Kohl's Corporation (KSS) CEO Michelle Gass on Q3 2019 Results - Earnings Call Transcript

Nov. 19, 2019 2:10 PM ET3 comments
by: SA Transcripts

FQ3: 11-19-19 Earnings Summary

Press Release *10-Q*

EPS of $0.74 misses by $-0.12 | Revenue of $4.36B (-0.25% Y/Y) misses by $-69.68M

Earning Call Audio Subscribers Only

0:00:00 -1:04:33

Kohl's Corporation (NYSE:KSS) Q3 2019 Earnings Conference Call November 19, 2019 9:00 AM ET

Company Participants

Mark Rupe - VP, IR

Michelle Gass - CEO

Jill Timm - SEVP and CFO

Conference Call Participants

Oliver Chen - Cowen & Company

Bob Drbul - Guggenheim

Lorraine Hutchinson - Bank of America

Dana Telsey - Telsey Advisory Group

Alexander Walvis - Goldman Sachs

Gabriella Carbone - Deutsche Bank

Chuck Grom - Gordon Haskett

Mark Altschwager - Robert W. Baird

Operator

Ladies and gentlemen, thank you for standing by. Welcome to Kohl's Q3 2019 Earnings Release Conference Call. At this time, all participants are in a listen-only mode. Later, we will conduct a question-and-answer session. [Operator Instructions] As a reminder, today's conference is being recorded.

I would now like to turn the conference over to Mark Rupe, Vice President of Investor Relations of Kohl's. Please go ahead.

Mark Rupe

Thank you, Greg. Certain statements made on this call, including projected financial results and the company's future initiatives are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995.

Kohl's intends forward-looking terminology such as believes, expects, may, will, should, anticipates, plans, or similar expressions to identify forward-looking statements. Such statements are subject to certain risks and uncertainties, which could cause Kohl's actual results to differ materially from those projected in such forward-looking statements.

Such risks and uncertainties include, but are not limited to, those that are described in Item 1A in Kohl's most recent Annual Report on Form 10-K and as maybe supplemented from time-to-time in Kohl's other filings with the SEC, all of which are expressly incorporated herein by reference. Forward-looking statements relate to the date initially made and Kohl's undertakes no obligation to update them.

In addition, during this call, we will make reference to adjusted net income and adjusted diluted earnings per share, which are non-GAAP measures. Information necessary to reconcile these non-GAAP measures can be found in our press release, which is filed as an exhibit to our Form 8-K with the SEC and is available on the company's Investor Relations website.

Please note that this call will be recorded. However, replays of this call will not be updated. So, if you're listening to a replay of this call, it is possible that the information discussed is no longer current, and Kohl's undertakes no obligation to update such information.

With me today are Michelle Gass, our Chief Executive Officer; and Jill Timm, our Chief Financial Officer.

I will now turn the call over to Michelle.

Michelle Gass

Thank you, Mark. Good morning and welcome to Kohl's third quarter earnings conference call. We are pleased to report that our business recaptured momentum during the third quarter, returning to growth with a comparable sales increase of 0.4%. The quarter started off positive in August, driven by our third consecutive year of growth during the back-to-school season and ended strong with October being the best performing month.

A few of the key highlights of the quarter included an acceleration in our active business, continued strength in digital, improved performance in our stores, and improvement across all of our lines of business versus the first half. In fact, all of our lines of business were positive except for one, which I will address later. This gives us confidence as we move into the important holiday season. We have an increasingly relevant product offering. We're seeing positive traffic trends and we have a compelling marketing plan in place to drive traffic and sales.

Our opportunity to drive growth and capture share this holiday is significant. We are leaning into growth and investing in customer value to drive engagement and new customer acquisitions. Our holiday kick-off event on November 1 was successful exceeding our expectations.

I'd now like to welcome Jill Timm as our new Chief Financial Officer, who many of you already know. Jill is a well-respected and seasoned finance leader with a great understanding of our business and the retail industry. She joined Kohl's in 1999 and most recently served as EVP of Finance, leading the finance organization and our operational excellence strategy, as well as supporting many of our top strategic initiatives. Jill has been an invaluable partner to the entire leadership team, and I am confident that she will continue to contribute significantly to the business.

I would also like to thank Bruce Besanko for his significant contributions to the company. Bruce added great value across many parts of the business during his time here and further strengthened our overall finance organization. We wish him well in his retirement.

I’ll now turn the call over to Jill, who’ll provide details on our financial results. After Jill’s remarks, I will return to add more color on the business and update you on our key initiatives.

Jill Timm

Thank you, Michelle. I'm honored and excited to lead Kohl’s finance organization during this very exciting time. Kohl's is an outstanding company with a strong foundation and promising future, and I look forward to continuing partnering with Michelle and the entire leadership team to successfully drive our strategic initiatives, create new opportunities for growth, and drive value for our shareholders.

I will now discuss our Q3 financial results. Comparable sales increased 0.4%, representing a significant improvement from the first half of the year decline of down 3.2%. As Michelle indicated, we had successful back-to-school season. However, we experienced softness during the middle of the quarter as we saw an increasingly competitive promotional environment, a seasonally warm weather, and encountered modest disruption from all of the activity taking place in our stores as we launched a record number of brands.

We reacted by enhancing our marketing offers and investing more in pricing. We are pleased with how the business responded with sales accelerating in October. Digital sales growth remained strong increasing at a mid-teens percent rate, which is on top of a mid-teens increase in the prior year. We also saw notable improvement in our stores during the period. Overall the West, Midwest, and South Central were the strongest regions.

From a line of business perspective, all improved relative to the first half of the year. In particular men's, accessories, and footwear outperformed the company, while home and children were in line, and women's was below the company average. Importantly, all lines of business were positive during the quarter except women's which was down 1%. Michelle will provide additional comments on our sales results in her remarks.

