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JWN - Q3 2019 Nordstrom Inc Earnings Call

EVENT DATE/TIME: NOVEMBER 21, 2019 / 9:45PM GMT

OVERVIEW:

Co. reported 3Q19 EPS of $0.81. Expects 2019 sales to decrease approx. 2%.

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PRESENTATION

Operator

Greetings, and welcome to the Nordstrom third quarter earnings conference call. (Operator Instructions) As a reminder, this conference is being recorded. At this time, I'll turn the call over to Trina Schurman, Director of Investor Relations for Nordstrom. You may begin.

Trina Schurman - *Nordstrom, Inc. - Director of IR*

Good afternoon, and thank you for joining us. Today's earnings call will last 45 minutes and will include 30 minutes for your questions. Before we begin, I want to mention that we'll be referring to slides, which can be viewed by going to the Investor Relations section of nordstrom.com. Our discussion may include forward-looking statements so please refer to the slide showing our safe harbor language. Participating in today's call are Erik Nordstrom, Co-President; and Anne Bramman, Chief Financial Officer, who will discuss the company's third quarter performance and outlook for 2019. Joining during the Q&A session will be Pete Nordstrom, Co President. With that, I'll turn the call over to Erik.

Erik B. Nordstrom - *Nordstrom, Inc. - Co-President, Principal Executive Officer & Director*

Thank you for joining us today. We're pleased with our results. Our market strategy is transforming our business model and how we're serving customers. We have a unique mix of assets, Full-Price, Off-Price, stores and online, and we are further linking our businesses to serve customers in new and differentiated ways. The success of our strategy in Los Angeles adds to our confidence as we expand to our top 10 markets. We recently achieved an important milestone with the opening of the New York City flagship store, significantly increasing our presence in the world's top retail market.

Turning to our third quarter results. Our earnings exceeded expectations, demonstrating substantial progress in the delivery of our strategy and strength of our operating discipline. Through our customer focus, we drove broad-based improvement and top line trend of more than 200 basis points relative to first half of the year. In particular, the Off-Price business delivered positive sales growth and increased profitability through strong inventory and expense execution. We're encouraged by the momentum in our Full-Price and Off-Price businesses as we execute our holiday strategy to establish Nordstrom as a gifting destination for customers.

Through our focus on driving top and bottom line, we've made notable changes to 2 key events: our Anniversary Sale and holiday. As we discussed previously, the priorities for Anniversary are to improve customer satisfaction, drive sales and increase profitability. Customer feedback from this year's event was positive, significantly raising satisfaction scores. We curated the assortment by building more depth in key brands and items, driving higher sell-throughs. As a result, we had fewer markdowns on Anniversary product in the third quarter, which contributed substantially to merchandise margins.

For the holidays, we're meaningfully expanding our gifting offer across Full-Price and Off-Price, and making it easier for customers to find gifts by recipient and price point. We're also making shopping more convenient with services such as free next day shipping, 24/7 order pickup and complementary gift wrapping. The momentum in our Off-Price business delivered positive sales growth on less inventory. We also increased turns for the eighth consecutive quarter and exceeded bottom line expectations. We've been purposeful about improving inventory flow, refining product allocation and emphasizing merchandise that's seasonally relevant. Our favorable inventory position allows us to be opportunistic in the marketplace and leads to having a good flow of new product for customers to discover.

Another way we're leveraging inventory is through our market strategy. Investments in digital capabilities, along with assets of people, product and place, enable us to serve customers on their terms. Our goal is to gain market share while driving customer engagement and inventory efficiencies. There are 2 elements to this strategy. First, we're giving customers greater merchandise selection with faster delivery without increasing inventory levels. Second, we're engaging with customers by offering express services such as order pickup, returns and alterations at additional locations. We first launched our market strategy in Los Angeles, our largest market, where results are exceeding expectations. Third quarter sales growth outpaced other markets by 100 basis points. In L.A., the growth in customers shopping in stores and online was also 100 basis points higher than our average. We anticipate that these customers will increase their spend by 4x. Additionally, merchandise sell-throughs were higher in these stores than in other markets, contributing to profitability. We recently rolled out our market strategy in New York City, San Francisco, Chicago and Dallas. In the broader New York City market, customers now have faster access to inventory across 8 full-line stores, including our flagship and our fulfillment center. This represents 7x more selection available for [next-day] (corrected by the company after the call) pickup or [delivery] (corrected by the company after the call).

