# Macy's (M) Earnings Report: Q1 2016 Conference Call Transcript

The following Macy's conference call took place on May 11, 2016, 09:00 AM ET. This is a transcript of that earnings call:

**Company Participants**

- Karen Hoguet; Macy's, Inc; CFO

**Other Participants**

- Lorraine Hutchinson; BoA Merrill Lynch; Analyst
- Matthew Boss; JPMorgan; Analyst
- Jeff Stein; Northcoast Research; Analyst
- Brian Tunick; RBC Capital Markets; Analyst
- Stephen Grambling; Goldman Sachs; Analyst
- Paul Trussell; Deutsche Bank; Analyst
- Michael Binetti; UBS; Analyst
- Kimberly Greenberger; Morgan Stanley; Analyst
- Oliver Chen; Cowen and Company; Analyst
- Randy Konik; Jefferies; Analyst
- Paul Lejuez; Citigroup; Analyst
- Todd Duvick; Wells Fargo Securities; Analyst
- Richard Jaffe; Stifel Nicolaus; Analyst
- Omar Saad; Evercore ISI; Analyst
- Bob Drbul; Nomura Securities; Analyst
- Javier Escalante; Consumer Edge Research; Analyst
- David Glick; Buckingham Research Group; Analyst
- Anjani Gupta; Credit Suisse; Analyst

MANAGEMENT DISCUSSION SECTION

**Operator**:

Welcome to the Macy's , Inc., first-quarter 2016 earnings conference call.

Today's conference is being recorded.

At this time, I would like to turn the call over to your host, Karen Hoguet. Please go ahead.

**Karen Hoguet** (CFO):

Good morning and welcome to the Macy's , Inc., conference call. I am Karen Hoguet, CFO of the company.

Any transcription or other reproduction of the statements made in this call without our consent is prohibited. A replay of the call will be available on our website, www.MacysInc.com, beginning approximately two hours after the call concludes.

Please refer to the investor relations section of our website for discussion and reconciliations of any non-GAAP financial measures discussed this morning.

Keep in mind that all forward-looking statements are subject to risks and uncertainties that could cause the company's actual results to differ materially from the expectations and assumptions mentioned today due to a variety of factors that affect the company, including the risks specified in the company's most recent Form 10-K and other SEC filings.

Sales in the first quarter were $5.771 billion, or 7.4% below last year, due both to the stores that we've closed in 2015 and the decline in comp sales. While we had planned comp sales to be below last year in the first quarter, our 5.6% decline on an owned-plus-licensed basis was worse than expected. On a two-year basis, the comp sales were down 2.9% per year.

While the quarter started stronger, the business weakened considerably versus our expectations beginning in mid-March and that trend continued through April. As Terry said in our press release, we are seeing weakness in consumer spending levels in apparel and related categories.

The number of transactions declined 7% in the quarter, which is far worse than what was experienced last year. This is the proxy, as you know, for traffic. AUR, average unit retail, was up slightly, and units per transaction was up approximately 1%.

Additionally, we continue to be negatively impacted by reduced spending by international tourists. Sales on international tourist credit cards were down 20% in the quarter, on top of a 21% drop last year in the first quarter. This reduction in spending impacted our comp by a little less than a point versus last year. This was disappointing and had a disproportionately negative impact on our center core businesses, given what these visitors buy.

Given that our stores are concentrated in major tourist markets, this is a big factor for us and we are no longer confident that it will improve anytime soon. While we are focusing on increasing our share of the domestic tourist business, we don't think we can offset all of the loss on the international side.

There were some businesses in the quarter that performed relatively well fine jewelry, dresses, active, fragrances, coats, men's tailored clothing, housewares, and furniture. However, the significant weakness in other parts of our assortments more than offset these good news stories. The softer businesses included handbags, fashion watches, women's shoes, kids, men's furnishings, and luggage.

Regionally, we continued to see weakness in our major tourist markets, which, as mentioned before, are many of our largest markets. Our performance in Texas was also disappointing. We achieved our strongest performances in markets across the country that are less dependent on international tourism, but are also smaller, such as North Carolina, Southern Virginia, Columbus, Ohio, Oregon and New England.

Digital sales continued strong, still growing double digits, but it too grew less rapidly than anticipated. Bloomingdale's trends were also weak due to the same trends impacting Macy's .

One major success in the quarter was the rollout of Last Act, our centralized clearance areas for most of women's and men's apparel within the Macy's stores. Merchandise in these parts of our stores are marked with a clearance price and they are not eligible for additional discounts nor coupons. Sales of these goods were up high single digits, driven entirely by the higher average unit retail.

Backstage, our off-price concept, also had a good quarter. We are particularly pleased with how our first two Backstage in-stores opened, one in Nanuet, New York, and the other in Waterbury, Connecticut. We are hoping these stores bring in new customers as well as add share of wallet of existing customers.

So far, both objectives are being reached, but it is premature to claim success. We just opened four more and we expect to open approximately nine more this year. If this strategy works, we could roll it out to approximately 250 to 300 of our Macy's stores.

Gross margin in the first quarter was 39.1%, up 10 basis points from last year's level. We ended the quarter with comp inventory down 0.8%. Total inventory was down 3.2%, due both to the comp drop as well as the closed stores.