Moving to gross margin, third quarter gross margin decreased 67 basis points. Margin contracted more than we planned at the time of our August earnings call. As we progressed through the quarter, we made the intentional decision to be more aggressive with our pricing in response to the competitive environment and to build momentum in October ahead of the holiday season.

This decision, along with the unfavorable mix due to the underperformance in our women's business impacted our gross margin. While cost of shipping continue to be a headwind, it normalized in Q3 and was in line with our expectations. SG&A increased 3.2% as we expected or $44 million to $1.4 billion. The increase was driven by a combination of the following. Store expenses increased as expected due to factors including costs related to the significant number of brand launches, wage rate pressures, earlier holiday hiring, and the Amazon Returns program.

Marketing expenses increased to support our efforts to accelerate sales, and technology expenses increased as we continued to prioritize investments. And due to the new lease accounting standard, rent expense was higher.

Depreciation expense of $227 million was $16 million lower than last year. The decrease was primarily due to the maturity of our store portfolio, as well as the adoption of the new lease accounting standards, which essentially offset the related higher SG&A expense. Net interest expense was $11 million better for the quarter, due primarily to the benefit of last year's debt reductions and the adoption of the new lease accounting standard.

Moving on to taxes, our effective tax rate for the quarter was 23.6% as compared to last year's 17.6%, which benefited from favorable audit results. As it relates to one-time items, during the third quarter we recognized a $9 million gain on extinguishment of debt related to the purchase of leased equipment that was accounted for as a financing obligation.

On a GAAP basis for the quarter net income was $123 million and diluted earnings per share was $0.78. Excluding the non-recurring benefit that I just mentioned for the quarter net income was $116 million and diluted earnings per share was $0.74.

Looking at our store portfolio, we ended the quarter with 1,159 Kohl's stores, gross footage was 98 million square feet and selling footage was 82 million square feet. We opened four smaller-format stores during the third quarter.

Turning to the balance sheet, we ended the third quarter with $490 million of cash and cash equivalents. This was a decline from last year as strong cash flows from operations, over the past year were used to repay debt in addition to funding our annual share repurchase program and dividends. Our inventory dollars increased 1%, which was an improvement relative to last quarter's 2% increase. We continue to expect to end the year with approximately flat inventory dollars.

Moving on to capital management, capital expenditures were $678 million year-to-date, $220 million higher than the prior year. As a result of our sixth e-commerce fulfillment center and increased investment in our store strategies including refreshes, new stores and right-sizes.

Kohl’s weighted average diluted shares and shares outstanding at quarter-end were $157 million. We repurchased 2.7 million shares of our stock during the quarter. Last week our Board of Directors declared a quarterly cash dividend of $0.67 per common share. The dividend is payable on December 24th to shareholders of record at the close of business on December 11th.

Turning to guidance, as you saw in the release we are revising our annual adjusted earnings guidance to $4.75 to $4.95 per share. Our updated annual guidance incorporates our year-to-date results and the investments we're making to take advantage of the opportunities to further accelerate our sales and capture market share. We expect the heightened promotional environment to continue through the balance of the year. For the top line, we now expect comp sales of down 1.5% to down 1% for the year, which implies Q4 comparable sales in the range of flat to up 1%.

As it relates to gross margin rates we now expect it to be down 60, 65 basis points for the year, which reflects our year-to-date performance and our outlook for the fourth quarter. For SG&A we expect expenses to be at the high-end of the existing range, which is a 1.5% to 2% increase for the year. As a reminder approximately 40 basis points of the increase in 2019 is related to the new lease accounting standards.

And lastly, our guidance continues to assume share repurchases at the higher end of the $400 million to $500 million range.

I'll now turn the call back to Michelle, who'll provide additional details on our results and an update on our key initiatives.

Michelle Gass

Thank you, Jill. Let me touch on our Q3 performance and then move into providing an update on our key initiatives for the holiday season and beyond. On last quarter's call, we highlighted the return to positive comparable sales trend late in the period. This continued into August and led to another successful back-to-school season, driven by growth in many of the key areas we leaned into including Active, Denim and our children's business.

However as Jill indicated, we experienced softness in September, as we saw an increasingly competitive environment and unseasonably warm weather. It was also an incredible amount of activity taking place in our stores during this time, as we launched a record number of brands. Given the heightened competitive environment, we responded by investing in pricing and enhancing our marketing offers recognizing the importance of entering the holiday season with momentum.

Our decisive actions were successful and enabled us to deliver a strong sales performance in October. While the quarter didn't meet our expectations I am pleased with how the entire team responded and worked with speed and agility to successfully execute all of our initiatives. In doing so, we positioned the business for a strong holiday season.

I'll now give you a little more color on our Q3 sales. Active continues to be a key growth driver in our business. Active sales increased 7% compared to last year. Active apparel sales increased at a high-single digit rate, driven by strong performance from our three key national brands Nike, Under Armour and Adidas, as well as additional relevant brands including Champions. And Active Footwear returned to positive growth with solid results from Adidas, Under Armour, Band [ph] and ASICS.

During the third quarter, we added Under Armour, Big & Tall and further executed against our in-store active expansion strategy. We increased the number of stores with additional active space to approximately 160 from 30. And we added 100 Adidas shop-in-shops expanding the penetration from 75 to 175 doors.

Now some additional details on our lines of business; Men's led the company driven by Active and Big & Tall. Our team business was also strong and benefited from the launch of our expanded online assortment with fanatics. Men's casual apparel was also a strength and from a brand perspective Levi's and Hagar, as well as our private brands Sonoma, and Apartment 9, all experienced solid growth.

Our accessories business performed well once again and was above the company average, driven by strong growth in beauty, which was led by fragrance. We are also particularly pleased with the growth we're seeing in fine jewelry and in our gifting categories. Footwear also performed above the company average and we're pleased to see this return to growth after a soft start to the year. Growth was driven by Active and our women's dress casual business.

