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JWN.N - Q2 2023 Nordstrom Inc Earnings Call

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OVERVIEW:

Company Summary

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CORPORATE PARTICIPANTS

Cathy R. Smith *Nordstrom, Inc. - CFO & Treasurer*

Erik B. Nordstrom *Nordstrom, Inc. - CEO & Director*

Peter E. Nordstrom *Nordstrom, Inc. - President, Chief Brand Officer & Director*

Sara Penner *Nordstrom, Inc. - Manager, Investor Relations*

CONFERENCE CALL PARTICIPANTS

Ashley Anne Owens *KeyBanc Capital Markets Inc., Research Division - Associate*

Blake Anderson *Jefferies LLC, Research Division - Equity Associate*

Brooke Siler Roach *Goldman Sachs Group, Inc., Research Division - Research Analyst*

Dana Lauren Telsey *Telsey Advisory Group LLC - CEO & Chief Research Officer*

Edward James Yruma *Piper Sandler & Co., Research Division - MD & Senior Research Analyst*

Matthew Robert Boss *JPMorgan Chase & Co, Research Division - MD & Senior Analyst*

Oliver Chen *TD Cowen, Research Division - MD & Senior Equity Research Analyst*

PRESENTATION

Operator

Greetings, and welcome to the Nordstrom Second Quarter 2023 Earnings Conference Call. (Operator Instructions). And as a reminder this conference is being recorded. At this time, I'll turn the call over to Sara Penner, Manager of Investor Relations for Nordstrom. Thank you. You may begin.

Sara Penner - *Nordstrom, Inc. - Manager, Investor Relations*

Good afternoon, and thank you for joining us. Before we begin, I want to mention that we'll be referring to slides, which can be viewed in the Investor Relations section on nordstrom.com. Our discussion may include forward-looking statements, so please refer to the slide with our safe harbor language. Participating in today's call are Erik Nordstrom, Chief Executive Officer; Pete Nordstrom, President and Chief Brand Officer; and Cathy Smith, Chief Financial Officer, who will provide a business update and discuss the company's second quarter performance.

And now I'll turn the call over to Erik.

Erik B. Nordstrom - *Nordstrom, Inc. - CEO & Director*

Thank you, Sara, and good afternoon, everyone. Thanks for joining us today. Before we begin, I'd like to welcome our new CFO, Cathy Smith, to our earnings call. Cathy is a proven finance leader with many years of experience delivering business results. She has deep expertise navigating the dynamic retail environment in her prior roles with some of the largest retailers in the country. We are thrilled to have her on the team. You will hear more from her today.

I'll start with our Q2 performance. We delivered solid results in the second quarter, with earnings per share higher than last year despite lower sales. As we've said since the beginning of this year, we saw clear opportunities to drive higher profitability even in a challenging sales environment. We continue to make progress on our 3 key priorities to improve performance at Nordstrom Rack, increase inventory productivity and optimize our supply chain capabilities. Our teams performed well, working to improve the customer experience while staying focused on these priorities.

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Our top line results improved sequentially from the first quarter at both banners. At the Nordstrom banner, our teams did a good job curating the assortment for our Anniversary Sale, balancing relevance, the things customers expect to find, with inspiration, the new items they discover shopping online and in-store. Customers responded positively to newness in our fall assortment during our successful Anniversary event, particularly in stores.

At its core, Anniversary is a one-of-a-kind event that rewards and engages our loyal customers with brand-new product from the best brands at reduced prices for a limited time. We saw higher engagement throughout the event with more customers this year attending over 740 events and over 90% of our highest level Nordy Club members shopping during the sale. In addition, we're pleased that Anniversary had a very strong inventory sell-through, which was up 15% from last year and puts us in a better inventory position as we enter the second half.

At Nordstrom Rack, our initiatives to improve our product mix with strategic brands helped deliver sequential improvements in both top line and profitability. Sales trends at the Rack also improved sequentially throughout the quarter, and July was our best month.

Looking ahead, we remain confident in our ability to deliver against the financial outlook we set for 2023, even as we continue to navigate economic uncertainty in the near term. We're encouraged by the progress we made this year and remain focused on delivering against our 3 key priorities in the second half to drive higher profitability and return to long-term profitable growth. I'll highlight a few wins we had during the second quarter within our 3 priorities: improving performance at Nordstrom Rack, increasing inventory productivity, and continuing to advance our supply chain optimization initiatives.

At Nordstrom Rack, we are delivering on our promise of offering great brands at great prices, and our teams made significant progress on our initiatives to improve both sales and profitability. As we shift our assortment mix to include more of the brands we know our customers respond to, we are seeing results improve through a higher sell-through and faster inventory turns, giving customers newness each time they shop at Nordstrom Rack.

In the second quarter, sales from strategic brands came in at our target of 65%, and we've planned our on-order for the second half similarly to meet our goal. We are pleased with the progress we made to expand our reach with 8 new Rack stores opened to date in 2023, and we look forward to opening 11 additional new stores by the end of the year. Rack stores are a great investment with returns that exceed our cost of capital in a short payback period. Rack stores also represent the largest source of new customers for Nordstrom and we are bringing the Rack's unique product offering and suite of convenient services to more markets as we expand our footprint.