While we are satisfied with our overall inventory level, the slowness in selling of warm weather goods will put pressure on our gross margin rate in the second quarter. SG&A in the first quarter, excluding the retirement plan-related settlement charges, was $1.966 billion, down $57 million, or 2.8%, below last year.

In the quarter, we benefited from the restructuring completed at year-end, the expense flex on the lower sales, and lower retirement expense, offset in part by omnichannel-related expense as well as the expense additions associated with Bluemercury, Backstage, and China.

Credit income was $182 million in the quarter, $3 million above last year. While our proprietary credit card penetration of 45.9% was 100 basis points above last year, credit sales were below last year due to the overall sales trend. We still expect credit income to be slightly below last year on an annual basis, primarily as a result of the sales decline.

Asset sale gains in the quarter were $14 million, $4 million associated with Brooklyn and $10 million for other asset sales. This compares to $20 million in the first quarter last year.

During the fourth-quarter conference call a few months ago, we explained that we would have non-cash charges for settlement accounting related to our retirement plans going forward.

We expected these charges to be triggered because of the increase in lump-sum distributions associated with our store closings, voluntary separation program, and organizational restructuring. This charge was $13 million in the quarter and we are still assuming approximately $135 million for the full year. These charges, as you saw, are broken out separately on the P&L and are not included in our guidance.

Operating income, excluding these settlement charges, was $289 million, down from last year's $409 million. As a percent of sales, operating income on this basis was 5% as compared to 6.6% last year.

Interest expense was $98 million. Tax expense was $63 million with an effective rate of 35.4%, down from last year's 38.5% due to the timing of some tax settlements. We still expect the annual effective tax rate to be approximately 37%.

Net loss attributable to non-controlling interest was $1 million versus none last year. Net income attributable to Macy's , excluding the settlement charges, was $125 million as compared to $193 million a year ago.

Average share count on a diluted basis was 313.5 million shares, down 9.5% from last year's 346.5 million shares. EPS on a diluted basis, excluding the settlement charges, was $0.40 as compared to $0.56 a share last year.

In the quarter, cash flow from operating activities, net of investing activities, was a use of $203 million this year versus a use of $328 million last year. The major variances were last year's Bluemercury acquisition, offset by lower net income and less cash coming from previously escrowed funds from asset sales this year. During the quarter we bought back $129 million of stock, or 3 million shares, under our repurchase program versus $385 million last year.

As you saw in our press release, we are focusing our efforts in three areas to improve our performance this year. One, speed up and scale up things that are working. This includes initiatives such as our jewelry pilot; Backstage in-store; beauty, including Bluemercury expansion; active; and Last Act.

Two, we will excite customers with greater newness and more exclusive merchandise. You saw some examples of this in our press release of exciting new collaborations and brands being introduced at Macy's .

We also have a renewed focus on product that can only be found at Macy's and at Bloomingdale's, including our private brands, exclusive brands, and exclusive product from the major brands.

Third, we are digging deeper to find expense reduction opportunities to free up money to invest in improving customer service, both in-store and online. Technology will obviously play a major role here. While we hope to see some improvement in our sales trends during the second quarter, most of these actions are expected to have a bigger impact in the fall and particularly in the fourth quarter.

With the evolving role of our stores, understanding opportunities with our real estate has become increasingly important. Doug Sesler, our new Executive Vice President of Real Estate, has jumped right in and is learning fast.

He is continuing the work in progress to explore potential opportunities for creating value through joint ventures or other partnerships for our mall-based properties as well as our flagship properties.

This is very complex, but I can say that the interest is very strong and I believe we will have some good options. But it will take time to evaluate. At the same time, he and our real estate team are seeking to monetize unproductive real estate.

While we are excited about our business-driving initiatives, we have lowered our expectations for the year, particularly the second quarter. For the year as a whole, we are now expecting comp owned-plus-licensed sales to be down 3% to down 4%. The upper end of this guidance, the down 3%, implies a similar trend for the remaining nine months of the year to the first-quarter trend on a two-year basis, down 2.9% per year.

As stated earlier, most of our new initiatives will not have a meaningful impact until the back half of the year. As a result, we don't expect comp sales in the second quarter to be significantly better than that in the first quarter.

Also, as you know, the year-over-year comparisons get easier in the third and fourth quarters given the weakness last year. We also are hoping for a more normal winter.

We are now assuming that our gross margin rate for the full year will be approximately flat to last year. And as mentioned earlier, we are working hard to reduce expense dollars given the lower sales outlook, while trying very hard to minimize any impact to our customers. Expense dollars are now assumed to be below last year for the full year, but the rate as a percent of sales will still be higher.

We are no longer expecting to be able to increase our EBITDA as a percent of sales this year, but we still believe that we will return to our 14% target, which we achieved just two years ago in 2014. Our EPS guidance for the year is now $3.15 to $3.40 per share, excluding settlement charges.

All of us have been reading the stream of negative news stories about various retailers over the past several weeks. Clearly, our industry is in something of a rough patch. We know we are not alone, but the consumer seems to be doing okay.

Employment in steady and wages continue to rise. The consumer savings rate remains high and most macroeconomic indicators are better than flat. So it is reasonable to conclude that the consumer will return to more aggressive discretionary spending at some point -- hopefully, sooner than later.

As we described today, we at Macy's , Inc., are taking tangible action now to mitigate the current headwinds and drive profitable sales. And as the overall tide rises, we believe we will be very well-positioned to capitalize on new opportunities.