Home improved significantly in Q3, driven by the introduction of our new brand, Koolaburra by UGG Home and Scott Living, as well as innovation in many of our key categories like housewares and electronics, where we saw strong growth in vacuums and gaming. Home in particular, benefited from our investments in pricing. Children's continued to be solid and performed in line with the company. During the quarter, we saw strength in key classifications, such as Active and licensed entertainment.

And lastly, let me address our women's business, which made progressive improvement relative to the first half of the year, but was our only negative performing category at down 1%. We continue to be pleased with the strong performance we are seeing in our Active and Intimate business. However, we are seeing mixed results in casual apparel. In the short-term, we've made a number of moves to position the business for long-term health. This included exiting the Dana Buchman brand and introducing Nine West and Elizabeth and James.

With these introductions we refloated the layout of the women's area in our stores. So the brand adjacencies would better align with customer shopping preferences. While this has some disruption in the short-term, it positioned us well for the long-term. Of note, while women's underperformed in our stores it outperformed in digital, which shows our new brands are resonating with our customers.

So speaking of digital, we continue to be pleased with the momentum we're seeing. As Jill noted, digital sales increased at a mid-teens rate in Q3, which was on top of a similarly strong mid-teens growth last year. Mobile continues to be the primary driver of digital growth, with particularly strong performance from the Kohl’s app. During the third quarter, the Kohl’s app grew significantly faster than digital overall, with nearly double the traffic growth and nearly tripled the sales growth, as our loyal customers have increased their usage.

We also continue to see benefits from customer adoption of BOPUS and BOSS. In Q3 in store customer pickup penetration further increased as a percent of digital orders. We are also improving on speed with 95% of bogus orders available within one hour, which positions us very well for the holiday rush.

Our stores are also fulfilling more digital ship to home orders and this holiday we will expand the number of stores from 10 to 135 carrying incremental inventory to support the peak volume periods of our digital business.

Now let me share a brief update on the Amazon returns program. As you know, we completed the nationwide rollout of the Amazon returns program late in the second quarter. We continue to be very pleased with its overall performance. And based on the results we are seeing, we remain confident that it will have a positive contribution to operating income in 2019.

With the extension of the program consumer research indicates that customers are very satisfied with the service. They find it simple and easy to us and they intend to use it again.

The program is driving incremental traffic into our stores and we are particularly encouraged by the disproportionate amount of new customers, which on average are also younger than the typical Kohl's customer. We are very much looking forward to the holiday season, which will be the first with Amazon returns in stores nationwide.

The entire organization is focused on delivering exceptional customer service and ensuring that we are capitalizing on increased traffic. While we are pleased with the conversion rate, and it's performing consistent with our pilot stores, we are continuing to innovate and test ways to further improve productivity. Few examples include enhanced training, testing different offers and merchandising the customer service area to drive impulse purchases.

I will now provide an update on our key initiatives for holiday and beyond. We remain very confident that we are set up to have a strong holiday season. This is driven by four key strategies. First, as I just mentioned, we will have Amazon returns in stores nationwide this holiday for the first time, which will drive additional traffic into our stores.

Second, we have more new brand launches than ever before. Third, we have a robust marketing plan and we'll be investing in value and pricing to drive new customer acquisitions. And fourth, we expect our strong double-digit growth in digital to continue.

The Holiday season is when Kohl's is at its best and this year will be no different. Our customers will discover new brands and be inspired by new gifting options literally at every turn. We're pleased with how we kicked off the holiday with our Black Friday preview event on November 1st. As we now look forward to the holiday season, we are confident that we have the right plans in place as we move into the key shopping weeks including new brands, exciting collaborations, new partnerships and leaning into key gifting categories.

As it relates to new brands we're delivering a record amount of newness this holiday. In September we launched Koolaburra by UGG Home and Nine West footwear, apparel and accessories. In October, we launched Scott Living, our collaboration with the property brothers Jonathan Andrew Scott, which fills an important wide space opportunity in offering modern home decor. And recently, we launched our partnership with Ashley and Mary Kate Olson where we became the exclusive retailer of Elizabeth and James branded apparel, handbags and accessories.

We view each of these brand launches as an investment in driving future growth, while modernizing the Kohl's brand and attracting younger customers. Collectively they are off to a good start. In addition, we have exciting collaborations in place this season. We just introduced an exclusive limited edition women's apparel capsule designed in partnership with globally renowned designer Jason Wu.

We also just launched in collaboration with Ellen DeGeneres on an assortment of pet offerings. New partnerships are also a key focus for us. Through our expanded relationship with Fanatics we've become an even stronger destination for team logoed sportswear and are attracting new and younger customers. And of course being the holiday season, we are leaning into key gifting categories.

We've expanded our cozy platform, doubled our toy assortment and are introducing new gift sets and beauty fragrance and fine jewelry. We will support our position as the leading destination for Active for the entire family with newness across sleeves [ph] and outerwear and we expect a strong licensed entertainment business, driven by the upcoming releases of Frozen 2 and Star Wars.

As we think about our marketing efforts, we know we need to be bold and strategic to cut through the increasingly competitive environment. The holiday period is the best time to capture new customers and we will take full advantage of maximizing this opportunity. We are committed to giving customers the most compelling and differentiated reasons to make Kohl's their holiday shopping destination. This season we are building on the strength of our marketing foundation and experimenting with new innovative ways to reach our customers both our core loyal customers and an increased focus on reaching millennials.

We continue to make progressive improvement in our personalization efforts, reaching customers with the most relevant messages for them. For the holiday season tens of millions of our customer connections will be personalized in some way. Our ongoing millions of our customer connections will be personalized in some way. Our ongoing testing demonstrates that we see an increase in both traffic and conversion through these personalized messages.

