Company Name: Burlington Stores Inc
Company Ticker: BURL US
Date: 2017-08-24
Event Description: Q2 2017 Earnings Call

Market Cap: 5,996.28
Current PX: 85.88
YTD Change($): +1.13
YTD Change(%): +1.333

Bloomberg Estimates - EPS
Current Quarter: 0.593
Current Year: 4.037
Bloomberg Estimates - Sales
Current Quarter: 1449.667
Current Year: 6035.500

Q2 2017 Earnings Call

Company Participants

- David Glick
- Thomas A. Kingsbury
- Marc D. Katz

Other Participants

- Ike Boruchow
- Matthew Robert Boss
- John Kernan
- Lorraine Maikis Hutchinson
- Kimberly Conroy Greenberger
- Bilun Boyner
- Brandon Cheatham
- Lindsay Drucker Mann
- Dana Lauren Telsey
- Robert Drbul

MANAGEMENT DISCUSSION SECTION

Operator

Greetings and welcome to the Burlington Stores Second Quarter Fiscal Quarter 2017 Earnings Conference Call. At this time, all participants are in a listen-only mode. A brief question-and-answer session will follow the formal presentation. [Operator Instructions] As a reminder, this conference is being recorded.

I would now like to turn the conference over to your host, David Glick, Vice President of Investor Relations. Thank you. You may now begin.

David Glick

Thank you, operator; and good morning, everyone. We appreciate everyone's participation in today's conference call to discuss Burlington's 2017 second fiscal quarter operating results. Our presenters today are Tom Kingsbury, our Chairman and Chief Executive Officer; and Marc Katz, Chief Financial Officer and Principal.

Before I turn the call over to Tom, I would like to inform listeners that this call may not be transcribed, recorded, or broadcast without our expressed permission. A replay of the call will be available until September 7, 2017. We take no responsibility for inaccuracies that may appear in transcripts of this call by third parties. Our remarks in the Q&A that follows are copyrighted today by Burlington Stores.

Remarks made on this call concerning future expectations, events, strategies, objectives, trends or projected financial results are subject to certain risks and uncertainties. Actual results may differ materially from those that are projected in such forward-looking statements. Such risks and uncertainties include those that are described in the company's 10-K for fiscal 2016 and in other filings with the SEC, all of which are expressly incorporated herein by reference.

Please note that the financial results and expectations we discuss today are on a continuing operations basis. Reconciliations of the non-GAAP measures we discuss today to GAAP measures are included in today's press release.

Now here's Tom.

Thomas A. Kingsbury

Thank you, David. Good morning, everyone. We are extremely pleased to report strong second quarter results, driven by a solid 3.5% comparable store sales increase, which was on top of a very strong 5.4% increase in fiscal 2016. Adjusted operating margin, or EBIT, expanded by 140 basis points, an outstanding result, driven by increased merchandise margins, which combined with our overall strong sales increase of 8.6%, drove an 85% increase in adjusted earnings per share, significantly ahead of our guidance.

Turning to highlights of the second quarter, this is our 18th consecutive quarter of positive comp sales growth. Our comp sales growth was in part driven by an increase in traffic, our 10th quarterly traffic increase out of the last 12 quarters. We delivered a 110-basis-point expansion in gross margin, which helped to drive a 140-basis-point increase in both our adjusted EBITDA margin and operating margin. And our adjusted earnings per share grew by 85%.

Another highlight of our second quarter was the performance of our new stores. While we exceeded the comp store guidance by 50 basis points versus the high end, our total sales exceeded the high end of our guidance by 90 basis points, which was driven by the better-than-expected performance of our new and non-comp stores. The continued strong performance of our new stores is a testament to the strength of our real estate and store operations teams' ability to find and open attractive new sites.

Moving to category highlights, our top-performing businesses were all areas of home; beauty, driven by bath, cosmetics and fragrances; Missy Sportswear, driven by better and active; men's sportswear, also driven by better and active; men's shoes and athletic shoes and handbags.

In terms of geographic performance, the Southeast, Northeast and Midwest were the best-performing territories, while the Southwest and West underperformed the company average, though these territories did comp positively. Moreover, 26 out of 27 regions had a flat or positive comparable store sales trend.

With regard to our inventory management this quarter, we were pleased once again with how our merchandising team managed our receipt flow and inventory as we entered the quarter with the comp store inventories down 8%, while comp store turnover improved by 10%. We are pleased with our aged inventory levels, as inventory aged 91 days and older declined once again versus the prior year as we focus on maintaining a fresh and exciting assortment for our customers.

In addition, we once again saw increases in our branded and better and best receipt unit penetration versus the prior year. Pack and hold, as a percent of our total inventory, was 27% versus 28% a year ago as we continue to focus on the quality and value of our pack and hold buys.

Given the current disruption we are seeing throughout retail, the marketplace remains vibrant for our buying teams, and we are thrilled with the great assortments at amazing values that we continue to deliver to our customers.

I'm also pleased with the value that we continue to bring to our shareholders as we repurchased over 1.2 million shares of common stock during the second quarter for $112 million. At the end of the second quarter, we have $39 million remaining on the existing share repurchase authorization. In addition, we are pleased to announce that on August 16, 2017, our board of directors authorized the repurchase of up to an additional $300 million of common stock, which is expected to be completed over the next 24 months.