We have always said that a down period in our industry is a great time for us to pursue gains in long-term market share. We are not counting on consumers to spend more this year, but we are working hard to give them reason to shop more with us.

As Terry has said, a setback is a setup for a comeback. That is how we are looking at the business, even if our comeback is taking longer than expected to take root.

We have a lot of newness in our pipeline. Not everything will work, of course, but we think that our proposition for the customer will be fresh and compelling in 2016, especially as we head into the all-important fourth quarter.

And we are absolutely not pulling back our commitment to digital and omnichannel retailing. Mobile remains a very high priority and we continue to invest. You may have seen that a leading trade publication last month ranked Macy's , Inc., as the sixth-largest online retailer in America, and as I said earlier, we are continuing to see double-digit year-over-year sales increases in online sales.

While we have already somewhat downsized our fleet of stores, we continue to see value and opportunity in physical locations that sync with desktops, websites, apps, and mobile in giving customers choices and meeting demand in new and different ways.

We would all prefer to be talking about sales and earnings increases today. We have confidence in our management team and organization to lead us in the direction of a recovery, and we are thankful for the heritage of innovation and the strength of outstanding brands on which we will continue to build.

So now it's time for questions.

Who has the first question?

QUESTIONS & ANSWERS

**Operator**:

(Operator Instructions)

Lorraine Hutchison, Bank of America .

**Lorraine Hutchinson** (Analyst - BoA Merrill Lynch):

Thank you. Good morning, Karen.

How quickly can you adjust your inventory commitments to reflect your new sales plan?

Specifically, how do you plan for a winter after such a warm one last year?

**Karen Hoguet** (CFO):

Those are two good questions. First, remember, a good chunk of our inventory is on replenishment and so that gets adjusted based on sales. So we really don't have to do anything to change that piece of it.

And the replenishment is not just what we would call basics. There is some fashion on replenishment as well, so that adjusts with sales trends automatically. But that is in part why we relooked at the fall plan when we did.

We're hopeful that what we've seen in the last -- in the end of the quarter is unusual and the trends will improve, but we thought we should not take the risk of waiting so that we could make a meaningful adjustment to our inventory and receipt plans, as well as expense for the back half of the year.

Your second question on how do you plan after a winter like last year, that's one of the interesting questions we've all been debating. We are actually planning it to be -- cold weather merchandise to be relatively flat with last year, but if there is what we call a normal winter, that would give us upside opportunity.

Now 2014 was an unusually cold winter, so we are sort of looking at half of the difference between 2014 as being what we think is reasonable. And that's over $100 million in additional cold weather merchandise sales, so that would be helpful to the top line.

**Lorraine Hutchinson** (Analyst - BoA Merrill Lynch):

Great. And then your newly-lowered EBITDA forecast obviously impacts your credit ratios. Is there any change in how you are thinking about share buyback versus debt repayment?

**Karen Hoguet** (CFO):

Well, I think you saw in the first quarter we did buy back less than a year ago, relating to the cash flow forecasts for the year. We remain committed to getting to the leverage ratios that we have targeted, the 2.5 to 2.8. Obviously, we are a little above that today. Our hope is to be able to get there through EBITDA, as opposed to reducing the debt, but we will have to see how things progress from here.

**Lorraine Hutchinson** (Analyst - BoA Merrill Lynch):

Thank you.

**Operator**:

Matthew Boss.

**Matthew Boss** (Analyst - JPMorgan):

If we exclude the 100 basis points tourism headwinds, clearly the underlying trend has deteriorated. I don't think you are alone on this either. But any signs of stabilization you have seen at all with traffic?

And then, larger picture, any anecdotes you are seeing from the consumer, or even by category, which reminds you at all of 2008?

**Karen Hoguet** (CFO):

That's a good question. I haven't looked at it in that context.

Look, I'm not going to comment on early May sales. We've done that before and usually the first couple weeks of a quarter don't necessarily predict it. Had I done that in February, the first quarter would have been very different.

So for now, we're assuming that what we saw in the first quarter could continue on a two-year basis. Again we hope we're wrong and we hope there's improvement and there was something fluky in the last six weeks of the quarter, but I don't know enough to say that.

And I don't know about going back to 2008. I will do that and look more into it. I'm not sure. When you look at the economic trends, you would say that's not the case, but I'm not sure.

**Matthew Boss** (Analyst - JPMorgan):

Okay. Then just a follow-up. Can you talk about the competitive landscape you are seeing out there? Any plans or do you see the need to increase promotional intensity? And just how you feel about inventory in the channel.

**Karen Hoguet** (CFO):

I think the competitive environment has become a lot more promotional. I think part of this is a result of the internet, where every promotion happens across the country immediately. And also there's a lot of price matching going on with some of the competitors and there is some irrational behavior that I think is giving us some challenges. That's in part why we lowered the expectation around gross margin a bit from what we had said earlier in the year.

**Matthew Boss** (Analyst - JPMorgan):

Okay, best of luck.

**Operator**:

Jeff Stein.

**Jeff Stein** (Analyst - Northcoast Research):

Morning, Karen. A question on gross margin. Little bit surprised that, given the environment and all, you were up 10 basis points in the first quarter. So looking back on it, could you or should have been more promotional? And can you give us some guidance in terms of what the implications might be for second-quarter gross margins?