Leveraging existing store assets and digital capabilities enabled us to implement this shared inventory approach without making additional material investments. Order pickup is our most profitable transaction, and the fourth quarter accounts for 40% of its volume. This represents a meaningful opportunity to increase convenience for customers during the holidays and at a lower cost for us. Going forward, we're accelerating this strategy to our remaining top 10 markets by the end of 2020 through a continued focus on shared inventory and access to services. This includes plans to open more Nordstrom local service hubs in Los Angeles and New York. We will leverage additional Rack locations to offer express services such as order pickup, returns and alterations. And finally, we opened our New York City flagship store on October 24. We've seen strong customer response with 85,000 visits during the opening weekend alone. New York City represents our largest online market, and we expect to see a halo effect when we open a physical location. Already, the sales uptick in the men's store is exceeding expectations. In addition, 1 of Nordstrom's key points of difference is the breadth of our merchandise assortment, which creates an inclusive shopping experience. Customers at this store have responded to our offering and top-performing brands include Nordstrom-made labels, Topshop, Nike, Canada Goose, Louboutin and Valentino. Opening this flagship has been perhaps the most important milestone in our company's long history. It is the culmination of efforts across so many people, and we are grateful to them all. First of all, the many Nordstrom alumni who, over the years, established a reputation with customers and as an employer that allowed this opportunity to be there for us. And to our current team across the company, our business is about team, and this has never been more true. We are proud of their dedication and passion in bringing this store to life. Pete and I feel most fortunate to work with so many talented, caring and hardworking people. I'll now turn it over to Anne to discuss our financial results and expectations for the remainder of the year.

Anne L. Bramman - *Nordstrom, Inc. - CFO & Principal Accounting Officer*

Thanks, Erik. For the third quarter, we reported EPS of $0.81, exceeding our expectations. We made meaningful progress in improving the customer service and continuing our operational discipline. The consistent strength of our inventory and expense execution contributed to EBIT margin expansion for the quarter. We are delivering on our strategy while driving top and bottom line results.

Third quarter sales decreased 2.2%, in line with expectations. Full-Price decreased 4.1% and Off-Price increased 1.2%. Sales trends improved by more than 200 basis points from the first half of the year. We saw broad-based improvement across Full-Price and Off-Price, driven by actions we're taking related to loyalty, digital marketing and merchandise assortment. Digital sales represented 34% of our business, up 300 basis points from a year ago. We saw sequential improvement in digital trends throughout the quarter, most notably at nordstrom.com.

Customer satisfaction scores on our loyalty program continue to rebound, and digital marketing efforts are driving traffic. As we rebalance our merchandise assortment, we are increasing depth in key items in Full-Price and accelerating seasonal receipts in Off-Price. All merchandise divisions in both businesses improved relative to the first half of the year. Our gross profit rate increased by 100 basis points over last year. We had fewer markdowns as the result of disciplined inventory management in Off-Price and higher sell-through of Anniversary product in Full-Price. We ended the quarter in a favorable inventory position, down 2.7%, and we maintained a positive spread between sales and inventory for the third consecutive quarter.

Our strong expense discipline drove our third quarter earnings beat. Expenses were down 2% from last year, excluding the credit charge in 2018, and preopening expenses for the New York City flagship. As a reminder, we planned $35 million in preopening expenses, of which roughly $10 million was incurred in the first half and $25 million in Q3. We continue to reduce our fixed cost by realigning our support structure in stores, making end-to-end process improvements in supply chain and technology and minimizing discretionary spend.