Now let me touch on our long-term strategic priorities focusing on driving comparable store sales growth, expanding our store fleet and increasing our operating margins. First, with regard to driving comparable store sales growth, our underlying strategies remain, one, enhancing our assortments as we continue to improve our execution of the off-price model with particular focus on underpenetrated businesses; two, building on our marketing initiatives to make sure that we are continuing to engage both new and existing customers; and, three, continuing to improve the store experience for our customers.

Across our business, we continue to believe that we have significant opportunities to increase our penetration across several categories including home, beauty and ladies apparel. With regard to home, we added a fifth DMM to this category earlier this year in order to support our current strong sales momentum in future expected growth.

In addition to building the penetration of highly recognizable national brands across many areas of the home, we will look to the store growth in the key underdeveloped categories of housewares, home decor and [indiscernible] (07:25). As we mentioned on our last call, we ended 2016 with a home penetration of 12.4% and we continue to set our sights on a 20% penetration rate which is more in line with our peers.

Our beauty business continues to outperform and represents a key growth opportunity for us. We'll focus our efforts in beauty on increasing the breadth of designer and prestige fragrances, expanding our product offering in accessories and reacting more quickly to emerging trends in cosmetics. As we've mentioned before, this area lends itself to gifting, which will be a key focus for the balance of the year.

Ladies apparel remains a significant opportunity as we ended 2016 at a 24.4% penetration level, well below our peer group at approximately 30%. Our performance this quarter reflected strength in our Missy sportswear business, driven by outperformance in both better and active. Going forward, we will continue to [ph] distort (08:25) these growth businesses as well as rebuild our assortments in better and social dresses and suits, and investing in the plus size opportunity. In addition, we recently added a seventh DMM in ladies apparel to focus on moderate tops in active, where we believe we have additional opportunities for growth.

From a marketing point of view, we will continue to reach our customers through our testimonial campaign. We consistently hear positive feedback from customers about the commercials and we are pleased with how they score relative to the percent of people who remember the ad and can name the brand.

In 2017, our dollars spent will be similar to last year. Our store experience continues to be an important initiative for us. We are pleased that our overall satisfaction scores have increased significantly since we began tracking in 2008. In an effort to provide the best possible shopping experience for our customers, we are planning to remodel 34 stores in 2017. We are committed to investing capital to continually improve our store portfolio and expect this will continue in the future.

The second growth initiative continues to be expanding our store fleet. We ended the quarter with 600 stores, adding four new stores, averaging 44,000 square feet. In total, new and non-comp stores contribute an incremental $70 million to our second quarter sales, 11% ahead of plan. We are a national retailer that operates in 45 states and Puerto Rico, and we only have 600 stores. We believe there is a sizable gap between our current store footprint and most, if not all, other national retailers.

Given the strong performance we've experienced in our new stores and the real estate opportunities that continue to be presented to us, we are pleased to announce that we are bringing our total to 48 gross new stores and 37 net new stores, up from 44 and 30 respectively. We remain confident in our ability to expand to 1,000 stores over the long term.

We also remain focused on our third growth priority, continuing to deliver operating margin expansion. From 2013 through 2016, we expanded our operating margin or EBIT by 280 basis points. While we are very pleased with that result, there is still significant opportunity versus our peer group. On a go-forward basis, we will continue to execute the same game plan that we have deployed over the last four years, driving total sales increases to leverage fixed cost, optimizing markdowns, remaining disciplined with inventory management and maintain an active profit improvement culture across all SG&A areas.

Now I'd like to turn the call over to Marc to review our financial performance and outlook in more detail. Marc?

Marc D. Katz

Thanks, Tom, and good morning, everyone. Thank you for joining us today. We ended the second quarter by recording our 18th consecutive quarter of positive comparable store sales. In addition, we achieved strong contribution from new stores, expansion in gross margin and strong SG&A control, which combined, delivered an 85% increase in adjusted earnings per share.

Turning to our review of the income statement, for the second quarter, total sales increased 8.6% and comparable store sales increased 3.5% on top of last year's strong 5.4% increase, which followed five straight years of strong comp growth.

For the quarter, our comparable store sales performance was driven by increases in traffic and units per transaction, while conversion and average unit retail were flat versus last year. The gross margin rate of 40.7%, an increase of 110 basis points versus last year, was driven primarily by lower markdowns and a higher IMU.

As with prior years, we took physical inventories in June, increasing the number of stores to 342 versus 210 last year. Our inventory shortage results in June were in line with our expectations, so there will not be any change to our original shortage accrual assumptions. As a reminder, we recorded 65 basis points of good news related to shortage in the fourth quarter of last year as last year's result was significantly better than the prior year.

This year, we're planning for our full-year rate to be only slightly below last year. Given that we accrue last year's annual rate for the first three quarters, Q4 is not expected to be significantly different. Accordingly, we continue to expect a 20-basis-point or $0.03 shortage headwind in Q4 of this year.

Product sourcing costs, which are included in SG&A and included the cost of processing goods through our supply chain and buying costs, improved 10 basis points from last year as a percentage of sales. While we are not planning for continued product sourcing cost leverage, we are nevertheless very pleased with the productivity improvements in our supply chain. While we continue to plan product sourcing cost deleverage going forward as we invest for growth, we will strive to minimize that deleverage by focusing on additional productivity gains.