Then a follow-up question would be can you comment on delinquency trends, which was a point you raised in the fourth-quarter earnings call? Thank you.

**Karen Hoguet** (CFO):

As I have said, we do expect the second-quarter gross margin to be under pressure because of the slow selling in warm weather goods. So I do think there will be -- we will have a less good second-quarter gross margin performance than in the first quarter.

I don't think had we promoted more the first quarter would've been a lot different, but that's a question we're certainly asking ourselves as we move forward. But I would not expect that performance in the second quarter to continue. And again, you have heard the guidance for the year as being flattish.

Delinquency levels remain somewhat elevated post our credit conversion, but the level is still within what I would call our normal range and certainly within the range of other issuers. Also the level continues to come down, so I do not think it's concerning at this point.

**Jeff Stein** (Analyst - Northcoast Research):

Thank you.

**Operator**:

Brian Tunick, Royal Bank of Canada.

**Brian Tunick** (Analyst - RBC Capital Markets):

Thanks. Good morning and thanks for taking my questions. Question on the center core slowdown. Was curious, outside of the tourist impact, did you see the domestic business slow as well in the handbags, watches, and footwear?

Then the other question is on SG&A. Are you giving us any kind of number on top of the $400 million worth of savings you are looking for this year?

**Karen Hoguet** (CFO):

On the domestic part of the center core, it declined as well, but the international piece of it made it worse than it otherwise would've been. But we saw the declines in the domestic business also.

And in terms of SG&A, I don't have an additional target at this time. We're obviously working on what that could be.

**Brian Tunick** (Analyst - RBC Capital Markets):

Terrific, thanks very much.

**Operator**:

Steve Grambling, Goldman Sachs .

**Stephen Grambling** (Analyst - Goldman Sachs):

Good morning, Karen. You mentioned online was a bit weaker than expected, but still growing double digits. Can you just talk about how the regional trends compare to what was in store and maybe even provide any other color you can on key online metrics such as conversion, traffic, etc.?

**Karen Hoguet** (CFO):

I think what we find is the online business, where it's strong, tends to be similar to the store business, so I don't see there's a big regional difference in terms of the online business.

**Stephen Grambling** (Analyst - Goldman Sachs):

What about as it relates to the key metrics? And I guess as a follow-up, you had mentioned price transparency is increasing online. How does that impact your view of consolidated gross margin longer term?

**Karen Hoguet** (CFO):

Well, I think the transparency is in part why we've lowered the guidance for margin. When we release the fourth quarter we had talked about the gross margin being up this year and we no longer think that will be the case. So I think that's where that came into play.

**Stephen Grambling** (Analyst - Goldman Sachs):

All right, thanks so much. I will jump back in the queue.

**Operator**:

Paul Trussell.

**Paul Trussell** (Analyst - Deutsche Bank):

Good morning, Karen. A few just related questions around real estate. I just wanted to reconfirm for the year that the plan remains for gains in the amount of around $235 million, which includes $86 million from Brooklyn.

I also just wanted to inquire on store count. Obviously, you closed a number of doors the very beginning of the year. Is there a likelihood of any further adjustments prior to year-end?

Then lastly, on the real estate side you mentioned the success of Backstage, those first few doors. Can you give us a little bit more color on the difference in productivity or traffic that you are seeing within that part of the store versus the balance?

**Karen Hoguet** (CFO):

So the asset sale gains, that's the easy one. There is no change in our guidance for the asset sale gains between Brooklyn and the other stores. So the $235 million would be the best guidance I could give you today on that.

In terms of the store count, as you know, we are always evaluating stores in terms of should there be any closures as we go forward. And at this point, I have nothing to report in terms of what we might do this year, but we're constantly looking at that store fleet, as you've seen every year that I can remember.

And in terms of Backstage in-store, it's too early to be talking about those kinds of statistics. Obviously we are pleased with what's happening, but with a couple of weeks of history I'm not going to give statistics yet.

**Paul Trussell** (Analyst - Deutsche Bank):

Then just to follow-up on the stores. You have often talked about the top 150 doors. Is there a meaningful spread between the performance of those doors versus the balance of the fleet?

**Karen Hoguet** (CFO):

The problem is many of the top 150 doors are also our top tourist doors, so in a number year we would see the top 150 doing a lot better. That's not the case now because of the slow tourist business. But we are pleased with the results that we are getting separate from what's happening on the international tourist side.

**Paul Trussell** (Analyst - Deutsche Bank):

Thank you, good luck.

**Operator**:

Michael Binetti.

**Michael Binetti** (Analyst - UBS):

Good morning, thanks for taking the question here. Just to get a cadence for our model, I think you said the second-quarter gross margin on a year-over-year basis would be a little worse than first quarter. I think originally for the year you said third quarter would be a decline in gross margin. Is that still the right thinking in terms of cadence?

**Karen Hoguet** (CFO):

I'm not sure. We're still planning the fall season. I still think the pressures in the third quarter will be there given last year relative to the fourth quarter, so I think what I said originally would make sense. But we will see as we plan the fall and we will talk about that in August.

**Michael Binetti** (Analyst - UBS):

Okay, thank you. As we listen to some of the other conference calls across the space lately from some of the bigger brands that are public companies, there seems to be more comments bubbling up about concerns in the department store channel that seem like they've taken more of a focus to the long term.