And we continue to leverage digital media more extensively and more efficiently to reach customers where they are. As an example, this past quarter we completed our effort to bring digital search in-house. And we're partnering with Google to increase the use of machine learning and our media buying. We have also significantly increased our use of social media to reach both our core and younger audiences.

Based on all of the efforts I have highlighted we are well-positioned for a strong holiday season and are strategically increasing our investments to fuel growth and customer acquisition. We believe that investing in the short-term will support our strategies to drive profitable growth over the long-term.

I will now transition to our customer experience initiatives underway in both our stores and digital channels. From a digital perspective and as I mentioned on last quarter's call we began piloting a new site experience to elevate the customer experience, including more product storytelling, more personalization and better search capability, while also continuing to deliver a strong value message.

While it's early days and we're only testing a small portion of our traffic we're seeing good engagements. Based on the results we will look to further expand the pilot to a greater portion of our traffic early next year.

With regards to our stores we continue to make significant investments to improve the customer experience. While new brand introductions have been an especially important element of this in 2019, we are also stepping up our investments in modernizing our store base through a greater number of full refreshes. This will remain an important part of our strategy going forward.

And beyond that, let me highlight a few of these investment areas in our stores. Active continues to represent a centerpiece of our strategy and is another way our customers are experiencing modernized Kohl's. As I mentioned earlier we have expanded the penetration of Adidas shop-in-shops to 175 stores. We have also increased active square footage by 25% in approximately 160 of our highest performing stores. These stores feature a wider selection across all zones, additional fixtures and unique items.

And another example of how we're dedicating more to Active is the expansion of our women's plus assortment. Building on the success of Nike Plus this quarter we're adding Adidas and Under Armour Plus. Based on the strong Q3 results and our ongoing tests with the customer we continue to see Active as a long-term growth opportunity.

In Beauty we're making great strides in our pursuit of significant long-term growth. We launched several new beauty brands this quarter expanded the pilot of our new beauty experience to 12 stores and rolled out our new beauty impulse concept in 200 stores and online. While beauty is a relatively small business for us today it is growing fast and we have plans for it to be much bigger in the future. We look forward to sharing more with you early next year.

Some of the other in-store experience projects include the outfit bar and Curated by Kohl’s. The outfit bar merchandising concept continues to test well and we are evaluating the opportunity to expand the pilot beyond the 50 current stores next year. And we continue to be excited about Curated by Kohl’s, our new innovative platform where we are showcasing emerging digitally native brands. We launched it last month in about 50 stores and online and are encouraged by the early results.

We're partnering with Facebook to bring Curated to life through social marketing efforts and to help identify brands that are creating a following on both their Facebook and Instagram platforms. We look forward to bringing new brands onto the platform next year.

We are also making progress with our store optimization strategy. During the third quarter two new right-size locations were opened by our partners and we expect several more to open in the fourth quarter. In addition, we opened four small format stores and see the potential for more in the future. Through both our rightsizing and small format strategies we continue to learn which will inform our future actions.

And lastly, let me remind you that we remain focused on our operational excellence initiative, which touches all parts of the business. We've been successful in saving well over our target of $250 million during the past three years and this has funded many of our growth initiatives. Our focus and efforts on this front will continue going forward.

In closing, although, the quarter didn't meet our expectations, I'm pleased that the business returned to growth. A direct result of the innovation the organization is driving across the company. And we expect the impact of these initiatives to continue to build. We remain firmly committed to driving strong financial performance and shareholder value over the long-term.

I'd also like to thank our incredible associates around the country. We introduced a lot of change into our business this quarter with the ramp-up of the Amazon returns program, the launch of several significant new brands and a lot of newness across the entire business. The team continues to execute very well and we're encouraged by the momentum heading into the important holiday season. We are ready to deliver an outstanding experience to both new and loyal customers at a time when Kohl's is at its very best.

We're happy to take your questions at this time.

Question-and-Answer Session

Operator

[Operator Instructions] Your first question comes from the line of Oliver Chen from Cowen & Company. Please go ahead.

Oliver Chen

Hi, thank you, and congratulations, Jill. Regarding promotions, it's been a promotional environment for a while. So I would love your thoughts on how this is different this year. And also what are your thoughts on what you're seeing with traffic? It sounds like you're pretty happy with traffic, has it been volatile?

And then finally would love more color on reflowing the layout of women's as it was a short-term disruption, but it seems like what the customer ultimately wants, how do we put that in the context of a lot of other new introductions that you're adding to the store? Thank you.

Michelle Gass

Thanks, Oliver for the question. So, I'll address each of your questions sort of separately. First of all, your question around the promotional environment, as we expressed in our remarks, we did see a heightened promotional environment in the third quarter, and especially as we entered into the more traditional fall season in September.

I think for us at Kohl's, we stand for value. We have the best loyalty program in the industry, and we're really known and famous for delivering outstanding value. So, we must maintain and preserve this position.

We're at a really unique time at the company. And with all of our initiatives, all the innovation, the new brands, the traffic we're seeing for Amazon Returns, it's really important that we capitalize on this moment and drive market share and customer acquisition.

So given the landscape and it is what it is and our guidance reflects that we expect that to continue into Q4, we are going to lean in and make this short-term investment in pricing and promotion as we need to make sure that we can capture these customers and importantly get them on our loyalty ladder for the long-term.

Secondly, to your point on traffic, overall traffic for the quarter, we are pleased. And while as I said in my remarks, we would have expected a different -- better results for the quarter, we made tremendous progress in both traffic and sales. From the first half of the year, we’re up 360 basis points to get to a positive comp. And for us, momentum on the business and driving long-term health in the business, it has to start with growth.

And then that has to start with traffic, and traffic has been and will continue to be the number one priority, and we are seeing really solid traffic in our stores, and that's coming from the initiatives we are launching, our marketing efforts, and yes the ramp up of the

Amazon Returns program. I would say where the volatility took place in the quarter was we came out of the gates really strong in back-to-school. Things softened up in September. Combination of factors, promotional environment we've hit on, weather becoming unseasonable and unfavorable for us and then we did have some disruption in our business, which I think speaks to your next question on the women's business.