SG&A, exclusive of product sourcing costs, was 27.1%, leveraging 10 basis points as a percentage of sales versus last year. Keep in mind that while we would typically get some leverage on SG&A at a 3.5% comp, we remind investors of our previous disclosure on the first quarter call that $3 million of expenses shifted from the first quarter to the second quarter of 2017. Excluding these items, SG&A would have leveraged by 30 basis points, driven by our strong profit improvement culture that is offsetting wage and stock compensation expense headwinds that we discussed on the last call.

Other income and other revenue increased 10 basis points, primarily driven by the previously disclosed shift from the first quarter to the second quarter of $2.5 million in New Jersey Grow tax credits, which were recognized in last year's first quarter.

Adjusted EBITDA increased 28% or $28 million to $127 million. Sales growth and gross margin expansion led to a 140-basis-point expansion in rate for the quarter. Depreciation and amortization expense, exclusive of net favorable lease amortization, increased $4 million to $43 million, and interest expense decreased $0.5 million to $14.5 million.

The effective tax rate improved 1,200 basis points to 25.6%, driven primarily by the adoption of the new accounting for share-based compensation, which contributed 1,140 basis points of the improvement. Exclusive of the accounting change for share-based compensation, our effective tax rate was 37%, compared with 37.6% during last year's second quarter. This improvement was primarily driven by a reduction of state income taxes. Combined, this resulted in adjusted net income of $51 million, an increase of 82% compared to last year.

We continue to return value to our shareholders through our share repurchase program. During the quarter, we repurchased more than 1.2 million shares of stock for $112 million. At the end of the second quarter, we had $39 million remaining on our share repurchase authorization that was approved last year.

As Tom mentioned earlier, we are pleased that our board of directors authorized an additional $300 million share repurchase program to be spent over the next 24 months. All of this resulted in diluted earnings per share of $0.66 versus $0.28 last year and diluted adjusted earnings per share of $0.72 versus $0.39 last year. The $0.72 per share represents a $0.22 beat versus our top-end guidance. This beat was split between $0.15 of true operating performance and the remaining $0.07 beat was due to a $0.09 benefit from the adoption of the new share-based compensation accounting. As a reminder, we had guided a $0.02 benefit for the adoption of the new share-based compensation accounting.

Turning to our balance sheet. At quarter-end, we had $33 million in cash, $147 million in outstanding borrowings on our ABL and had unused credit availability of approximately $363 million. We ended the period with total debt at $1.3 billion. Merchandise inventories were $727 million versus $745 million last year. This decrease was due to an 8% decline in comparable store inventory, which contributed to a 10% improvement in comparable store inventory turnover as well as a decrease in pack and hold inventory. Pack and hold inventory as a percentage of total inventory represented 27% at the end of the second quarter of fiscal 2017 compared with 28% at the end of the second quarter last year.

Cash flow provided by operations decreased $37 million to $72 million, primarily related to the changes in our inventory levels and income taxes payable, partially offset by our improved operating results. Capital expenditures, net of landlord incentives, were $98 million for the first half of the year.

During the quarter, we opened for new stores, ending the period with 600 stores. We expect to open 37 net new stores for the year, up from our previous plan of 30 net new stores.

In terms of our year-to-date performance, total sales rose 6.8% and included comparable store sales increase of 2%, following a 4.9% comparable store sales gain in the first half of last year. Gross margin was 40.8%, representing an increase of 90 basis points versus the first half of last year, primarily due to a lower markdown rate and higher IMU. In addition, product sourcing cost improved by 10 basis points versus last year.

As a percentage of net sales, SG&A, exclusive of product sourcing costs, decreased 20 basis points to 26.8%. Expense leverage was driven by mainly by reductions in business insurance and advertising spend, partially offset by an increase in stock-based compensation. Adjusted EBITDA increased by 20% or $44 million to $264 million, representing a 110-basis-point increase in rate for the first half of 2017.

Depreciation and amortization expense, exclusive of net favorable lease amortization, increased by $7 million to $85 million, and interest expense decreased $2 million to $28 million. The effective tax rate improved 940 basis points to 28.2%, driven primarily by the adoption of the new accounting for share-based compensation, which contributed 880 basis points of the improvement.

Exclusive of the accounting change for share-based compensation, our effective tax rate was 37% versus 37.6% last year. The decrease in effective tax rate was a result of a reduction to our state income taxes. Combined, this resulted in net income of $99 million, an increase of 71% versus last year, and adjusted net income of $107 million versus an adjusted net income of $70 million last year, up 54%.

Diluted earnings per share were $1.40 versus $0.80 last year. Diluted adjusted net earnings per share were $1.51, inclusive of $0.16 per share benefit related to the accounting change for share-based compensation versus $0.97 last year, an increase of 56%. Excluding the $0.16 benefit, adjusted EPS grew 39%. Our fully diluted shares outstanding were 71.2 million shares versus 72.2 million shares last year.