How have the conversations with your bigger brands changed? Are you seeing more brands asking questions about some of your lower-tier door counts? Are you see more brands pushing back on being included as some of the sales that you guys like to run to drive traffic? And if so, how does that impact your merchandising strategy?

**Karen Hoguet** (CFO):

I think there are lots of conversations going on with our big brands, as you expect. I'm not sure there's a chicken and egg in here, too. But we're both working hard to figure out what's the right path forward so that we both can grow profitably.

Those conversations are going on, as you might expect. Little bit more deeply today just given the weaker businesses.

**Michael Binetti** (Analyst - UBS):

Okay, fair enough. Thank you very much.

**Operator**:

Kimberly Greenberger.

**Kimberly Greenberger** (Analyst - Morgan Stanley):

Great, thank you. Good morning, Karen. I am wondering about your commentary on the price transparency that is created by digital commerce and that does appear to be playing a role in merchandise margin erosion.

It strikes me that perhaps this issue could be a bit more structural, rather than transitory, and I'm wondering if you agree with that. If yes, are there other levers that you can pull in order to help get the business back to that 14% EBITDA target other than merchandise margin?

**Karen Hoguet** (CFO):

I don't think it's transitory, so I agree with that statement. But we were not counting on gross margin to be hugely helpful in getting us to the 14%, so I'm not sure there's really a change in our thinking there. We had expected sales productivity and expense to really help us get back to the 14%. So a little bit of margin just getting back to a normal level after last year, but I don't disagree with your first statement.

One of the things we're all focusing on is having more exclusive merchandise that you could only get at Macy's and you can't price compare as easily. But also giving the customer just a better experience so that she is more likely to come in and buy from us at regular price.

**Kimberly Greenberger** (Analyst - Morgan Stanley):

That makes a lot of sense. My last question; you commented on the first-quarter earnings call about a slight increase in credit delinquencies that may have been temporary related to the holiday or perhaps loosening of some credit terms. I'm wondering if you can take a look at how that portfolio is performing and give us any insight or new learnings.

**Karen Hoguet** (CFO):

I think I had just commented on that. The delinquency levels are -- still remain a little elevated, but we think it's more a function of the system conversion that we did last fall, as opposed to the customer been weaker. And we expect that level to come down as we go through the year.

The level today is still in the range of most issuers, so not a concern.

**Kimberly Greenberger** (Analyst - Morgan Stanley):

Okay, not a concern. And any change or update to your forecast for credit income this year?

**Karen Hoguet** (CFO):

No, we still expect it to be down versus last year on an annual basis. There will be some odd trends by quarter, just given last year and this year's numbers and how they match up, but overall we expect it to be down versus last year.

**Kimberly Greenberger** (Analyst - Morgan Stanley):

Great. Thanks so much, Karen.

**Operator**:

Oliver Chen.

**Oliver Chen** (Analyst - Cowen and Company):

Thanks a lot. We had a bigger picture question for the 10-year picture in department stores. What do you think about food, exercise, healthcare, Generation Z? What role do you want to department stores to play as cultural institutions, as you think about generating traffic for the long term and making sure that you have a really exciting bricks-and-mortar experience that really captivates the younger customer, which has a lot of attention issues in terms of things happening?

Then also on the center core issue, are there any key aspects we can focus on for positive aspects to really reinvigorate the center core?

**Karen Hoguet** (CFO):

Let me start with we absolutely agree with you that we need to work hard to make the bricks-and-mortar experience a lot more exciting. And we are working on that and trying to test some concepts, one of which actually is the whole health and wellness. So we agree with you that making our bricks-and-mortar experiences even better is a very high priority and we are really focused on that.

And, to your point, some of the things that we are looking at are the health and wellness arena, so we will see as we go. But, again, agree with the basic theory that you have there.

In terms of center core, I would say a couple of things one is the jewelry pilot rollout should be very helpful to that area and we think that will be good. I think also we're testing a shoe pilot similar to the jewelry; similar in terms of its focus on a specific category. Different strategies out in California this fall and we're hopeful that that will help the shoe business.

We've got a lot up our sleeves in the beauty area including the rollout of some more Bluemercury stores. So we do think it will get better. I don't know that it will return to the growth that we've had in recent years this fall, but we're hopeful.

**Oliver Chen** (Analyst - Cowen and Company):

Okay, thank you. It sounds like you've been really thoughtful and prudent about how to promote in the safest way possible. So with the warm weather goods that are elevated here, what is the methodology for how you'll think about promoting those in terms of which way do you feel most comfortable to mitigate and soften the least impact possible?

**Karen Hoguet** (CFO):

I think the answer is we have lots of tools for clearing merchandise. And I think you have found over the years our gross margin has help up pretty well, so we balance all the different ways of doing it. And now we have Last Act, which is working so well.

So I feel comfortable that our merchant team will figure out a way of dealing with the warm weather goods in a way that isn't irresponsible.

**Oliver Chen** (Analyst - Cowen and Company):

Just our last question. You were really helpful with your comments on what seemed like somewhat of an optimism on the way the customer and the economy is functioning. So how do you help us reconcile that versus what you are seeing?

And just how are you thinking about that bigger picture in terms of what seems like different trends fundamentally versus a certain health in the customer and the economy?