That being said, we addressed all of those things and we leaned in when the conditions improved and ended the quarter with a very strong October. And then lastly, I was just going to hit on your women's question on the reflow, which is a deliberate action on our part to setup the women's business for long-term growth and health.

We have a very aggressive and thoughtful strategy, which includes exiting brands that we don't see as part of our portfolio going forward and introducing new relevant brands that will resonate with our core customers, as well as drive a new younger customer. And that includes brands like Nine West of course, Elizabeth and James, the Jason Wu collaboration and there'll be more to come in the future. That did require us to exit Dana Buchman. We have plans to exit more as we look forward, and we took this opportunity to actually reflow the women's pad in our store so that the brand adjacencies would make sense.

We know from history, anytime you're moving things around in the store, that's going to create some short-term disruption. But we're confident in the rebound. And importantly, the women's business digitally outperformed the digital average and the new brands are doing great. So I have great confidence we're making the right moves for the long-term.

Oliver Chen

Just a follow up on women's, it's been a tough category across the sector and for you in this way. What is your thought on what's happening with that shopper and timing of reception of the new brands and store layout just to assess the nature of risk within the women's apparel category?

Michelle Gass

Oliver, you're absolutely right. I mean, there's a lot of choices out there for women. I think for Kohl's, we stand for value, we stand for style relevancy, and we really stand for that casual apparel sector. And that's where we're leaning in to really have that right balance of your casual basics as well as your fashion relevancy. As I highlighted in my comments, the Active business which speaks to how she's living today, the Active at leisure, we had a very strong quarter in women's apparel in Active, also Intimates, she's coming to us for the basic.

Where we're course correcting is to make sure that we can drive a better balance as it relates to kind of basics and casual apparel, the T shirts, the Denim, et cetera, with fashion relevancy, and that's where we're leaning into brands like Nine West and Elizabeth and James. But I think ultimately, where Kohl’s wins is in this terrific balance of both that kind of casual, active, and fashion.

Oliver Chen

Thank you, best regards.

Michelle Gass

Thank you, Oliver.

Operator

Your next question comes from the line of Bob Drbul from Guggenheim. Please go ahead.

Bob Drbul

Good morning. Jill, welcome on your new role. I guess just a couple of quick questions for me. The Amazon Return program, are you seeing -- is there a number or anything you could share with us in terms of the new customers that are coming into the store that are making purchases at Kohl's or signing them up as new Kohl's car holders or customers from that perspective? And then just curious on the variation between August and October, and I guess could you also just give us any update in terms of how November has trended for you so far? Thanks.

Michelle Gass

Michelle Gass

Thanks, Bob. So as it relates to Amazon returns, we are really pleased. I mean, this quarter, fully scaled it. We are seeing performance very consistent with our pilot. And I think we're especially pleased with the level of new customers which you were asking about, so we are seeing a disproportionate amount of new customers relative to the amount of new customers we generally acquire. And we're seeing a younger customer, which is also very exciting and right in line with our strategic priority.

Today, our conversion rate, so for people coming in who are shopping is also very consistent with what we saw in the pilot, which when you net that all out for the year will be accretive to our profitability. But we're not stopping there and we have a lot of focus, we see the tremendous opportunity to drive even further conversion. And so we're doing things like enhancing training for our associates, we're testing different offers, we're doing that as we speak today and we're adding incremental merchandising opportunities right in the area where the Amazon returns are accepted.

So my hope is that we can drive that conversion even further, but it is today, meeting expectations. I do think really importantly too is that the way we're doing it is hitting the bar of both Kohl's, and Amazon in terms of the customer experience. And we are very pleased with that. I mean, we've done statistical surveys, and the customer is very satisfied with the program. They see it as simple and easy, which is intentional, and importantly, they intend to use it again. So very happy with that. And I'll let Jill actually talk about the quarterly sales flow.

Jill Timm

Hey, Bob. So August, as we indicated started out really well. We had a very strong back-to-school season, but we did see a softening in September, some of that driven by the unseasonable weather. What we did then is we reacted as Michelle indicated, and we leaned into our value equation and we drove momentum into October.

So we actually ended October incredibly strong, and we're building that momentum as we move into the holiday season. I think another data point for the strong holiday that we're expecting is the fact that our ad leak was very successful and that showcased a lot of our products and our merchandising strategies that we're going to continue to lean into as we move into the holiday.

So I think the way the quarter came out was just a little bit of softening, but we reacted well, we found out what worked with the customer and we feel confident with our merchandising strategy as we move into the all-important holiday season.

Bob Drbul

Got you. And just a question on the footwear piece of it, I think you didn't call out Nike as one of the brands, can you just maybe just give an update on what you saw from Nike or what you're seeing from Nike and why it wasn't called out at this point? Thanks.

Michelle Gass

Yes. Sure, Bob. So as I mentioned overall for each of those brands they were all positive and the brands had particularly strength in apparel including Nike. On the footwear side and I believe we talked about this on the prior call, we did see softness on Nike footwear. They are all over it and this past quarter we saw improvement in Nike footwear from the first-half. We're not all the way to positive yet but I'm confident we'll get there it's a very big priority for them and we have new platforms coming in.

Bob Drbul

Thank you very much.

Michelle Gass

Great, thanks.

Operator

Your next question comes from the line of Lorraine Hutchinson from Bank of America. Please go ahead.

Lorraine Hutchinson

Thanks, good morning. Looking at all the investments needed to drive this positive comp in 3Q and 4Q, could you help provide a roadmap to margin stabilization over the coming quarters?