Turning to our outlook, for the 2017 fiscal year, which includes a 53 week, we now expect total sales growth in the range of 8.4% to 8.9%, including 1.4% related to the 53 week in the fourth quarter; comparable store sales to increase in the range of 2% to 3% for the balance of the year, resulting in a full-year increase in the range of 2% to 2.5% on top of last year's 4.5% increase; adjusted EBITDA margin expansion of 70 basis points to 80 basis points; interest expense to approximate $58 million; an adjusted tax rate of approximately 34%. We expect the new accounting rules related to share-based compensation to have a favorable impact of approximately 300 basis points on the effective tax rate in 2017.

Capital expenditures, net of landlord allowances, are expected to be approximately $210 million to $215 million. This is higher than prior guidance and is due to the 48 total new store projects Tom mentioned earlier related to 2017 as well as early spending for 2018 spring new stores.

Depreciation and amortization, exclusive of favorable lease amortization, to be approximately $178 million. This results in adjusted diluted earnings per share guidance in the range of $4.11 to $4.18 using a fully diluted share count of approximately 70.5 million versus 2016 actual adjusted diluted earnings per share of $3.24.

Please note the 53 week is expected to have a $0.04 per diluted share positive impact in the fourth quarter of the year and the change in share-based compensation accounting is expected to have a $0.17 positive impact for the year.

As a reminder, our initial 2017 annual guidance was $3.77 to $3.87, which we had increased to $3.86 to $3.96 on our first quarter call. For the third quarter of 2017, we expect total sales to increase in the range of 6.7% to 7.7% and comparable store sales to increase between 2% and 3% on top of last year's 3.7% increase.

Diluted adjusted earnings per share is expected to be in the range of $0.58 to $0.61, utilizing a fully diluted share count of approximately 69.7 million versus $0.51 per share last year. This reflects a $0.01 benefit from the recent accounting change for share-based compensation.

Now I would like to turn the call back over to Tom for concluding remarks.

Thomas A. Kingsbury

Thanks, Marc. In summary, we believe our results this quarter demonstrate the agility of our business model. We drove both sales and earnings above our expectations, and we are accelerating our new store growth. We remain confident in our outlook and believe in our focus on evolving our off-price model and our ability to capitalize on the rapidly changing retail landscape. This positions us well to bring more great brands, styles and value to customers and increased value for our shareholders.

Again, I'd like to thank the store's supply chain and corporate teams for their contributions to our strong year-to-date results.

With that, I'd like to turn the call over to the operator to begin the question-and-answer portion of the call. Operator?

Q&A

Operator

Thank you. [Operator Instructions] And our first question today comes from the line of Ike Boruchow with Wells Fargo. Please go ahead with your question.

<Q - Ike Boruchow>: Hey. Good morning, everyone. Congrats on another really strong quarter.

<A - Marc D. Katz>: Thanks.

<A - Thomas A. Kingsbury>: Thanks, Ike.

<Q - Ike Boruchow>: Yeah. So one for Tom, one for Marc. I guess, Tom, first question. So you announced that you're increasing the number of the net new stores from 30 to 37. So how should we think about the forward-looking years? What does this mean to the pace of new store openings going forward in your eyes?

<A - Thomas A. Kingsbury>: Well, Ike, our decision to increase the number of net new store openings in 2017 is primary a function of the opportunity to capitalize on the availability of high-quality, attractive sites. That's what is driving the pace of our openings. I want to emphasize, it is not that we are chasing store count. We go at it deal by deal. And when the environment is as attractive as it is currently, we have the financial strength and flexibility to take advantage of the opportunities.

Having said that, let me walk you through some additional factors. As I mentioned in my prepared remarks, remember, we have only 600 stores while our two largest competitors have over 1,000 and 2,000 stores, respectively, in the U.S. We are a national retailer, but are far smaller than our competitors in terms of the number of stores, and our store density by market is much lower. We still have a significant amount of white space in most of the markets that we compete in.

In addition, as I've stated many times before, the size of our new stores continues to shrink, opening up significantly more opportunities than what's available to us before. There are many more sites becoming available in the 45,000 square-foot range than there were over 60,000 square feet. And given that we have significantly reduced our inventory levels per store, we are more comfortable operating smaller stores. And the fact is there are significant number of retail store closings that are adding to the number of attractive sites in off-mall, high-traffic retail hubs. Our success over the last several years has made us a more attractive tenant where developers are seeking us out. So we remain very confident in our ability to ultimately operate 1,000 stores.

Another key point to consider is that we are more aggressively closing and relocating stores that do not fit our brand profile any longer. While we are opening 37 net new, we are closing or relocating approximately 11 stores in 2017. And finally, and most importantly, we are accelerating our store openings because of the strength and performance versus our underwriting model and plan. Year-to-date, our new and non-comp stores are 13% ahead of plan. So that may be a long list of answers. But to summarize, our store base is small versus our peers. Real estate opportunities are plentiful. And we believe our new store underwriting model and attractive performance validates this decision to open more stores.

<Q - Ike Boruchow>: Got it. Now, that's super helpful. Thanks, Tom. And then, Marc, just a quick follow-up. So pretty significant EPS beat, even ex the tax benefit. Maybe you could just walk us through the components of the beat in the quarter. Specifically, gross margins are up really, really nicely; product sourcing costs leverage again, so that's now two quarters in a row. Just conservatism aside, is there any reason we shouldn't expect more of the same going forward on those two line items? How do we think about that?