Turning to our second priority of improving inventory productivity, we continue to manage with leaner inventories, improved sell-through, and faster turns across most of our categories, resulting in gross margins that are on par with last year's Q2, which was the highest margin quarter of 2022. We also made progress rightsizing our designer inventory and continue our work to further reduce our position there. We are entering the second half of the year in a good inventory position at both banners, with overall levels down 18% compared to last year versus an 8% decrease in sales. Stronger sell-through during the Anniversary Sale positions us well to be more responsive to what customers are buying in the second half of the year. Our lower inventory levels will set us up to deliver gross margin improvements, particularly in the fourth quarter compared to last year.

Turning now to our third priority, supply chain optimization, we delivered a better experience to our customers through faster delivery, especially during Anniversary. For the fourth consecutive quarter, variable supply chain costs fell by over 100 basis points as a rate of sales versus the prior year, helping to mitigate overall SG&A deleverage on lower sales.

Since we started, we're delivering faster and at lower cost. We began our current supply chain optimization work in early 2022. And since then, we have delivered significant customer benefits and operational efficiencies. Compared to the first quarter of 2022, supply chain costs per unit in the second quarter of this year were 5% lower against an inflationary backdrop of about 7% over that time. Looking ahead, we continue to seek out additional efficiencies in flow and improve productivity through inventory management initiatives.

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In closing, we are making solid progress against the 3 priorities we set at the beginning of the year, and we'll continue to focus on these goals. We are fortunate to have an experienced team who has embraced a more disciplined operational approach we are taking to manage near-term headwinds while continuing to keep the customer at the center of everything we do.

We have a strong balance sheet and cash position and are confident that by continuing to invest in our digital and supply chain capabilities as well as in our stores, we will be better positioned to drive sustained profitable growth and long-term shareholder value. We look forward to sharing our continued progress in the quarters ahead.

With that, I'll turn it over to Pete.

Peter E. Nordstrom - *Nordstrom, Inc. - President, Chief Brand Officer & Director*

Thanks, Erik. I'll cover our category performance and the Anniversary Sale, and then I'll discuss the progress we're making on inventory management and supply chain.

Starting with merchandise performance. Most categories improved sequentially from the first quarter in terms of year-over-year trends. The active category was up slightly from last year, driven by active footwear. Customers responded well to new offerings and selections from brands HOKA, On Running, New Balance, and Nike. Beauty continued to perform relatively well at both banners and the category was up slightly versus last year. At Nordstrom Rack, our expanded offerings from great brands, including MAC, Too Faced and Clinique did well. Kids and men's apparel each performed better than average. Women's apparel improved sequentially from the first quarter but performed lower than average.

Within men's and women's apparel, we saw customers drawn to more dressed up and tailored looks with contemporary brands, including Veronica Beard, Vince and Theory. At Nordstrom Rack, sales of accessories, especially handbags, showed strength. As anticipated, designer remains under pressure. We made significant progress reducing our inventory position during the second quarter, and we'll continue to rightsize to the shift in consumer demand in this category. In order to improve inventory flow and margin health, we are focused on driving faster turns this year across both banners. During the second quarter, we made solid progress on this.

Now turning to Anniversary. As Erik described, the Anniversary Sale is a unique event that rewards and engages our loyal customers with brand-new products for many of their favorite brands, marked down during the sale before they are marked up to full price. Customers responded well to our curated assortment, which balanced both relevance and inspiration. This helped drive the very strong sell-through Erik highlighted earlier and puts us in a favorable inventory position as we entered the second half.

We were pleased to see customers shop activewear and fall items, including dressed up looks in sweaters, boots and jackets. They also shop for baby gear from brands like Nuna. In addition, customers responded positively to our improved assortment of Nordstrom private brands, which are important to the event's success.

Our teams did an outstanding job during Anniversary, welcoming customers into our stores and at Nordstrom.com, and delivering a convenient and connected experience through events and personalized services. We were better prepared to start the sale this year given complete and timely delivery of product as a result of the continued productivity initiatives in our supply chain.

Total Anniversary event sales were 5% lower compared to last year, in line with overall trends given the ongoing softness in customer spending. This includes the 8 days that fell in the third quarter this year, whereas 1 day was included in last year's Q3 results. We are pleased by the strong sell-through on Anniversary products, which exceeded our plans and put us in a favorable inventory position as we enter the second half of the year.

We are committed to serving customers on their own terms, and we've integrated our physical and digital assets to create a seamless journey. Digital sales accounted for over 60% of the overall event, and over 40% of these digital sales were enabled by our stores through either buy online, pick up in store, store fulfill or ship to store. We had our highest hour of demand on Nordstrom.com of all time during our early loyalty member access window of the sale.

