything that was planned to happen. It just happened. And it's something that we have to correct.

Operator:

Ike Boruchow of Sterne Agee.

Ike Boruchow (Analyst - Sterne, Agee & Leach):

A question maybe for Frank -- when you look at the holiday on the Anthropologie side of the business, the comp is a little slower this quarter than what it was in the first half. Are you planning the Anthropologie brand to bounce back to its run rate from the first half? Are you expecting it to settle into what we've seen over the last few months?

Richard Hayne (Chairman, President, CEO):

I'm going to ask David McCreight to talk about that.

David McCreight (CEO, Anthropologie Group):

Yes; if you were to look at first glance at Q3 it would indicate a slowing. But if you actually look at it as a stacked multiyear view, our Q3 comps rates were about consistent with what we were in Q2. And as you heard, we were very pleased with our product margins, but we believe we left some money on the table in terms of waste and how we transitioned into Q3.

Going into Q4, we do believe we are well set for holiday. Our product deliveries have been full. Our stores, we believe, are transitioning quite quickly. Anecdotally, the feedback from the stores has been positive around the new receipts. And we believe we've got a very compelling assortment, particularly improving in the winter weight product and sweaters, cold weather, as well as how our home looks.

That being said, we are being very cautious about the season and will be prepared and have call to action ready to drive store visits from our customer where necessary. So we have inventory to do very solid positive comp growth to the degree that our creative and our product designs please her.

Operator:

Richard Jaffe of Stifel.

Richard Jaffe (Analyst - Stifel Nicolaus):

If we could just follow up on some of the things that are working at Urban, I know there has been some efforts obviously at the higher price points, the more sophisticated fashion, some of the outside brands. I'm wondering if you could give us some good news or things to look for in the fourth quarter.

Richard Hayne (Chairman, President, CEO):

Ted, do you want to take that? Give him good news.

Ted Marlow (CEO, Urban Outfitters Group):

Sure, Richard. As we go into the quarter, our initial messaging has around the dress assortment, which -- dresses as we came through the spring season -- May, June, July -- are really our big flex months for dresses. And we were a bit disappointed about how that played out. We like what we're seeing off the performance of the dress assortment at the present time for the kickoff of the season.

The tops business -- whereas we've had pretty strong cut-and-sew business coming through the year, that was as well strong in third quarter, that's both at retail and direct, we've since gotten a bit of complementary business kicking in on the wovens side of things. So tops as well are coming around in regard to performance through the month of October into November.

I go back to the comments that I made earlier. I can't give you a lot of positive commentary on the subject of bottoms. We just aren't seeing the kind of response that we would like to see to the few things that we had in the mix that we felt had some volume attached to them. So that is the piece of the mix that is remaining to cause us some concern.

That being said, as we've come through the year and, in particular, the kickoff of the fall season, we like what we are seeing out of our accessory business pretty much on the category-by-category basis. I'd like to see us get our IMU in better shape in accessories, and that we have been delivering more branded and market product there. But acceptance from the customer has been quite good.

Richard Hayne (Chairman, President, CEO):

If just to add a couple things to that, the intimates area has been quite good as well, as has home. So, I think what you are seeing is in the stores it's really a deficit that has been created by apparel and specifically mostly bottoms. And in the direct business there's very little. As a matter of fact, there are no categories that aren't performing.

So, I think there is good news there. And we intend to use that as a base going forward.

Meg Hayne (President, Free People, CCO, URBN):

I'd also like to add that the marketing efforts for direct are significantly improved over last year, and we are very proud of the holiday shops that we've created, whether they are single category or cross merchandising. The creative team did a great job with concepting new ways to get to the customer. And you will see that this year for all the messaging that will happen for the months of November and December.

Operator:

Mark Altschwager of Robert W. Baird.

Mark Altschwager (Analyst - Robert W. Baird):

Just one more follow-up on UO -- Dick, what tools do you have in the toolbox to aid in distorting the buys in the right way? It sounds like you are pleased with the direction of the fashion, so I'm just trying to get a better sense of how the processes are changing to drive a better result in the stores.