<A - Marc D. Katz>: All right. So I think there were three parts to your one question there, Ike. We'll try to get these in order here, buddy. What I'll do is I'll start with the EPS beat, Ike, and then I'll go in a more color on margin and product sourcing. So as far as the EPS beat, it was $0.22 beat, as you said. $0.15 came from true EBIT improvement in our operating performance, we like to call it. $0.07 was the change in accounting; we had guided $0.02 and it came in at $0.09.

So specifically related to the $0.15 beat, this was one of those quarters where just every line of the P&L came out favorable in terms of our guidance. Sale is obviously driven off the total sales we'd guided, a 7.7% increase at the high-end; came in at 8.6%. We got some strength there not only in our comp stores, but our new and our non-comp stores as well. So that was great to see.

From a gross margin point of view, we ended the first quarter so clean that we were expecting good news in our merchandise margin rate. But the 110 basis points did exceed our guidance as well. So between sales and gross margin rate, that was worth $0.06 of the beat. The leverage and product sourcing cost, as you mentioned, that was worth another $0.02 of that $0.15. And from an SG&A point of view, we beat it by $0.05, and that was just relative to our strong cost control across many lines of the P&L. The team just continues to embrace our profit improvement culture here, and almost all areas of sales support contributed to that. The final $0.02, Ike, was spread across other income, depreciation and a lower share count. So that was the $0.15 beat.

Let's talk a little bit more now about our gross margin rate, 110 basis points better. That was a combination of a lower markdown rate and improved IMU, with the markdown rate being more heavier-weighted.

As I mentioned earlier, we ended Q1 really clean. We're expecting good news in markdown rate, beat our expectations. We really need to credit our merchandising team for how well they managed receipts in the quarter. I think Tom mentioned comp store inventories were down 8%; comp store turn increased 10%. And at the end of Q2, our goods aged 91 days and older are really at record-low levels. So we feel really good about that. The team did a fantastic job, as I said, managing receipt. The improvement in IMU, I mean, that's not new. I think we talked about that throughout last year as well, continued to come through, and we continue to see that across our different buy types. So another big driver.

All right. We'll move to product sourcing costs now. So here we've got to tip our hats to our supply chain team. They're having another fantastic year in terms of profit improvement that's really resulting in a lot of productivity gains in our DCs. If you remember back in Q1, we had a reduction in goods moving in and out of our reserve locations. And, again, our reserve locations, that's where we store, pack and hold product. That's where we store short-stay product, which is an allocation technique we use to minimize [ph] item (32:45). So that reduction in Q1 helped reduce cost.

We did not get that benefit in Q2. That wasn't one of the drivers. Q2 was all productivity gains. In Q2, that type of activity was higher than last year. And as we look at our fall plans, it's even expected to go even higher than last year and be a negative to us. But as we've said before, we're going to continue to invest in our merchandising team, continue to invest in our supply chain. They're both absolutely critical to this model. We are planning some slight deleverage for product sourcing cost for fall. But we're going to strive to minimize that by remaining focused on these productivity gains.

<Q - Ike Boruchow>: Got it. Thanks so much, everyone, and congrats.

<A - Marc D. Katz>: Thanks, Ike.

Operator

Our next question is from the line of Matthew Boss with JPMorgan. Please proceed with your question.

<Q - Matthew Robert Boss>: Thanks. Congrats on a great quarter, guys.

<A - Thomas A. Kingsbury>: Thanks, Matt.

<A - Marc D. Katz>: Thanks, Matt.

<Q - Matthew Robert Boss>: So my first – Tom, if you broke down the category performance, you mentioned home, beauty, Missy, men's, athletic, and handbags as continued strength. What drove the overall 300 basis points of improvement versus the first quarter? And more so, how best to think about the apparel business in the second quarter? And does this represent additional back-half opportunity in your view?

<A - Thomas A. Kingsbury>: Well, the areas of strength we highlighted the first quarter call continue to perform at a similar trend to Q1, such as home, beauty, Missy, sportswear, men's, and athletic shoes and handbags. But our higher comp this quarter was largely driven by an improvement in the apparel business across men's, women's, and children's. In addition, we continue to be very pleased with the momentum demonstrated in the second quarter in athletic shoes, the athletic shoe category across men's, women's, and kids.

Given the opportunity, we still have in ladies apparel, we've recently added the seventh DMM to focus on moderate tops and active. And the active categories we believe have additional opportunities for growth. So, really, the things we've talked about in the first quarter, they were still very, very strong, and the apparel business kicked in in the second quarter to obviously improve our trend significantly.

<Q - Matthew Robert Boss>: That's great. And then, just a follow up for Marc. Can you help us dig deeper into the comp metrics in the second quarter? So traffic remains positive, but the flat AUR, I think, was the best performance in almost two years. Is that sustainable? And can you just talk about drivers of the improvement?

<A - Marc D. Katz>: Sure. Sure, Matt. So I think as you mentioned, our comp store sales performance was driven by an increase in traffic and units per transaction, conversion in AUR flat for the quarter. I tell you, we feel absolutely great about traffic increases in 10 out of the last 12 quarters. And, Matt, I know you know this, but just in case anybody new to the story that's listening, our proxy for traffic is, in fact, traffic based on traffic counters in our stores. When we co-traffic, it's not transactions.