Year-to-date, we have achieved $170 million in savings and expect to well exceed our plan of $150 million to $200 million for the year. Our financial position remains strong. We apply a consistent approach that balances reinvesting in the business and returning capital to shareholders. For the past several years, we have made significant investments in new markets and in digital capabilities to fuel future growth. With the opening of the New York City flagship, we're exiting this generational investment cycle. As a result, we expect CapEx to slow down from 6% of sales this year to 3% to 4% beginning in 2020. This reflects a normalized level inclusive of our market strategy investments related to technology, supply chain and additional Nordstrom locals. We anticipate that moderating CapEx will accelerate free cash flow next year.

We remain committed to our investment-grade credit rating. Adjusted debt to EBITDAR was 2.8x, and we expect it to be roughly 2.7x by the end of the year, in line with 2018. On November 6, we issued $500 million in debt, and in early December, we expect to use the proceeds to fully retire the outstanding May 2020 notes. A onetime financing charge of approximately $0.04 in the fourth quarter is not included in our revised EPS outlook.

Turning to our expectations for the full year, we updated our EPS outlook by raising the low end of our range by $0.05. We're maintaining our annual expectations for a sales decrease of approximately 2%. We expect SG&A dollars to be down roughly 1% for the year when excluding last year's credit charge. Gross profit rate is expected to be relatively flat.

As you may recall, we planned sales growth in the second half to reflect a 400 basis point improvement from the first half, and we are on track to meet these expectations. For the fourth quarter, the New York City flagship is expected to contribute approximately 150 basis points of growth, and the remainder is evenly weighted across 3 drivers: merchandise assortment, loyalty and digital marketing. As a reminder, gross profit is expected to deleverage from occupancy cost for the New York City flagship. Merchandise margin rate is planned flat, which contemplates a continued promotional environment.

To wrap up, we're pleased with our third quarter results. We made significant strides in delivering on our strategy, and we're encouraged by the customer response. Our achievements, including strong Off-Price execution, improved Anniversary economics, success of our market strategy and the New York City flagship reflect continued focus on the customer and operating discipline. I'll now turn it over to Trina for Q&A.

Trina Schurman - *Nordstrom, Inc. - Director of IR*

Thank you, Anne. Before we get started with Q&A, we would appreciate if you can limit to 1 question to allow everyone a chance to ask a question. Also, as a reminder, the company does not plan to comment on an 8-K filing on October 28. We'll now move to the Q&A session.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question is from Omar Saad with Evercore.

Omar Regis Saad - *Evercore ISI Institutional Equities, Research Division - Senior MD and Head of Softlines, Luxury & Department Stores Team*

Nice quarter. I wanted to ask some follow-ups around the omnichannel initiatives, what you're seeing in the local market strategy, dive in a little bit deeper on New York, and I think you'd now rolled out San Francisco, Dallas, Chicago. What's different in New York, base it from what you've learned in Los Angeles? And it seems to be really feeding into this kind of overall improvement in the profitability of the company as these capabilities come online. Is that the right way to think about it into next year as you expand to even further market -- in new markets?

Erik B. Nordstrom - *Nordstrom, Inc. - Co-President, Principal Executive Officer & Director*

Thanks, Omar. Let me start at the end. I think the way to think about it, number one, is it resonates for customers. I mean, none of these strategies work if it doesn't resonate with customers. A lot of customers, certainly, all customers like more selection, and receiving things faster. But a good chunk of customers like the control of picking up in store, be it an apartment without a doorman, or things get stolen off their porch, or they want to try it on before they take it home, having that alternative means a lot. Secondly, how you should think about after, customer relevance. It's really about leveraging, for the most part, existing assets that we have to serve the customers better. So it's really efficient for us. Our biggest investment is inventory, and inventory in stores, in particular, and that inventory store is close to customers. So being able to leverage that inventory to give customers bigger selection at a faster delivery is terrific, but it also helps the efficiency of our inventory significantly.

I think you asked what we learned in New York so far, and I think this makes sense. But it's -- we opened 2 local service hubs in September. And the traffic to those have ramped -- both of those has ramped up much faster than what we saw in Los Angeles. It's just more intuitive to customers who live in New York, that they're not getting in their SUV and driving to a parking lot. So to be able to have a neighborhood service hub where they can do returns and roadside pickups and alterations, customers get it immediately. Our traffic in those locations, with the locals has been very strong. And it's also, we're utilizing our Manhattan Rack locations as well for those services and the uptake on those services has significantly exceeded our expectations.