**Karen Hoguet** (CFO):

We're, frankly, scratching our heads. We see the same economic data you all see and it would point to a customer that would be spending more. I think that gets to what he and she are spending it on.

Savings rates are high, which tells you that either they are purposefully saving more or that there's some of that savings that can be used for discretionary spending if they get motivated to do so. Some of it is spending in different categories health, restaurants, travel.

I'm not sure, but I would say that we, too, are somewhat puzzled by the data that we are seeing on the consumer and the traffic we're seeing in the stores and on the sites. So I think we just will watch. Thank you very much.

**Operator**:

Randy Konik and Company.

**Randy Konik** (Analyst - Jefferies):

Thanks a lot. Good morning, Karen. Quick question. Given the differences you are seeing in categories from a sell-through perspective, do you think about changing the density of category commitments in any way in terms of dedicating more or less of a store towards, let's say, handbags or less towards handbags, watches, etc., given the changes we're seeing in that category?

How should we think about ongoing long-term density changes from a category perspective?

**Karen Hoguet** (CFO):

I would say if you think about the strength of a department store, we have the ability to flex resources based on what's selling, so we're constantly looking for opportunities to make our space, particularly first floors of our stores, which are the center core categories, more productive.

You don't want to change space based on a short-term trend, so there is some balancing there, but we are working very hard to make this space as productive as we can. And you may see other categories growing and shrinking based on the sales trends. But that is the strength of a department store, our ability to do that.

**Randy Konik** (Analyst - Jefferies):

I guess a follow-up is

**Karen Hoguet** (CFO):

In that case, part of the answer will be becoming more aggressive in what customers want in the whole wearable tech side, so you will see a movement towards that. Again, we are focused on making our space as productive as we can as well as our site.

**Randy Konik** (Analyst - Jefferies):

Got it. And I guess one thing that didn't come up in the call was you spoke a bit about the trends around tourism markets.

Is there any kind of variability in trend by geography where we may have seen more temperate climate versus more of the cold climate during the quarter? Just wanted to try to get some perspective there.

**Karen Hoguet** (CFO):

Weather continued to be an issue in the quarter. So obviously where we've had colder weather in the last six weeks, eight weeks, until recently, clearly has hurt the warm weather. And the warmer February hurt on the cold weather goods.

But, honestly, after last year, I just couldn't talk about weather again today. But it continues to be an issue and, yes, we did see some changes, but they weren't as dominant as the tourist issues that we talked about.

**Randy Konik** (Analyst - Jefferies):

Perfect, all right. Thanks for the help.

**Operator**:

Paul Lejuez.

**Paul Lejuez** (Analyst - Citigroup):

Thanks. Hi, Karen. Can you talk about the performance of the private-label versus third-party brands? And just remind us of the private-label penetration versus what that looks like compared to last year.

Then also, I'm just curious if you have an idea of how you are planning fourth-quarter inventory at this point.

**Karen Hoguet** (CFO):

On private brands, we made a lot of progress in the first quarter. One of the things our team there is doing is really paying attention to the buy-now/wear-now mindset of the customers, which is getting to how we flow merchandise, which I think will be very important to the business and did help us in the first quarter.

And also very much focused on editing. Some of our apparel brands had become somewhat duplicative and so we are really trying to edit and reduce overlap, which didn't necessarily help us in the first quarter but will help us, we believe, as we get to the fall season.

Another thing that has happened is we have worked on our home area and trying to add some interest and color and print into some of the home product, which we are also seeing beginning to do well. So if we are making changes and the private-brand business is doing relatively well, so we will continue to work on that. Because as I said earlier, our exclusive product is very important to us as we go forward.

**Paul Lejuez** (Analyst - Citigroup):

What percent of total sales are private brand?

**Karen Hoguet** (CFO):

I'm sorry, it's a little over 20%.

**Paul Lejuez** (Analyst - Citigroup):

Got you. Did they outperform in this last quarter?

**Karen Hoguet** (CFO):

It varies by area, but overall did very well.

**Paul Lejuez** (Analyst - Citigroup):

Got you. And just last one. Can you just talk about Doug Sesler? What's he specifically been asked to do and how is he incentivized?

**Karen Hoguet** (CFO):

Well, he has been asked to manage our real estate function and to work on the work that had been started last year on the flagships and the mall properties to see if there might be a joint venture partnership structure that would add shareholder value that makes sense. So he is very focused on that and at the same time, as I said earlier, trying to monetize unproductive real estate.

**Paul Lejuez** (Analyst - Citigroup):

And incentivization for him?

**Karen Hoguet** (CFO):

I'm not going to comment on that.

**Paul Lejuez** (Analyst - Citigroup):

Okay. Thanks, Karen. Good luck.

**Operator**:

Todd Duvick, Wells Fargo .

**Todd Duvick** (Analyst - Wells Fargo Securities):

Good morning. Thank you. Wanted to ask you about the real estate initiatives. It looks like the options you were considering generally involve moving from owned real estate to a lease structure. And given that lease expense factors into your target leverage range, can you tell me, if you engage in a transaction that increases your lease expense, is it fair to assume that you would consider options to reduce funded debt to maintain leverage within your target range?

**Karen Hoguet** (CFO):

Yes, we would have to. Again, we have said that any of these transactions would not jeopardize our investment-grade rating. So should we take on incremental rent expense that would change our leverage ratios, we would have to reduce the funded debt to make that happen.