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We continue to enhance our inventory flow across most of our categories, with inventory turn improving slightly in the second quarter. For the second half, we are focused on managing with discipline by improving inventory health in both banners and will continue to drive for higher productivity. We are maintaining reserves against our buy plans, which enables us to respond in season to trends and customer demand.

At Nordstrom Rack, we made significant progress increasing strategic brand penetration, and we'll continue to improve our mix in the second half. Strategic brands have better productivity than other brands in terms of sell-through. They also create a point of differentiation with our customers because we know they want great brands at great prices.

Turning to supply chain. Erik spoke earlier to the benefits our teams delivered from our supply chain optimization initiatives. Looking forward, we expect to deliver additional operational efficiencies by continuing our work in inventory productivity, returns processing and transportation, and ramping up RFID initiatives.

To wrap up, we're making solid progress on each of our 2023 priorities. We're confident in our ability to improve our profitability this year. There's more to accomplish ahead, and we're well positioned for the second half.

With that, I'd like to welcome Cathy to our call, and I'll now turn it over to her to discuss our financial results.

Cathy R. Smith - *Nordstrom, Inc. - CFO & Treasurer*

Thanks, Pete. I'm excited to be part of the Nordstrom team. I have tremendous respect for the company, brand and legacy of customer experience and service. I am honored to help Nordstrom drive profitable growth and long-term success. I look forward to reconnecting with those of you I already know and getting to know those of you I don't.

Now I will expand on what Erik and Pete have already shared about our quarter. I'll start with our second quarter results and then discuss our outlook for the remainder of 2023.

For the second quarter, we reported earnings per share of $0.84 compared to last year's earnings per share of $0.77. When excluding charges related to the wind down of Trunk Club, last year's adjusted earnings per share was $0.81. We are pleased with the year-over-year EPS increase despite the $330 million fewer sales.

Net sales as well as gross merchandise value, or GMV, decreased 8% in Q2. Net sales included a negative impact of 275 basis points from the wind down of Canadian operations. They also reflect a negative impact of approximately 200 basis points from the timing shift of the Anniversary Sale with approximately 1 week falling into the third quarter this year compared to 1 day last year. Excluding the impact of these 2 items, net sales would have been down about 4% versus last year.

During the quarter, sales trends improved each month when excluding the impact of the Anniversary timing shift, and the improvement was most pronounced at Rack. Nordstrom banner sales and GMV each decreased 10% versus last year, with sales improving sequentially from the first quarter when year-over-year net sales decreased 11%. The wind down of Canadian operations included a negative impact on Nordstrom banner net sales of 400 basis points, and the Anniversary timing shift had a negative impact of approximately 300 basis points.

Nordstrom Rack sales decreased 4%, improving sequentially compared to a 12% year-over-year decrease in the first quarter. We estimate the decision to eliminate store fulfillment of Rack digital orders starting in the third quarter of 2022 had a negative impact to this year's Q2 sales of approximately 500 basis points.

Digital sales decreased 13% in the second quarter. This includes an estimated 500 basis point negative combined impact from eliminating store fulfillment of Rack digital orders in the third quarter last year and sunsetting Trunk Club in the second quarter of 2022. It also includes an estimated 300 basis points negative impact from the Anniversary timing shift.

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Gross profit as a percentage of net sales decreased 20 basis points, primarily reflecting deleverage on lower sales, partially offset by lower buying and occupancy costs.

Ending inventory decreased 18% versus last year compared to an 8% decrease in sales. Our inventory is better positioned as we move into the back half of the year, thanks to the strong sell-through during our Anniversary Sale. Looking ahead, we will continue to benefit from improved inventory management routines and disciplines while meeting customer demand.

SG&A as a percentage of net sales was flat to last year's second quarter, driven by improvements in variable costs from supply chain efficiency initiatives, which helped offset higher labor expenses and deleverage from lower sales. In addition, expenses in the second quarter this year benefited from a couple of items outside of our normal run rate, namely a gain on the sale of a real estate asset and lower carrier costs than previously expected. We are pleased with the momentum in our supply chain initiatives, and as Erik mentioned, this marks the fourth consecutive quarter where we have delivered over 100 basis points of improvement in our variable costs as a percentage of sales.

EBIT margin was 5.3% for the second quarter, up 20 basis points from last year's EBIT margin. After excluding charges in last year's second quarter related to the sunsetting of Trunk Club, for comparison purposes, EBIT margin was flat to last year's adjusted margin of 5.3%, again, despite lower sales this quarter.

We continue to maintain a solid balance sheet and financial position, ending the second quarter with $1.7 billion in available liquidity, including the full $800 million available on our revolving line of credit.

Turning to our outlook for the rest of the year. I'll start by discussing the current environment and related assumptions underlying our guidance. We continue to see a cautious consumer, and it remains to be seen how changes in inflation and higher interest rates will affect discretionary consumer spending in the second half of the year, particularly during the holiday season. We saw sequential top line improvement in the second quarter. However, while it is early in the third quarter, sales trends have decelerated at both banners. We expect to make continued progress on our key priorities, which will help improve our profitability and mitigate inflationary cost pressures. Considering these factors, we are taking a cautious approach to planning. We maintain our outlook for the full year despite better-than-expected results in the first half.