Richard Hayne (Chairman, President, CEO):

Well, the tool box are humans. And Ted will talk about it.

Ted Marlow (CEO, Urban Outfitters Group):

Sure. I'd like to jump right into that because it's a piece of the equation in the Urban business that, over the time I've been involved with the business, more times than not I feel our crew has done a pretty darn good job there. The piece of the equation that came into play in regard to the planning of the assortments for this third quarter was a significant rise vis-à-vis last year in AUR, not necessarily to where we would like to be or have previously been.

And the quantification of the buy on the retail side -- it's not such an issue on the direct side. We would like to have more ownership in direct where we are doing business as opposed to dealing with expense and pick, pack, and ship, but not as much of an issue in regard to covering your sales opportunity.

And the retail side, however, to the points that have been talked about previously, did end up -- and I think the women's piece of the business in an over assorted situation and under quantified, even under quantified on the things that we had confidence could drive volume.

So, we really have been in chase mode on the business ever since the receipts started coming into kickoff fall in the middle of July. We are at a point now where we are really taking a look on a buy classification basis, really the base within each individual class and how we have it financed. That is something that we have very good visibility and a lot of dialogue around on a weekly basis.

So, I am confident that that is something that, again, we will deliver strongly on through our buy crew.

Operator:

Simeon Siegel of Nomura.

Simeon Siegel (Analyst - Nomura Securities):

Frank, given the continuing strength online, can you quantify the call-out for the higher 3Q marketing and tech expenses to drive the online traffic? And then where do you see normalized online EBIT margin settling in or other impact to the consolidated margin?

Frank Conforti (CFO):

I don't want to break out the specific dollars, I guess, or rate increase related to the web marketing and the technology investment. But if we're going to mention them as main drivers of the SG&A, you can be sure that those are the main drivers as to where SG&A is being invested in.

Operator:

Omar Saad of Evercore ISI.

Omar Saad (Analyst - ISI Group):

Dick, I was hoping to get your thoughts on the brand position, Urban Outfitters' brand position, especially given in light of the history of the brand. It feels like we're going through, at least in the US but I think globally too, this kind of re-urbanization and re-embracing of the urban, city environment. And the brand is so synonymous with cool, young, and urban.

How do you think about marketing and brand building around the heritage of the brand and the centrality of the Urban experience? Or is it really product what matters most and the rest will follow?

Richard Hayne (Chairman, President, CEO):

Certainly, product is a big portion of what we do. I think everybody knows that. But what you are talking about is precisely what we have been at work at over the last 12 months. If we dial back about a year and a quarter, we had an awful lot of product in the stores that may have been reasonably appropriate for a middle-aged teenager or even a young teenager in the suburbs at the mall in terms of printed T-shirts and things like that, but not particularly appropriate for the man or woman living in Brooklyn or living in (Albuquerque) or anyplace else that is reasonably cool in the US or around the world.

So, we set out to do what we have done for the last 40 years, and that is get that customer and represent that customer and forget about the teenager and let them go someplace else. And as I said before, I think we've done an awfully good job with the product and with the marketing and the imagery, particularly those latter two as it applies to online, of returning to the brand position that we believe in.

And I think that we are doing the same for stores. It may take a little bit longer. But I'm very, very convinced that the product that we have is going in the right direction.

The product has not been even, as Ted talked about. We've had a lot more problems in the bottoms area than we have in the tops. But we will get there and I'm convinced of that. And we will return to that customer that we know and love for the last 40 years.

And so I'm very -- as I said in my prepared remarks, I'm very optimistic and very bullish about where the brand is now positioned. And I think it's just a matter now of executing and fine-tuning that execution. So thank you very much. And I thank everyone for being on the call.

Operator:

Ladies and gentlemen, thank you for your participation in today's conference. This concludes the program. You may now disconnect. Have a wonderful day.