Yeah. This was – the first time in many quarters AUR was flat. I want to make sure that we're clear that the difference was when we've talked about AUR being down slightly in the past, I don't want you to think that it moved from like down mid-singles to flat. So it was down low-singles that moved to flat, but it did, in fact, move that way.

We think some of the things that caused that movement come from the combination of a higher better best penetration, we had slightly higher full price sales versus markdown sales in the quarter. And then finally, Tom called out Missy and men's sportswear categories that outperformed, and that was a lot driven by better and best growth being pretty significant there. So that's what helped us in Q2.

As we think about AUR going forward, Matt, the one thing that's worth pointing out is we don't have a strategy to move AUR from X to Y, right? We have a lot of merchandising strategies here to grow traffic and comps. And AUR is really a byproduct of those merchandising strategies. So all of those merchandising strategies, some have upward pressure for AUR and some have downward pressure on AUR. Downward pressure is going to continue to come as we disproportionately grow home and beauty, right? The downward pressure is going to come as we continue to strive to pass value onto our customers, right? And then what's the upward pressure? Increases in better and best penetration is going to have upward pressure. One of things you just mentioned [indiscernible] (37:23), the potential for higher full price sales versus markdown sales will have upward pressure there and that's how we kind of see it playing out.

<Q - Matthew Robert Boss>: Great. Best of luck.

<A - Marc D. Katz>: Thanks, Matt.

<A - Thomas A. Kingsbury>: Thank you. Thanks, Matt.

Operator

Our next question comes from the line of John Kernan with Cowen & Company. Please proceed with your question.

<Q - John Kernan>: Good morning, everyone. Thanks for taking my question, and congrats on outperforming your peers again.

<A - Thomas A. Kingsbury>: Thanks, John.

<A - Marc D. Katz>: Thanks, John.

<Q - John Kernan>: So just wanted to go back to the gross margin question for the back half of the year, can you help us understand what your assumptions are for IMU and markdowns embedded for Q3 and Q4, given you seem to have momentum on both line items right now?

<A - Marc D. Katz>: Yeah. Obviously, we're going to continue to see gains in our reported margin less our product sourcing cost. The one thing that we'd like to do is stick to the full year, John. So for the full year, we're now seeing 70 basis points to 80 basis points of increase in EBITDA margin. 70 basis points of that we see coming from reported margin less product sourcing cost with the other 10 basis points coming from if we hit the high-end of our sales, we'll pick it up in SG&A. Obviously, we expect both to continue to drive that net 70 basis points. The one callout since you brought up margin that we just wanted to remind everybody is related to the shortage. We were pleased with the shortage results that we got.

From here on out, we only see minor improvements in our shortage rate because of how low we ended last year. So we're not going to see the big dips versus the other quarters. And when you look at Q4 versus the prior year where we had the 65 basis points of good news, that's where we see the headwind in Q4.

<Q - John Kernan>: Okay. That's helpful. And then, follow-up question on inventory. Comp store inventory reduction and turn performance has been pretty incredible. And obviously, a big boost to cash flow. I'm just wondering, are you bumping up against any limits to reducing this as you invest in new categories like home and beauty?

<**A - Thomas A. Kingsbury**>: No. We really feel confident we can continue to reduce our comp store inventories by mid- to high-single-digits for the foreseeable future. As we build the home business, and as we build the beauty business, we're going to take inventory away from some of the apparel areas, which we feel we can turn even faster. We do have an opportunity even though we've done a really nice job increasing our turns, we just feel that that's something we can continue to do. And as we get better at executing the off-price model, our sell-throughs continue to improve and we really feel that is something that we're going see in the foreseeable future in terms of growth, in terms of turnover.

<**Q - John Kernan**>: All right. Thank you. Best of luck.

<**A - Marc D. Katz**>: Thanks, John.

<**A - Thomas A. Kingsbury**>: Thanks, John.

Operator

Our next question is from the line of Lorraine Hutchinson with Bank of America. Please proceed with your question.

<**Q - Lorraine Maikis Hutchinson**>: Thank you. Good morning.

<**A - Thomas A. Kingsbury**>: Hello, Lorraine.

<**A - Marc D. Katz**>: Hello, Lorraine.

<**Q - Lorraine Maikis Hutchinson**>: I was hoping for an update on wage pressures, what you're seeing out there for the back half and the upcoming years and what the potential offsets of any pressure might be.

<**A - Marc D. Katz**>: Sure, Lorraine. I'll take that question. So baked into our 2017 guidance for wage pressures, about $14 million, and that is split evenly between our stores and distribution centers. Just for the timing of that, that is more heavily weighted to the fall. So that $14 million was [ph] plus 2 in Q1, Q2, plus 5 (40:57) in Q3, Q4. We're going to continue to look at this on a year-over-year basis, like we've done for the last couple. And that is really on market-by-market review at the end of the year taking a look at where we are, and in what markets do we need to become more competitive and raise, and in what markets are we in pretty good shape. I will tell you taking that approach over the last couple of years, our non-exempt turnover continues to decline in our stores. So we feel pretty good about that.

Don't have a number for 2018 in terms of what it's going to be worth. Certainly, there's going to be something there, but we'll continue with our profit improvement culture to look for offsets.

<**Q - Lorraine Maikis Hutchinson**>: Thank you.