I'll highlight a few factors that shape our outlook for the rest of the year, starting with revenue. We continue to expect revenue to decline 4% to 6% versus 2022. This outlook includes an approximately 2.5 percentage point negative impact from the wind down of our Canadian operations, which delivered sales of approximately $400 million in 2022. It also includes an approximately 1.3 percentage point positive impact from the 53rd week in fiscal 2023, which we expect will add approximately $200 million in sales in the fourth quarter. Year-over-year sales comparisons will become more favorable in the second half of the year, and we continue to expect sequential top line improvement compared to the first half.

Two things benefit year-over-year comparisons in the third quarter. One, we will start to lap the impact of eliminating the store fulfillment of Rack digital orders. Second, the Anniversary Sale timing shift will positively impact third quarter sales by approximately 200 basis points. Offsetting the tailwinds are headwinds with respect to our credit card business. Our credit card revenues were up 10% in the first half of the year from higher revenue recognized in connection with our credit card partner agreement, and with lower-than-expected credit card losses. That said, we have seen delinquencies rising gradually, and they are now above pre-pandemic levels, which could result in higher credit losses in the second half and into 2024.

Turning to EBIT, we continue to expect adjusted EBIT margin of approximately 3.7% to 4.2% for the full year versus 3.3% in 2022. Our forecast assumes that adjusted EBIT margin expansion will be driven primarily by gross margin improvements in the second half from our focus on inventory productivity when compared to the elevated markdowns we took in 2022. We expect SG&A expense rate will be impacted by deleverage from lower sales given our sales trend outlook, with partial offset from our ongoing supply chain optimization initiatives, although to a lesser extent as time progresses.

We also maintain our outlook for adjusted EPS for the full year. Our GAAP earnings per share outlook remains $0.60 to $1.00 for the full year, which includes the Canadian wind-down charges and related tax impact. Excluding the impact of these charges, we continue to expect adjusted earnings per share of $1.80 to $2.20 for the full year.

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Shifting to capital allocation, our priorities remain the same. The first is investing in the business to better serve our customers and support long-term growth. We continue to plan for capital expenditures of 3% to 4% of net sales. Our second priority is reducing our leverage. We remain committed to an investment-grade credit rating through a combination of earnings improvement and debt reduction and continue to target a leverage ratio below 2.5x. Our third priority is returning cash to shareholders. Last week, our Board of Directors declared a quarterly cash dividend of $0.19 per share.

We are pleased with our solid results in the second quarter and progress on our 2023 priorities of improving Nordstrom Rack, increasing inventory productivity and optimizing our supply chain capabilities. We continue to focus on driving profitable growth. We remain confident in our ability to navigate through the near-term uncertain environment and deliver shareholder value over the long term.

With that, Sara, we're ready for questions.

Sara Penner - *Nordstrom, Inc. - Manager, Investor Relations*

Thank you Cathy. Before we get started with Q&A, we ask the participants please limit themselves to one question and one follow-up. We'll now move to the Q&A session.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And the first question comes from the line of Noah Zatzkin with KeyBanc Capital Markets.

Ashley Anne Owens - *KeyBanc Capital Markets Inc., Research Division - Associate*

This is Ashley on for Noah. Just first with the guidance and stronger improvement in Rack relative to full price this quarter, how should we be thinking about the pace of both banners in the back half? And then I have a follow-up.

Cathy R. Smith - *Nordstrom, Inc. - CFO & Treasurer*

Ashley, it's Cathy. I'm sorry, can you repeat that? I didn't quite catch the back half of your question?

Ashley Anne Owens - *KeyBanc Capital Markets Inc., Research Division - Associate*

Yes. So with the stronger improvement in Rack relative to full price, just how should we be thinking about the pace at both banners in the back half of the year?

Cathy R. Smith - *Nordstrom, Inc. - CFO & Treasurer*

Yes. Thank you. Ashley. So as we -- first off, just to remind us, we had a good, solid second quarter. We're really pleased with the results that we're delivering, and we did reiterate our full year guidance for the back half. So thinking through the sequential improvement we've seen already through the first half of the year, we would expect that to continue, sequential improvement through the back half. So particularly Q4, we'll -- you'll see the benefit of that 53rd week. So think about that. And then it's going to be a little bit offset by the loss of the Canadian operations. And then obviously, we have a little bit better, easier comp in the fourth quarter. And then Q3, I would think of it as kind of in between Q2 and Q4.

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Ashley Anne Owens - *KeyBanc Capital Markets Inc., Research Division - Associate*

Okay. Great. And then just on inventory, could you provide us with some additional color on the current mix? And then maybe where you think you are at in your efforts to rightsize designer?