Operator

Our next question is from Oliver Chen with Cowen.

Oliver Chen - *Cowen and Company, LLC, Research Division - MD & Senior Equity Research Analyst*

Congrats on New York. Regarding rebalancing the assortment and the merchandise, what are your thoughts about that opportunity ahead? And will that continue to be an opportunity into next year? And as we think about digital in both digital marketing and your digital sales growth, how should we model that line? In what inning are you in with the refinement of digital marketing, which I'm sure is very dynamic?

Anne L. Bramman - *Nordstrom, Inc. - CFO & Principal Accounting Officer*

So Pete, do you want to take the rebalancing assortment, and I will, Erik and I can tag team the digital marketing?

Peter E. Nordstrom - *Nordstrom, Inc. - Co-President & Director*

Sure. Hey Oliver, it's Pete. In terms of balancing our assortments and relative to price points and I guess, what I would say about that is we're really in the early innings of it because we really landed on the strategy and tactically got after it a couple of months ago, but the lead time's pretty long, particularly in the Full-Price part of the business. And it's not something you can affect in a very short-term because largely what you're dealing with are MSRP's, and so it's not how we bring in and choose to market down. It's coming in at regular price. And so what we have to do with the assortment and the selection upfront. I think as long as we, and we will do this, continue to ground our efforts and actions around customer data so that we have a more objective view and I think it's good -- I think it's the right place. And what you should expect to see is continuous improvement on those lines over the next several months. We're not here to declare victory, that we get all A's at this moment. But we -- I think we have a clear understanding of how to more surgically implement our buys in a way that's going to benefit the business. So we feel good about what we're working on there.

Erik B. Nordstrom - *Nordstrom, Inc. - Co-President, Principal Executive Officer & Director*

Let me take a stab, and Anne, you can follow-up on the digital, such as you asked. The big drivers in our digital sales growth, loyalty, digital marketing and merchandise, we've talked about the last couple of quarters, we're on the journey on those. Loyalty has made significant progress all through the year, our program there, and we're seeing that with increased engagement online with our loyalty customers. Digital marketing is becoming more productive for us. We're seeing increased traffic online, and we believe there's still some runway there. The merchandise piece, having the right balance Pete just touched on. The other comment I'd just make on our digital sales is, we view digital sales as a mean to an end as opposed to the end, in and of itself. And what that means is, we look at our digital assets like our other assets, how do we get to -- before we can serve customers better, and in often in unique ways. And it kind of ties back to our market strategy. And I think some good examples of how much order pickup in stores is driving online sales growth. So overall, for the quarter, 1/2 of our digital sales growth came from order pickup. And in Los Angeles, where we're most advanced in our market strategy, it was 2/3 of our digital sales growth came from in-store order pickup. So that's going to be a big part moving forward. And we are like barely in the first inning on that one.

Oliver Chen - *Cowen and Company, LLC, Research Division - MD & Senior Equity Research Analyst*

That's really helpful. Just a follow-up. New York's a competitive market, and you've been really holding your own. What are your thoughts regarding the promotional environment in New York and department store closures that we've been having here?

Peter E. Nordstrom - *Nordstrom, Inc. - Co-President & Director*

Yes, thanks. This is Pete. The promotional thing is something that we've got to be reactive to, and there's all kinds of factors going on out there. It's probably -- and I think Anne may have mentioned this, one of the wildcards in terms of how we predict how we're going to end up in this next quarter, we like the momentum that we're on and everything, but it's difficult for us to predict exactly what's going to happen with the promotional part of the business. So I guess what I can tell you about that is we pay close attention, we're monitoring what's going on everywhere. And we're working closely with vendors to make sure that whatever adjustments we need to make, we can make them quickly, and so that customers feel like they can trust our pricing and everything, so it's just part of our ongoing long-term strategy about making sure that we're really staying close to it. And I wish I had a cleaner answer for you there. There are factors that would be happening with the others that really aren't in our control. So we have to get into a bit of reactive mode.

Operator

Next is Edward Yruma with KeyBanc Capital Markets.