**Todd Duvick** (Analyst - Wells Fargo Securities):

Makes sense. Then related to that, with respect to your desire to maintain your investment-grade credit rating, can you say that that applies to all of you bonds as opposed to just your corporate credit rating?

**Karen Hoguet** (CFO):

I'm not sure I understand that question, but the key is that we do want to be an investment-grade company, so I think that's true overall.

**Todd Duvick** (Analyst - Wells Fargo Securities):

I guess where I was going was that any transaction you would consider you would not look to subordinate some of the existing bonds.

**Karen Hoguet** (CFO):

I can't comment on structure, but the key is that we will be an investment-grade company.

**Todd Duvick** (Analyst - Wells Fargo Securities):

Fair enough. Thank you, Karen.

**Operator**:

Richard Jaffe, Stifel.

**Richard Jaffe** (Analyst - Stifel Nicolaus):

Thanks so much. Just a couple of follow-ons. Karen, could you break out number of exclusives or percent of your business that is both private-label and third-party exclusives? And what you (multiple speakers)?

**Karen Hoguet** (CFO):

I think the limited distribution product is north of 40%.

**Richard Jaffe** (Analyst - Stifel Nicolaus):

And I assume you see that going higher in the next year?

**Karen Hoguet** (CFO):

Yes.

**Richard Jaffe** (Analyst - Stifel Nicolaus):

So do you give us a sense of how high?

**Karen Hoguet** (CFO):

No. And again, it's a hard number to move in a major way, so again I can't be specific, but that would be our intent.

**Richard Jaffe** (Analyst - Stifel Nicolaus):

Could you just talk about the in-store Backstage sourcing, how much of that is coming from actually in-store and how much from other sources?

**Karen Hoguet** (CFO):

None is coming from in-store. It is being merchandised by a separate off-price organization and they are buying 100% of the goods not from sort of the other side of the store.

And they are trying to buy categories of merchandise that complement what's in the main store. Things like toys and games, some electronic kind of products, gourmet food, if you can believe that, home decor, which has been a huge success for us, and some knock-down furniture pieces. Again, trying not to compete with what's in the remainder of the store.

**Richard Jaffe** (Analyst - Stifel Nicolaus):

Just last question on marketing and the opportunity to shift some of your initiatives given the success on digital and social media in the fourth quarter to try and grab some more traffic.

**Karen Hoguet** (CFO):

We have been shifting that and we plan to continue to do so. So I think that's all part of the plan as we look to accelerate the sales performance of the company.

**Richard Jaffe** (Analyst - Stifel Nicolaus):

Okay, thanks very much.

**Operator**:

Omar Saad.

**Omar Saad** (Analyst - Evercore ISI):

Thanks. Good morning, Karen. I know you just said a few minutes ago you didn't really want to spend too much time on weather. But I wanted to ask one follow-up.

It did seem like it was a bit warm early spring, a nice start to the spring and then it's been colder and wet, at least in the Northeast. I'm trying to understand -- I get the idea -- and maybe you've thought about this -- that in a digital world weather can have a bigger impact than it used to when everyone has got a store in their pocket or pocket full of department stores in the phone, in their computers. But I'm trying to understand why is that -- why do you think that's not being made up with e-commerce and why that's not compensating for the loss of traffic.

**Karen Hoguet** (CFO):

I'm not sure I understand why you think digital would make it up. If the weather -- and I agree with your statement. We did have warmer weather than usual in February and March, which hurt our cold weather sales, and when we got to April and the weather was cooler, it impacted the warm weather sales. But I'm not sure why digital would change that.

**Omar Saad** (Analyst - Evercore ISI):

Everyone has got in their pocket an internet full of department stores. Maybe there's less impetus to go out shopping if it's rainy and wet or the change in weather is not spurring…

**Karen Hoguet** (CFO):

I think it's so much a traffic issue, but it's -- if it's in February and it's warm, you're not going to buy the cold-weather goods that we have in our stores or online. You're just going to not need it.

**Omar Saad** (Analyst - Evercore ISI):

Got it.

**Karen Hoguet** (CFO):

We do find, for example, when there used to be major snowstorms the internet business does go up, but this is not so much about store traffic as it is what people are buying. And when the weather is unseasonal they are buying less seasonal merchandise.

**Omar Saad** (Analyst - Evercore ISI):

Sure, the catalyst to buy.

**Karen Hoguet** (CFO):

So it's a different point, correct.

**Omar Saad** (Analyst - Evercore ISI):

Okay. Then a quick question on real estate. In the past you had expressed some caution around the idea of burdening the core operating business with any sort of significant rent expense or burden there. I'm assuming the company's and management's views haven't changed on that aspect.

**Karen Hoguet** (CFO):

That's correct. That was the whole conversation I just had with Todd, but that is correct.

**Omar Saad** (Analyst - Evercore ISI):

Thank you.

**Operator**:

Bob Drbul.

**Bob Drbul** (Analyst - Nomura Securities):

Just a couple quick questions. The first one is on the focus on more exclusive brands. Can you just talk about your expectations around net profitability with margin support and margin guarantees from the branded vendors? What your expectation is on the inventories and sort of net sellthroughs on some of the private, exclusive brands that you guys focus on?