Cathy R. Smith - *Nordstrom, Inc. - CFO & Treasurer*

Maybe -- Ashley, this is Cathy. I'll start, and then I'll ask Pete to comment on designer a little bit. So we're really pleased that we've continued to drive inventory productivity. It's 1 of our top 3 priorities this year, as you guys know, and the team has done a terrific job. Inventory is down almost 18% on sales down 8%. Units are down even more than that. And so we're really pleased that we're going into the back half of the year in a healthy inventory position. It allows us to really chase after the consumer demand and make sure that we can meet them. And then on designer, maybe Pete can answer a little bit there.

Peter E. Nordstrom - *Nordstrom, Inc. - President, Chief Brand Officer & Director*

Yes. On designer, as you know, if you've been listening to the calls over time, we've had really good growth in the designer category, and we've invested against that. And it changed rather abruptly about a year ago. And so we found ourselves with more inventory, more on-order than we would have liked, given the sales trends. And we have yet to work through that. It takes some time, this doesn't turn as fast as other categories.

A lot of that product is continuative product. And so it's not as inherently perishable, but it is aging at the same time, and we do have more weeks forward covered than we need. So it takes time to work through that, and we're working through it with our vendor partners on the designer side.

Operator

Next is from Brooke Roach with Goldman Sachs.

Brooke Siler Roach - *Goldman Sachs Group, Inc., Research Division - Research Analyst*

I was hoping you could provide some more context on the drivers of the Rack performance during the quarter. You mentioned that trends performed better each month of the year, but you've also seen a little bit of a recent deceleration. How did traffic, ticket, and conversion trend throughout the quarter and into the beginning period of back-to-school, relative to your expectations? And as you look ahead, can you contextualize the most important drivers of Rack performance you expect through the back-to-school and holiday season?

Erik B. Nordstrom - *Nordstrom, Inc. - CEO & Director*

Brooke, this is Erik. Yes, we're really pleased with our -- the trend of our Rack performance. So it's in a steady upward trajectory throughout this year. And as you know, really, the foundation of our focus has been great brands at great prices. We know the reason most customers come to Nordstrom Rack is to find the great brands they love at terrific prices. And so we've been very intentional in devoting more of our inventory to these strategic brands. And as we've increased that proportion, we've seen our business get better. And I know it sounds simple, but it's -- that has been our focus and it is paying off for us. So we feel really good about our inventories there, that we're in a position to be more aggressive and reactive to what we're seeing from customers. But again, the overarching strategy is to put more of those dollars into these strategic brands. So that's what we mainly look at. And again, as we've done that, we've seen our business get better.

To your question on traffic, conversion, ticket. Traffic has both -- across both banners has been softer. What's -- what we've seen strength in is in conversion and spend per customer. So that's a good reflection of the content we have and the customer experience we're providing.

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Brooke Siler Roach - *Goldman Sachs Group, Inc., Research Division - Research Analyst*

Great. And if I could just ask one second question. You spoke in the prepared remarks about rising headwinds in credit as a result of delinquencies. Can you provide a bit more detail on what you're seeing there and your expectation for credit contribution into the back half?

Cathy R. Smith - *Nordstrom, Inc. - CFO & Treasurer*

So first, bigger picture, our loyalty program and our credit card customers are really an important part of our business. They are typically our most engaged and most loyal customers. So we always think of that cohort in that light. We do typically have a little higher quality credit consumer as well in our credit customer, which means they're going to be a little bit more resilient. What you did hear us say, and you'll see it in the filings that are -- we're seeing good strength in credit card revenues through the first half of the year. But as we mentioned in the prepared remarks, we've seen delinquencies slowly rising throughout the course of the year, and they are now at a kind of around pre-pandemic levels. That just -- those can be a precursor for higher credit losses in the future. And so we're going to be mindful there and continue to watch it. And we do watch the portfolio closely. But as we said, I think our consumer tends to be a little bit more resilient, and so we'll continue to watch that.

Operator

And next is from Dana Telsey with the Telsey Advisory Group.

Dana Lauren Telsey - *Telsey Advisory Group LLC - CEO & Chief Research Officer*

Welcome Cathy. Just following up on the credit for a moment. When you go back to the great financial crisis 2008, 2009, any parallels to learn of what happened then and what you're seeing now? And then following up on the Rack business and the new stores that you're opening this year, how is new store productivity ramping versus what you may have expected or versus previous? And then just lastly, seeing what happening currently in the current environment. Any adjustments to plans for holiday from what you've typically done in the past?

Cathy R. Smith - *Nordstrom, Inc. - CFO & Treasurer*

Dana, first off, great to see you or hear you again. So I appreciate that. Maybe I'll start with credit. And if Erik wants to talk a little bit about Rack productivity or I can, and then maybe I'll finish up with Pete on holiday and how we're doing that.

So with regards to credit, you made me smile when you asked the question because I lived through the financial crisis in a homebuilder. And to my very first question to the team was, tell me about how we performed in '08, '09 and '10 as well. So it made me smile that that's where you went as well. And I would tell you, first off, for a lot of reasons, the business is a little different now than then, we have a different arrangement with our credit card partner. We have a great partner there. And so it is a little different arrangement. We continue to have a very strong credit quality in our portfolio as well.