Jill Timm

Yes, so Lorraine, I think a couple of things, if we stand back and look at the history of Kohl's, we've had a strong discipline around inventory management and that's really been a key enabler for us to expand margin in the past. Clearly Q2 we were impacted by the soft spring season and our inventory was up 2%. So in Q3 we did make progress our inventory was only up 1% and we really did this despite the fact that we supported all the new brand launches within the quarter. And you've seen that we have our commitment to get back to flat by the end of the year.

So we do believe that inventory management will be a key enabler, but of course we're going to continue to take that over a paced approach because we always want to ensure we're protecting sales.

I think second, we've done a lot of testing around personalization and we're going to lean more into targeted offers as we think that'll be more productive from a customer perspective. And then third we're going to continue to drive proprietary brands, you see that with the new brand introductions specifically in women's and that will obviously benefit our merchandise mix as well. So I think those are three key enablers that are going to help us get back to a healthy margin.

Michelle Gass

And I would just -- I would add to Jill's comment and reiterate, this is a really unique time for the company. We have a record level of exciting initiatives, we've got this new Amazon returns program, we just got off the ground, we are seeing more new customers. And so we have to make sure we're putting our most assertive foot forward to capture these new customers and get them on our loyalty ladder. So it is an investment to drive new customer acquisition and traffic to ensure we are positioned for profitable sales growth over the longer-term.

Lorraine Hutchinson

And just any timeframe on when you think that you'll be able to drive that profitable sales growth?

Jill Timm

Yes, obviously, we don't give long-term guidance at this point. I think when we come back out in 2020 we will be able to give you some more details. But I think first it starts with growth for us, so we want to continue to lean into our number one priority of driving traffic. Obviously, we're continuing to work through inventory management, so we're going to see those types of things starting to take hold as we move in to the next year.

And then we continue to leverage our second priority of operational excellence to find efficiencies within all these processes and take out the costs whether it'd be in margin or SG&A that will help us deliver the long-term growth. So I think you'll get more clarity on that as we move forward, but know that we're going to start with growth and we're committed to our operational excellence initiatives to help do that profitably over the long-term.

Lorraine Hutchinson

Thank you.

Michelle Gass

Thanks.

Operator

The next question comes from the line of Dana Telsey from Telsey Advisory Group. Please go ahead.

Dana Telsey

Good morning, everyone. As you think about the level of promotions required to drive the sales and you mentioned home being a key category of promotion, how are you thinking about the investments that you mentioned for holiday, is it solely promotion, is it advertising, how do you how do you triangulate what the key strategic investments are and where they fall in terms of the penetration rate? And as you think about 2020, Michelle, given all the newness that you have in holiday, any updates on what we should be looking forward to for 2020? Thank you.

Michelle Gass

Thanks, Dana. So to your question around investments for the Q4 time period, I mean, that's exactly what it is. And we're really investing across all parts of our business. I mean, clearly, starting with ensuring that we're showing up with compelling value. And that takes the form of pricing, it takes the form of promotion, and of our loyalty program. And we have a pretty sophisticated model where we look at what levers are to be applied when.

You mentioned home and I think that's a good category to look at. It had a really tough start in the first half of the year and we're really pleased this quarter that we got it back to positive growth and roughly consistent with the company. And home in particular is where we disproportionately lean into pricing, where we've seen a lot of that competitive activity, we also brought forward some new promotions, et cetera.

As I was saying earlier, it's just absolutely critical that we maximize this opportunity right here right now to capture the new customers, especially coming in for the new brands, we're launching all the innovation and then new traffic and new customers who are being introduced to Kohl’s for the first time through the Amazon returns program.

So, our investment will certainly -- we have, like I said, we have sophisticated models, pricing elasticity models that we use against the competitive environment to make sure that we are appropriately pricing ourselves and offering the right promotions. I would say that, the team has really built up its muscle to be responsive and operate with agility so that when conditions are not in our favor, like whether we can pull back and when they are in our favor we can lean in.

And that's to the other part of your question that, while certainly pricing is -- investing in pricing is a part of it, it's also investing in media. And I mentioned in my remarks, we're seeing very good results of bringing in our digital search capability in house also elevating our partnership with Google with some new tools so that our search activity can be that much more impactful.

So when we lean in, we get the right message, the right value, we will also elevate our efforts from a marketing standpoint. And I just can't reiterate enough I mean, holiday not only with all the initiatives we have, but holiday is such a key time period for the industry only with all the initiatives we have, but holiday is such a key time period for the industry and for Kohl's around exposing all we do around our innovation and our product offering and not just the newness, but also the strength of our core offering we talked about Active earlier it was up 7% we expect that momentum to continue. So our organization priority one continues to be driving sales, driving traffic to fuel long-term customer acquisition, which ultimately leads to long-term sustainable and profitable growth.

As it relates to 2020 well, as Jill was just saying, we haven't put guidance out there, per se. I mean, you can expect to see the same kind of top line energy and focus, driving excitement within our core business, bringing in new brand. That's a key strategic priority for the company.

The team is hard at work, we have new things that we'll be sharing and rolling out next year, while we also drive our operational excellence discipline. And that includes the focus on inventory management, overtime, we expect to get back to margin expansion and certainly the focus on our SG&A and our expense structure. So, I feel very good, like I said, I think we're at a point in time to make these investments. But I feel very confident in the strategies we have ahead.

Dana Telsey

Thank you.

Michelle Gass

Thanks, Dana.

Operator

Your next question comes from the line of Alexander Walvis from Goldman Sachs. Please go ahead.

Alexander Walvis

Good morning. Thanks so much for taking the question. I have -- my first question is around the smaller stores I believe you opened for this quarter. Can you talk a little bit about, how those are performing and how the strategy is evolving that I think you said that there would be more of those to come, so any color on that would be would be interesting as well?