Operator

The next question is from the line of Kimberly Greenberger with Morgan Stanley. Please proceed with your question.

<**Q - Kimberly Conroy Greenberger**>: Great. Thanks. Good morning. I'll add my congratulations as well for a very fine result this quarter.

<**A - Marc D. Katz**>: Thanks, Kimberly.

<**A - Thomas A. Kingsbury**>: Thanks, Kimberly.

<**Q - Kimberly Conroy Greenberger**>: Tom, I think you talked about a 13% above-plan result from your new stores, and I'm wondering if – have you been seeing this consistently, or is this an acceleration in performance from your new stores? And then, if you could talk about the drivers of this improvement, is this better or higher underwriting

standards, better site selection, better inventory buying, marketing, there may be many contributing factors. So I'm just wondering if you can sort of peel back the onion on this for us? Thanks.

<A - Thomas A. Kingsbury>: Okay. We've been pleased with our performance versus underwriter model for a few years now. And it's getting even a little bit better than we had been performing previously. So, yeah, there's a little bit of a ramp-up. And again, it gives us all kinds of confidence in terms of adding new stores.

We've really put a lot more analytics behind our site selection process over the years. That's really helped us out a lot. The sites that we're going into are better. The fact that we can now open up a 40,000 to 50,000 square foot box versus over 60,000 square foot box, that's helped us a lot in terms of also getting better sites.

But I think it's really rooted in the fact that we have more analytics behind it. We've identified seat points where we should have stores overall. But, yeah, we're very pleased in terms of how our new stores are performing.

<Q - Kimberly Conroy Greenberger>: Great. Thanks.

Operator

Thank you.

<A - Thomas A. Kingsbury>: Hello?

Operator

Hi. Thank you. Our next question comes from the line of Brian Tunick with Royal Bank of Canada. Please go ahead with your question.

<Q - Bilun Boyner>: Hi. This is Bilun on for Brian. Thanks for taking our question. First, I wanted to ask about your branded better or best goods. Can you remind us where the penetration for those are currently in the product mix? And then, are your conversations with vendors changing at all? I know a number of key vendors have been pretty vocal about intentions to lower sales for the off-price channel, but also, on the other hand, department stores, store competitors increasing private label penetration, closing stores. So how do you see this environment playing out for your better and best good availability and your access to maybe desirable brands?

<A - Thomas A. Kingsbury>: Okay. I'll take that. First of all, we don't really give our penetration of better and best. That's just something we haven't given. All I can tell you, though, to give you some color on it, is that it's been improving. The penetration continues to grow every single quarter and every single year. Our relationships with our manufacturing community has never been better. People are very interested in terms of helping us grow our business overall, and there's plenty of availability, as I mentioned in our prepared remarks. We're really thrilled at all the opportunities that we have.

Sure, a handful of manufacturers have stated that they're going sell less to the off-price, but we deal with over 5,000 vendors. So we have a lot to choose from. And we have an opportunity even to grow the number of brands we have in our assortments currently. We're below our competitors, but we continue to add a lot of vendors, we continue to edit vendors, but there's plenty of product, plenty of manufacturers to choose from, and we're not inhibited by some comments by some of the manufacturers to sell less to the off-price because there's plenty of product to choose from.

<Q - Bilun Boyner>: Great. Thank you.

Operator

Our next question is from the line of John Morris with BMO Capital Markets. Please proceed with your questions.

<Q - Brandon Cheatham>: Hey, guys. This is actually Brandon Cheatham on for John. Let me also add my congrats on a great quarter.

<A - Thomas A. Kingsbury>: Thanks, Brandon.

<Q - Brandon Cheatham>: If I could piggyback on the real estate opportunity, you mentioned that the decision was driven by the availability of quality centers. Could you kind of go into what your ideal center is and some of the analytics that you look at, do you look at competitors in the area or, say, a department store's closing, would you want to be in, say, a strip center nearby?

<A - Thomas A. Kingsbury>: Well, our preferred location is really in strip center. That's where we see there's more traffic. I don't have to tell anybody how tough the mall businesses have been overall. So to answer your first question, it's really the preferred is high quality strip centers. That's where we want to have our stores overall.

And our real estate decisions are basically made on the demographics, make sure the demographics are in line with who our customer is. And so that's really – that's most of the science that we have behind it. We look for density – population density, we look for household income, we look at co-tenants, who's in there, ethnicity, et cetera. So those are the things that really help us in terms of choosing the right sites.

<Q - Brandon Cheatham>: And if I could follow up on the availability of products, does that kind of change your approach to pack and hold? How should we think about that going forward?

<A - Thomas A. Kingsbury>: No. There's plenty of product available, plenty to pack and hold. Our pack and hold levels at the end of the quarter were about the same as they were in the prior year. We don't really target how much pack and hold we have. We usually let the deals speak for themselves. And that's how we determine pack and hold. But we really – we don't want to drive the pack and hold numbers to a really high number because we want to have open to buy flexibility to chase goods in season. So we're comfortable right now with the level of pack and hold we have, but there's plenty of product to put into pack and hold that come to us every single day.

<Q - Brandon Cheatham>: Great. Thank you.

<A - Marc D. Katz>: Thank you.

Operator

Our next question is from the line of Lindsay Drucker Mann with Goldman Sachs. Please proceed with your questions.