So for a lot of reasons, although our credit losses aren't projected to be anywhere near where they were in the financial crisis, it's a different book of business and a different arrangement. So we feel very good about where we are and kind of how we're projecting it. They have pretty good insights because you do see the delinquencies coming, so feel like we're in a good place there.

And again, I'll go back to the big picture, and that is they're a really important part of our customer set. We -- they typically are most engaged customers, so we're really pleased with that. Maybe I'll turn it over to Erik on Rack productivity of new stores and then Pete on holiday.

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Erik B. Nordstrom - *Nordstrom, Inc. - CEO & Director*

Dana, we're really pleased with our Rack new store performance and I'll just center you on the importance of Rack new stores. First and foremost, it's a great return on our investment. And Rack new stores, the returns we're getting out of those is very strong, well ahead of the cost of capital, and we're encouraged by that.

Peter E. Nordstrom - *Nordstrom, Inc. - President, Chief Brand Officer & Director*

Dana, it's Pete. With regards to holiday, in terms of changes from the past, I think the biggest thing is coming out of Anniversary Sale clean and having efficient inventory is super helpful. And we obviously have our plan, and it's to continue to focus on the gifting target, but we also have some dry powder so that whatever we're able to learn here in the first couple of months of fall, we could invest back into holiday in terms of replenishment and a lot of those more kind of staple items that can help us a lot during the holiday season. So I think we feel really good about the new things we're able to invest in and how we're able to activate and energize the store and the shopping experience, with making sure that we've got the proper amount of money we can properly invest into the business for that time. So we feel good about it.

Operator

And the next question is from Edward Yruma with Piper Sandler.

Edward James Yruma - *Piper Sandler & Co., Research Division - MD & Senior Research Analyst*

I guess first on gross margin. I was wondering if you could unpack a little bit and kind of break out the impact of deleverage on lower sales versus lower markdowns versus last year? And how we should think about markdowns given the improved inventory level going forward? And then just as a follow-up, obviously, lots of discussion about shrink. We all saw the video what happened in Topanga. Just trying to understand how you see shrink play out for the remainder of the year?

Cathy R. Smith - *Nordstrom, Inc. - CFO & Treasurer*

Ed. So good to hear you again and look forward to seeing you live at some point. On gross margin, I'll unpack that a little bit. And then maybe I'll ask Erik to comment on shrink and theft as I know it's been a topic with many retailers.

But starting with gross margin to your question on deleveraging of sales, that absolutely has an impact, as you think about for the quarter, always does. Overall, though, with our -- the continued work of the team, we were down, gross margin, only 20 basis points on the deleveraging of the sales, partially offset by a little bit of lower building and occupancy costs, so -- or buying and occupancy cost. So generally, I would feel really good about gross margin. As we think about going forward, though, for gross margin, Q3, you're going to see -- continue to see that the supply chain productivity for EBIT, which obviously don't show up in gross margin as much. A little bit of sales deleverage.

But then going into the back quarter or the fourth quarter, last year, remember, we had a lot of inventory that we bought through and marked down. We're not going to see that same level or not planning to this year, given the quality or the health of our inventory going into the back half. So I think, overall, we feel really good about being able to focus on the things we can control, no matter what the consumer environment provides. Maybe, Erik, you could talk a little bit about shrink or theft.

Erik B. Nordstrom - *Nordstrom, Inc. - CEO & Director*

Yes, sure. Let me start with just, the safety of employees and customers is always the top priority. Certainly, what happened in our Topanga store is disturbing to all of us. But the loss is a concern. Losses from theft are at historical highs. And I'd say we find it unacceptable and needs to be

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addressed. That being said, while it's unacceptable, it is within our plans. We have not seen continuing rising of shrinkage that has exceeded what we've planned. So it's in line with how we lead out this year.

But the drag on earnings, just from a financial performance, that needs to come down. And we've done a lot of things, and we're looking at everything we can do to make our stores safe and secure, first of all that they can be, but also to address the loss. And there's things within our control that we can invest in, but also involves partnering with local jurisdictions, law enforcement. I think legislation is part of the mix too here that all industry needs to come to some better solutions on.

Operator

Next is from Blake Anderson with Jefferies.

Blake Anderson - *Jefferies LLC, Research Division - Equity Associate*

I wanted to start with Nordstrom Rack. Can you talk about kind of what inning are we now for getting the top brands back to normal in terms of the mix? I think you're pretty close, but just wanted to ask about that? And then just more broadly on newness, how did that trend throughout the quarter? And how are you planning on newness for the back half?

Peter E. Nordstrom - *Nordstrom, Inc. - President, Chief Brand Officer & Director*

Yes. This is Pete. In terms of the Rack top brands and where we are in that journey. It's a little hard to say, but we've made considerable progress. And I think if you go back to our original intentions of how to think about this, we're getting pretty close. It feels like by the end of this year, we should have a really, I think, a good picture of where this settles out. And I don't think we're particularly far from that right now. And certainly, our buys indicated. We're talking about it relative to the sales our future on-order, I think, really represents where we think we should be. So we're fairly close. I don't know. Maybe we're in the bottom of the sixth, or top of the seventh, I don't know, in terms of innings, if that's the analogy. And I'm sorry, the second question was about what? Just newness in the Rack stores?