Michelle Gass

Yes, so I'll take this one. So we did open four stores and we're somewhere in the 15-ish range right now on these stores. So just for clarity sake, they're about 35,000 square feet, compared to our average at about 90,000 square feet. So it is a much smaller footprint. We have been in the spirit of Kohl’s and what we do testing and iterating along the way.

I will tell you, I feel very good about these last four that we've opened because we've learned from the first versions of those and how to take kind of the best of Kohl’s to merchandise things differently to modify the adjacencies based on what you need in a smaller format.

So I'm really, really encouraged and to the comment of I think we have more opportunity. I mean, there's still -- people are still building stores even in this environment. For us, especially given our omni-channel reach, the intent would be to find places where we can build these small footprint. And what we do know is when we do have a presence in the neighborhood that that also helps drive our digital businesses as well.

So, while, we certainly haven't put any specific numbers out there, and I would consider we're still in the piloting stage. We're getting smarter about these stores and you can expect to hear more from us next year on what our plans are.

Alexander Walvis

Great, thank you. And then my second question is on the promotions expected to remain elevated through the holiday season, any color at this stage on, what we should expect into next year for promotional activity and gross margins. Is there -- do you have a timeline in mind on how long the elevated promotional environment is likely to last?

Jill Timm

So, Alex, I don't think we have any guidance into next year other than, we're going to deploy the initiatives that I had mentioned around inventory management, targeted offers and driving proprietary brands that will continue to help lift our margin moving forward. I think Q4 is always a unique time of year. So as we saw the heightened promotional environment moving out of Q3, we fully expect it's going to maintain within the holiday period, because it always brings a new level of promotions.

So we wanted to ensure that our guidance gave us the room to react appropriately, so we can continue to be relevant to the customer drive sales, as Michelle said, acquiring new customers. Over the last two years, we've mentioned to you that we've acquired customers in the low double digits during this timeframe. And this year, we have the unique Amazon returns partnership that we're able to capitalize on, to actually accelerate that customer acquisition.

So we look at this as not only just an investment in terms of the sales growth, but really from a long-term perspective bringing in those new customers. And as Michelle said, evolving them to the loyalty ladder, so they can continue to unlock value with Kohl’s.

Alexander Walvis

Fantastic. Thanks for the color guys.

Operator

Your next question comes from the line of Paul Trussell from Deutsche Bank. Please go ahead.

Gabriella Carbone

Hi, good morning. This is Gaby Cabone on for Paul, thanks for taking our question. So tariffs haven't been mentioned yet, was wondering if you could discuss how that impacted results this quarter and kind of what you're expecting for the rest of the year? And then if you can just give an update on how your conversations with vendors are progressing? Thanks.

Jill Timm

Thanks, Gabby. So from a tariff perspective, we have our arms around that and what I want to say is we have an amazing merchant team that's worked closely with our vendors, so that we were actually able to offset tariffs and not really have an impact to our business this quarter, while still delivering great value to our customers. I think, we continue to employ our diversification strategy, which we've been doing for quite some time, and will continue to do that to further reduce our exposure to China.

However, we do recognize this is a fluid situation. So everything right now is embedded in our outlook. But if the tariff numbers would change, we would have to go and come back and reassess that.

Michelle Gass

I would add on just a comment to Jill's point, if you take a step back for us from a sourcing strategy standpoint, we have been on this kind of journey and mission for some time and moving business to other parts of the world to have a great diverse supply base. And that's been in full support of our speed to market opportunity. When we talk about some of the other opportunities, we have in inventory management, et cetera one of the biggest initiatives supporting us is speed to market and we've reduced roughly 40% of our timeline end-to-end and that's been in due part by diversifying, our supply base and producing in areas and with vendors who can get us product quickly.

So I would just echo what Jill said on the tariff piece, in particular and with China, we're in great shape, we have very deep, long enduring relationships with these vendors. And for me, it's managing that, but also ensuring that we've got a great diverse supply base that can support us on our speed agenda.

Gabriella Carbone

Thanks. And then just a quick follow up, I understand you're making all these new, strategical investing, could you kind of prioritize them for the rest of the year?

Michelle Gass

Can you elaborate a little bit more on that in terms of…

Gabriella Carbone

Just kind of how should we be thinking about in the way you're prioritizing these investments you're making? Where do you feel is the most important?

Michelle Gass

Yes, I mean, the way I would think about it, especially if we're talking for the fourth quarter, is ensuring that we have a very strong holiday season and I think that comes with a number of factors. I would reiterate that we are entering the period with momentum, we have a strong holiday kickoff, we have lots of great activities planned over the next couple of months. Then I would speak to our strategic initiatives that we are investing behind.

We're investing behind both our core business. I mentioned the Active investment as an example, we just expand and we just completed that expansion to 160 doors. We added roughly 100 shop-in-shops of Adidas, so overall Active is in great shape. And we see Q4 as no different in terms of driving the Active business. So that has been an investment as well as the investment on our lineup of all the newness and new brands. So that's point one.

Two, I mean, clearly we've been leaning into the Amazon returns program. We just had our really first ramped up quarter. This will be our first holiday with Amazon returns, so we're leaning in and investing there. Our digital business has been a strong performer. We will continue to support and invest that business to make sure we can maintain that double-digit growth.

And then marketing, which we've spoken about given the competitive environment, we have to make sure that we are relevant and that we are leaning in during this really critical period where it's naturally for Kohl's been a place where we've acquired a disproportionate amount of new customers and now will only be exaggerated this quarter given all the new brands that we're marketing behind and of course the returns program.

So I'm really excited, I feel like we have positioned ourselves, we have positioned the quarter and guided appropriately, so we will make these investments so that we exit the quarter with a strong holiday and importantly a whole bunch of new customers that we can now build loyalty for long-term profitable growth.

Gabriella Carbone

Great, thank you so much for all the color.

Michelle Gass

Great. Thanks.

Operator

Your next question comes from the line of Chuck Grom from Gordon Haskett. Please go ahead.