<Q - Lindsay Drucker Mann>: Thanks. Good morning. I had two quick ones. First, just following up on the branded better and best penetration, Tom, could you talk about is there any specific category or categories where you're seeing that increase more pronounced than others? And then, just secondly, for your stores that are in malls, co-located with some of these large department stores that are closing, are you seeing any impact to your business with a mall store, to the downside, if traffic is falling in that mall; or maybe if you're picking up market share, to the upside? And then, for stores that are near to – in a strip center by a mall that might have a closed department store, what kind of impact are you seeing on those stores? Thanks very much.

<A - Thomas A. Kingsbury>: Sure. I'll take the first one, and then Marc can take the second one. Better and best is really across the board in terms of where we're seeing the growth. As I mentioned in prepared remarks, we had a very strong performance in ladies and men's better product. But it's really – it's pretty pervasive. And as we've talked about before, as we're locating our stores in better locations, we've been able to increase our business with customers that make over $75,000 a year. So we're cleaning up our stores, we're getting better locations, we're adding more better and best product, and it's attracting a different customer. Marc?

<A - Marc D. Katz>: Yep. Sure. As far as the closing question, Lindsay, I think we've talked about before, we felt really good about our ability to test the 2016, the Macy's closings and the impact that that had on our stores. That we feel good about. And just to remind you, post-liquidation stores that were either co-located or within half a mile from that closing actually saw a modest drop. And that's because our thoughts are just overall traffic into those centers were down. The stores that we had that were between 0.5 and 5 miles away from the closing saw a pickup. They actually did see a slight pickup. Net-net when we put it all together, it was a very, very small pickup, but it was really immaterial in total.

In terms of 2017, there's just so many closings throughout the channel, it's really difficult to parse out the impact and be able to put your finger on it. We really don't believe that the 2017 closings are acting any differently than the 2016's did; just much more difficult to test. At the end of the day, to state the obvious, you think about the long term, these ongoing store closings just represent that much more share, that's up for grabs. And we're going to remain focused on what we control, finding a great store experience and executing our model.

<Q - Lindsay Drucker Mann>: Great. Thank you.

<A - Marc D. Katz>: You bet.

Operator

Our next question comes from the line of Dana Telsey with Telsey Advisory Group. Please proceed with your questions.

<Q - Dana Lauren Telsey>: Good morning and congratulations on the performance.

<A - Thomas A. Kingsbury>: Thanks, Dana.

<A - Marc D. Katz>: Thank you.

<Q - Dana Lauren Telsey>: As you saw the progression of the quarter, did comps at all vary or was there anything to note? And as you're thinking about the back-to-school season, anything that you're seeing there different than last year? And with that better and best penetration, I've been noticing the brands that you've been getting, which is very impressive. Do you see that ever capture going in the stores? And what percent of the business could that be? Thank you.

<A - Marc D. Katz>: Well, to talk about the comps, the monthly comps during the second quarter, they're all healthy. They're all healthy. We had obviously a strong quarter overall. As far as back – we're not going talk about back-to-school right now. Obviously, we'll talk about that when we do our third quarter call. As far as better and best, we just think that's going to continue to grow in terms of penetration overall. I don't see a ceiling in terms of that. But we're also very mindful. We're very mindful of making sure that we have the right balance between good, better, and best because we really feel that's the best way to maximize the business when you have that right balance of inventory.

<A - David Glick>: Operator, we have time for one more question.

Operator

Yes. That question is coming from the line of Bob Drbul with Guggenheim Securities. Please go ahead with your questions.

<Q - Robert Drbul>: Hi, guys. Good morning. Congratulations.

<A - Thomas A. Kingsbury>: Thanks, Bob.

<Q - Robert Drbul>: I was just wondering on the store – on the comp store sales, is there a big disparity between your best-performing stores and your worst-performing stores? And then, I guess, the second question within that is with some of the new stores that you're opening, the percentage of total sales being generated from your new formats, like where does that stand today? And what's the latest thinking on when like the majority of your stores will be in the newer formats?

<A - Marc D. Katz>: Sure, Bob. I could start with that. Certainly, we have stores that perform at the high end and then we have stores that are more difficult. We don't look at it so much at that level of detail when – we look at it more by region. And I think one of the things that we talked about in terms of overall performance is that 26 out of 27 of our regions had a flatter positive comp which we feel good about. Really only had one region that was down and that was in Texas. As far as the last part of your question, I think, was the brand standard question. So, Tom, I don't know if you want to...

<A - Thomas A. Kingsbury>: Well, one of the things I mentioned is we're continuously working on our portfolio. This year with 48 new stores and remodeling 34 stores, there's 82 stores that added to the brand standard overall and we ended last year with 592. And we're just going to work our way through the portfolio. It's really a high priority for us. We really feel within the next five years or so, the majority of our stores will be at our brand standard overall. But that's something that's a mission of ours is to continue to improve our stores through new stores and remodeling stores.

<Q - Robert Drbul>: Thank you.

<A - Thomas A. Kingsbury>: Thank you.

Operator

Thank you. I will now turn the floor back to Tom Kingsbury for closing remarks.

Thomas A. Kingsbury

Thanks for joining us today. We look toward to speaking with you when we report third quarter results in November. Thank you.

Operator

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