Blake Anderson - *Jefferies LLC, Research Division - Equity Associate*

Yes, that's right. I wanted to ask I guess more about Rack in terms of (inaudible).

Peter E. Nordstrom - *Nordstrom, Inc. - President, Chief Brand Officer & Director*

Yes. We talk a lot about inventory turns, and there's really 2 reasons for that. One of them is inventory -- faster inventory turns, the leading indicator of margin health, means you're probably selling through pretty well. You don't have markdowns. But particularly in the Rack business and the Nordstrom banner, too, the flow really matters. And if we can really even out our flow and have that stability and predictability, it gives us a lot of agility down the line to be able to respond. And customers, particularly in the Rack, they like to come in often and see what's new and what's going on there. So a big part of our turn agenda is around flow and that impacts the newness. So we're -- I think probably like a lot of retailers are hearing from, the newness has always been a key driver for us in terms of what drives top line.

Blake Anderson - *Jefferies LLC, Research Division - Equity Associate*

That's helpful. And then I wanted to ask on the quarter-to-date traffic decline. Can you give any more detail on maybe what you think is driving that in terms of any type of income cohort? Or how much is it -- I know you talked about designer remains under pressure. Any other commentary you could provide would be helpful.

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Cathy R. Smith - *Nordstrom, Inc. - CFO & Treasurer*

Yes, Blake, maybe I'll give it a try. So traffic, as Erik mentioned, traffic trends have remained soft. We're seeing sales made up obviously with higher conversion and higher selling price than we've seen versus last year. On an income cohort basis, we do see softness across the income cohorts, but the higher income cohorts are performing better than obviously the lower. I guess that seems pretty obvious when I say it out loud. But we see that in the data as well. So the good news is we tend to have a little higher income cohort in the Nordstrom banner, and those are performing well. So I think that's generally what's been driving the traffic trend. In the, by banner, though, earlier in the quarter was a little softer, and then we did see some strength. But again, we'll continue to think about where we're going in the back half, and we'll focus on the things we can control and hopefully have a great assortment for our customers to keep coming in.

Blake Anderson - *Jefferies LLC, Research Division - Equity Associate*

And if I could squeeze in 1 more. Maybe, Cathy, if you want to take a shot at this and welcome. On can you help us at all in terms of how to think about Q3 versus Q4 EPS? Or maybe just a little more commentary on the margins.

Cathy R. Smith - *Nordstrom, Inc. - CFO & Treasurer*

Yes. Sure, I'm happy to. And then -- Blake, always happy to do that in a follow-up as well. But thinking about Q3 versus Q4. So top line has got a little bit of noise moving through. Obviously, still sequential improvement, which I talked about earlier. As you think about from Q1 to Q2, we'd expect Q3 and then Q4 continued sequential improvement. That's also coming off of last year, a little bit easier comps, Q3 and then Q4 was the easier comp. So that's the first thing top line. Second thing is we have the 53rd week in the fourth quarter. So think about those as you think about the shape of the quarter.

On an EBIT or EPS and subsequently, on a profitability level. We're going to have continued supply chain productivity continuing in the back half of the year. It will start to moderate a little bit. We've been seeing the 4 quarters of over 100 basis points of improvement, so you'll start to see that moderate a little bit in the quarters going forward. But I think probably most significantly is in the fourth quarter, you're going to see the lack of markdowns to the extent we had last year. So that will help the profile of profitability into the fourth quarter.

Operator

Next is from Oliver Chen with TD Cowen.

Oliver Chen - *TD Cowen, Research Division - MD & Senior Equity Research Analyst*

Regarding e-commerce, what's your path forward in terms of resuming growth there? And what's assumed for the back half in terms of guidance? And as we think about women's merchandise at large at both banners, what are your thoughts on the main issues? And also how you're doing with the younger customer as well as in women's apparel.

Erik B. Nordstrom - *Nordstrom, Inc. - CEO & Director*

Oliver, it's Erik. I'll start on the digital one and Cathy can join in and then Pete can take the one merchandising question. As you know with us, we don't really get hung up on channel splits. It's -- we look at our business by banner. We've invested a lot over the years to have a seamless experience and really be where the customer wants us to be. And you add to it that economically we get the same profitability -- roughly the same profitability out of a Nordstrom.com sale that we do on a Nordstrom store sale. So we always got to -- start with the customer experience as a real focus on the channel experience.