Chuck Grom

Hey, thanks. Good morning. A few questions for me, first, curious how the cadence of actual Amazon returns into your store progressed throughout the quarter, and is it possible to quantify the list?

Second is in the pilot locations for the returns, curious, if you test some of these value investments to get new customers on the loyalty ladder I guess that gives you the confidence that these price investments will actually pay off? And then third with all that you're doing I'm a little bit surprised that you guided to the two year decelerating here in the fourth quarter. I'm just curious, if you could speak to maybe quantify how November started off and I guess what -- why the expected slowdown on the stack? Thanks.

Michelle Gass

Okay. So I'll take the first couple of here Chuck. First of all on the cadence on Amazon returns, we were still ramping. I mean we have close to 1,200 stores. We rolled it out across the system. So I think it's fair to say that during the quarter, we continued to see things ramp consistent with our expectations. And the fourth quarter we'll continue to be the same. So we're not breaking out the particular cadence, but what I can tell you is that there has been an ongoing ramp as customers get used to this new service.

And as I quoted in the research that we've collectively done I'm particularly encouraged with the strong customer reaction that they intend to use the service again. The conversion rate is consistent with what we saw in the pilot. And that is adequate to meet our financial objectives, but we are testing and experimenting with some new offers as you just asked about. On that front, we're in the testing phase. So we have nothing yet that we're rolling out, but know that we have multiple tests going on and we have the technology capability in order to test and try.

So I fully expect that we'll be implementing some new value offers by early next year, if not before. We are to your point on getting on the loyalty ladder. It's early days. So it's really difficult. I mean, we're only a few months in to track the kind of ongoing stickiness of who's converting to Kohl's charge, et cetera. But we will be monitoring that. And we have over efforts to be messaging the value that you get with Kohl's charge at that point of interaction with the Amazon return customer.

And then, I'll let Jill address the guidance piece.

Jill Timm

Yes. So I think, we feel really good with the momentum that we pulled out of Q3. We feel good with the ad leak as that positions us well for the holiday. However, as we said it's a very competitive environment. So as we gave our Q4 guidance we wanted to be thoughtful. We put up a 0.4 comp, so this really bookends that's comp for the quarter, but could just an acceleration. So I don't love the two year stack.

I could challenge you to stand 3-year stack were up of the two-year stack I could challenge you to say on a three year stack we're up nine. So that's another way to look at it, but I think we feel really good about how we approach the holiday period of the strategies that we've employed and the momentum that we've gained as we move out of October, but really just want to be thoughtful, Chuck, as we gave guidance.

Chuck Grom

Okay. And then just bigger picture, I think, Lorraine, asked about this earlier about your margin structure, clearly it looks like you'll end the year close to say 6%, 6.5% that's way lower than where you've been. Should we think about this as sort of the new normal for you guys as you kind of focus on value and try to gain customers down the road.

Michelle Gass

So, Chuck, so let me just reiterate, I do believe we are at a very unique point in time given all the initiatives what we've been talking about over the last hour, unique time to get new customers and invest in them because of our initiatives, Amazon returns, et cetera. But we are very committed to growing both the top-line and the bottom-line overtime. And while we haven't put out 2020 guidance you can expect to hear from us next year. We have lots of efforts underway, things we've talked about, some things we haven't yet talked about to fortify and continue to accelerate our top line sales.

Like I said earlier, we're pleased from where we started the year to where we are today, we saw a material improvement in the top line. And then as it relates to our profitability we have a number of initiatives building on the success we've had with operational excellence and inventory discipline. So you absolutely should expect from us that overtime we look to drive sales and expand margins.

Chuck Grom

Okay, great. Jill, congrats.

Jill Timm

Thank you.

Operator

And we have time for one last question that question comes from the line of Mark Altschwager from Baird. Please go ahead.

Mark Altschwager

Great, good morning. Thanks for squeezing me in. I'm curious on the traffic and spending trends you are seeing from some of your more loyal customers. It sounds like you're pleased with what you're seeing from a customer acquisition standpoint. So just trying to reconcile that with a flat to 1% comp trajectory, maybe bigger picture as you transition the brand portfolio to really focus on that younger that new customer, how do we assess the risk of cannibalization of your existing sales base versus driving incremental top line growth? Thanks.

Michelle Gass

Thanks, Mark. Great question. I think it's absolutely critical for us to protect, preserve and grow the core customer base, while we complement with this newer and arguably younger customer for the future. We have to do both. We have many strategies that are aimed at both, our product strategies, whether we're talking on the apparel side, we've been talking about on the women's side like a Nine West.

We're seeing that brand resonate especially with existing customers Elizabeth and James might skew a little younger, but again we see the existing customer pick up on that and certainly all the home innovation speaks squarely to that core customer in addition to the new.

From a marketing standpoint and especially a loyalty standpoint protecting our core is vital. And in fact, we did see as we think about our newer customers versus our Kohl's Charge customer we did see sequential improvement in the third quarter versus the first half of the year. So it demonstrates even in the third quarter that we are seeing this enhancement improvement, but know that we're taking a very thoughtful balanced approach to make sure that we preserve the core, while we reach for these more new customers.

Mark Altschwager

Thank you. Best of luck over holiday.

Michelle Gass

Great, thank you. Thank you to everyone listening on the call today and wishing you all a wonderful holiday season.

Operator

Ladies and gentlemen this conference will be available for replay after 11 a.m. Eastern Time today through December 19th at midnight. You may access the AT&T Teleconference replay system at any time by dialing 1-800-475-6701 and entering the access code 468-137, international participants dial 320-365-3844. Those numbers again are 18544-foot those numbers again are 1-800-475-6701 or 320-365-3844 with the access code 468-137. Replays are also available in the Investors section of Kohl's corporate website.

That does conclude your conference for today. Thank you for your participation and for using AT&T Executive Teleconference. You may now disconnect.