Is there more risk in that strategy, especially around weather and seasonal merchandise?

**Karen Hoguet** (CFO):

I would say that there's more risk, but there's also more reward, so I think it's both sides of it. And I think the key thing is, from a customer perspective, what I think will help to drive traffic to Macy's , whether it be online or in-store, is having that unique special product that is at really good values. And I think these exclusive products, whether it be from a major brand or our own private brand, will be helpful to making that happen.

**Bob Drbul** (Analyst - Nomura Securities):

As you look to the rest of the year you talk about greater newness and more exclusive. Are there any of the new collaborations or brands that you would call out that you are most excited about as we think for the remainder of 2016?

**Karen Hoguet** (CFO):

I think you saw a lot of it in the press release. Obviously, we put the ones we are most excited about in the press release, so I would just look there.

**Bob Drbul** (Analyst - Nomura Securities):

Okay. Then just the last question that I have is when you think about coming out of sort of the fourth-quarter comp inventories, how much have you worked through on some of the excess merchandise? Is there an excess from the fourth quarter versus your spring overage on inventories at this point that you could talk to, like separate the two as buckets?

**Karen Hoguet** (CFO):

We are through the fourth quarter so-called overage, some of which we had purposefully kept over thinking February would be colder, but we are through that overage, if you want to call it that. And by the way, that's where Last Act was very helpful.

**Bob Drbul** (Analyst - Nomura Securities):

Okay, thanks very much, Karen.

**Operator**:

Javier Escalante.

**Javier Escalante** (Analyst - Consumer Edge Research):

Good morning, everyone. My question has to do with more details about one of the leading categories, beauty. If you can clarify whether the Bluemercury expansion is within Macy's traditional stores or this is just an acceleration of the freestanding store concept.

And secondly, if you feel that you need to increase the number of beauty brands to compete with the specialty stores. And if so, how you think that is going to impact the layout vis-a-vis other plans that you have made with glasses and stuff like that that you had mentioned in the past? Thank you.

**Karen Hoguet** (CFO):

Yes, we are rolling out Bluemercury both freestanding and in-store, so I would say both there. We are planning to open 24 freestanding stores this year and 18 shop-in-shops for Bluemercury. And we're very excited about how they are performing and what they are going to be able to add to the Macy's location. So that we feel good about.

We're also rolling out beyond these stores the proprietary brands from Bluemercury, M-61, which was just recently launched on Macys.com. So that's also adding to our beauty arsenal.

And in terms of more brands, we are doing that in a couple of ways. One is we have our Impulse beauty installations in so many of our stores, which are a combination of smaller brands. We continue to bring new brands in and add to that footprint as we go forward.

On the upper end, you've got Bluemercury that also has a lot of these smaller brands. So, yes, we will continue to do so and, at the same time, fully support the big cosmetics brands that are the bread and butter of our beauty department.

**Javier Escalante** (Analyst - Consumer Edge Research):

Thank you.

**Operator**:

David Glick, Buckingham Research.

**David Glick** (Analyst - Buckingham Research Group):

Thank you. Just a quick follow-up, Karen. Just trying to understand the change in trend from 4Q to 1Q. Obviously tourism and weather; you referred to seasonal categories been difficult in both quarters. That seems to be a common thread.

Was the biggest change really a deceleration in center core? And in addition, is it -- you guys focus on some top brands. Are you seeing a deceleration in the performance of some of your key organizing brands? Is that another -- obviously without naming them, but is that part of the challenge? Thanks.

**Karen Hoguet** (CFO):

I would say if you look at the number of transactions, in the fourth quarter it was down 4% and in the first quarter it was down 7%. So something really changed on that dynamic which negatively impacted the business.

Yes, center core did get weaker, but I think that's those key categories in center core, but I think a lot of that relates to the international tourist business. So I think that's more of a factor there.

**David Glick** (Analyst - Buckingham Research Group):

And then one quick follow-up, if I could. On tourism, a lot of companies have been talking about fourth quarter was going to be the end of the headwind, then first quarter, then summer. You are basically saying it's going to continue based on the first-quarter performance.

Do you look at certain metrics to try to predict that, whether it's hotel bookings or flight bookings coming from Europe? Are you just kind of saying, look, this is how it is; we're not going to assume in our guidance it's getting any better?

**Karen Hoguet** (CFO):

I think I would say we're just assuming that as we are giving guidance, and more importantly planning internally, that we don't think it's going to get better this year.

**David Glick** (Analyst - Buckingham Research Group):

Okay, great. Thank you very much. Good luck.

**Operator**:

Michael Exstein, Credit Suisse.

**Anjani Gupta** (Analyst - Credit Suisse):

Sorry about that. This is Anjani on for Michael. I apologize if this question has been answered before, but for gross margins, they did improve 10 basis points. Were there any one-time positive items flowing into gross margins this quarter?

**Karen Hoguet** (CFO):

No.

**Anjani Gupta** (Analyst - Credit Suisse):

No? Okay, that was the only question. Thank you very much.

**Operator**:

We have no further questions in queue. I would now like to turn the conference back over to our moderator for any additional or closing remarks.

**Karen Hoguet** (CFO):

Great. Thank you all for your interest and your support. As always, if you have further questions, reach out to Matt, reach out to me, and we will try to get them answered as quickly as we can. Thank you.

**Operator**:

This does conclude today's conference call.