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That being said, I think this year, you're seeing out of us and I think others too, that there is a return to stores. Stores have relatively performed well. With us, there's some added noise in our digital sales of -- in the comparisons against last year. If you remember, last year, we turned store fulfill from our Rack.com that had some softness, Trunk Club sunsetting, there's some noise in those numbers there. That being said, longer term, we think Nordstrom.com is a growth vehicle for us. We think Rack stores are the big growth vehicle for -- in the Rack banner. But in the Nordstrom banner, we think that the digital channel presents a lot of opportunity for us. It is leveraging our physical assets. So we see, continue making investments, in particular things around selection, that we can continue to bring our customers the breadth of selection that they want from us.

Peter E. Nordstrom - *Nordstrom, Inc. - President, Chief Brand Officer & Director*

Relative to the women's apparel, we've made good progress there, and it feels like a broken record probably. A lot of that has to do with just having our inventory levels to be in the right spot. We've had good success and we learned a lot through Anniversary Sale, which is a huge advantage for us being able to get that kind of read on what's going on and how to be able to project a little bit what's going to happen in fall.

But the dressed up looks for us really across the board in men's and women's has been good. But I think about women's like selling a third piece, so it's a jacket or it's a sweater. That business has been really strong. I think particularly in the contemporary types of categories, if you look at that price level and with those types of brands, we've had a good -- really good solid business, and we feel great about that. We feel like we're on a positive trajectory with women's apparel.

The other thing I'd say about women's apparel and the Rack, it's a disproportionately important category there. And that's another place where we just -- we have a lot more efficiency with our inventory. We're focusing on those strategic brands, that might make up a much higher percentage of our inventory ownership, and so that inventory is working for us better. So if we can continue to smooth out the flow and respond to the newness that goes with that, be opportunistic in the Rack, in particular, we're in good shape.

You mentioned the younger customer. I mean it feels like that's a bit of an evergreen opportunity. We need to do better with the younger customer and we have plans to do that. I think our own label programs are going to be a big part of that. I wish we could flip the switch and change that overnight. But as you know, these things take a little while. But I like where our plans are with that and what we're trying to accomplish and how that's going to appeal to a young customer, both with style and price. But I think that's a good opportunity for us. And then in '24, we should be able to see improvements to that young customer business that will be accretive to our total women's business.

Oliver Chen - *TD Cowen, Research Division - MD & Senior Equity Research Analyst*

Okay. And a follow-up, as we zoom out a bit, you do have an advanced data analytics platform as well as AI within your IT. What are you thinking about your merchant organization and how that can get faster and test, read, and react and how that can intersect with the analytics capabilities you have to just drive more inventory agility overall?

Peter E. Nordstrom - *Nordstrom, Inc. - President, Chief Brand Officer & Director*

This is Pete. I mean relative to AI and analytics and all that, it has to go without saying, I guess that, that is a key element to success in retailing. I mean we've got to be able to embrace data and I think whatever tools technology brings to the party that allows us to be faster and more agile. If we learned nothing else with COVID -- that's the kind of stuff that we need to invest in. And we talk a lot here about how technology becomes an enabler for all things we do, but particularly in merchandising. So I don't have anything to announce or declare here other than we're staying close to that, and we're always looking for ways that we can improve our efficiency and effectiveness in merchandising.

Cathy R. Smith - *Nordstrom, Inc. - CFO & Treasurer*

Maybe the only thing I would add on is, as at all companies right now, and particularly all retailers, too, our team has been working for some time on a great data platform. So we have a lot of richness there and are now starting to apply AI in all the places you would expect, everything from

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enhancing the customer experience to the operational capabilities to the merchant organization, like you just said, probably a long way to go, but I think everyone is putting some real energy around it.

Operator

And our last question comes from the line of Matthew Boss with JPMorgan.

Matthew Robert Boss - *JPMorgan Chase & Co, Research Division - MD & Senior Analyst*

So Erik, at the Rack, with the strategic brand penetration target now reached, what do you see as the timeline from here for Rack to return to positive top line growth? Maybe just help us to think about incremental opportunities that you see to drive continued top line improvement at the Rack banner multiyear as we think about price mix or categories?

Erik B. Nordstrom - *Nordstrom, Inc. - CEO & Director*

Yes. We -- as we've mentioned, we see continued sequential improvement, which you play that out, that gets us to having increases by the end of the year. And we see the Rack banner overall being a growth driver for us. One part of that is new stores, but we do see comp store growth coming. The strategic brands, it's part of the power and effectiveness for us has been in simplicity. But it is a bit of a blunt instrument. As you get within those strategic brands, they're not all created equal. And it varies with seasons.

So within that mix of strategic brands, we're in a position to move quickly and invest in those brands that are performing better. So it's not just about hitting a number of 65% our sales are in strategic brands. It is -- we continue to see opportunities within that chunk to have more productive inventory. And there's a lot of opportunities out there in off-price. And we have our inventories in a position to where we can be on offense and we have the focus directionally of where we want to go. So we see those growth opportunities ahead of us and that they're sustainable.

Sara Penner - *Nordstrom, Inc. - Manager, Investor Relations*

We want to thank you for joining today's call. A replay, along with the slide presentation and prepared remarks, will be available for 1 year on our website. Thank you for your interest in Nordstrom.

Operator

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

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