Edward James Yruma - *KeyBanc Capital Markets Inc., Research Division - MD & Senior Research Analyst*

Congrats again on New York. Just real quickly, on the digital sales, I know you guys had indicated that sales had accelerated intra-quarter? I know that you've been doing tweaks in performance marketing and the loyalty, but kind of, maybe any more color you can give on why the performance accelerated? And then as a follow-up to the previous questions on local, as you think about the longer-term opportunity to roll out local, how quickly do you think you can move now that you've kind of tested this in different types of cities and markets?

Erik B. Nordstrom - *Nordstrom, Inc. - Co-President, Principal Executive Officer & Director*

To your -- digital sales, I guess, in addition to what we commented on Oliver's question, in-stock rates has been another area of merchandise mix we are focused on, and we've made good progress on that over the last quarter, definitely contributed to part of the momentum that you see in our results. As far as the speed of the local rollout, we went into the quarter, our plan was to expand our market strategy to New York. So adding Chicago, Dallas and San Francisco was something we were able to do ahead of our plans. And it reflects that we can move pretty quickly on it. There is not a material capital investment to expand this to other markets. It is mostly a story of leveraging existing assets. There is some work to be done. We can't just flip it on. There's some systems work and certainly some operational work to prepare this. Our plan is to, we're in 5 of our top 10 markets now, and our plan is to have this market strategy rolled out to the rest of our top 10 markets by the end of next year, and we will be pushing that as fast as we can.

Operator

Next is Alex Walvis with Goldman Sachs.

Alexandra E. Walvis - *Goldman Sachs Group Inc., Research Division - Research Analyst*

I had a question on the inventory management coming in again below sales this quarter. Can you talk about how happy you are with the composition of, level of that going into the holiday period? And then just related to that, I think that you said that the merch margin guide was around flat out for the fourth quarter. Can you talk about the puts and takes there? And if that kind of surprises one way or another, what would be the driver?

Anne L. Bramman - *Nordstrom, Inc. - CFO & Principal Accounting Officer*

Yes. So I'm going to take a first pass of it, Alex, and Pete and Erik, feel free to enhance the answer. So on the holiday. So coming into our inventory position. Overall, we're very, very pleased. I think, as both Erik and I referred to in our comments, in particular, our Off-Price business has done a remarkable job of increasing their inventory turn, a much, I think, more fluid flow model and being very opportunistic in the marketplace as far as seasonal relevant goods in the Off-Price space. And that's really reflected in what we're seeing in the top line and the bottom line results. So we talked about that, we also talked about the fact in Q3, the sell-through in our Anniversary product, we had fewer mark-ups and sell-through was really high, which was very intentional on part of our Anniversary strategy, so that certainly helped our merchandise margin rate for Q3. And we did see a highly promotional environment, but those 2 factors, between Anniversary markdown and our Off-Price business really helped to offset any promotional headwinds we might have seen in that quarter. In the fourth quarter, going in to it from a holiday perspective, we've actually pulled forward some of our holiday receipts. We've set holiday gifting, if you go on our site or in our stores, you'll see that we have a very deliberate message on gifting at certain price points just for the customer and what they're looking for, because we know from our customer feedback, people buy at certain times for certain people at certain price points, so we've really tailored the strategy and the inventory levels to match that. And so you're seeing that both in our Off-Price business and in our Full-Price business. And so we're real -- and I would also say that we've got -- we're very encouraged by the early reads we're seeing in our gifting strategy as we set that earlier than we did last year.

Peter E. Nordstrom - *Nordstrom, Inc. - Co-President & Director*

Yes, this is Pete. The only color I would add to that is, our inventory is in really good position because -- and we got there in the right way. We didn't do it through a bunch of markdowns to get ourselves in line or canceling a bunch of things. As Anne mentioned, because we've been achieving our plans and having a lot of discipline around our execution of our plan, which allowed us to pull inventory forward, to be responsive to what's going on with the traffic in the stores. And it's certainly helpful to our top line and being in a fluid position as we go forward like this just creates so much more flexibility, and I think opportunity for us that we feel good that we've gotten there in a really healthy way for the business, and that should pay benefits as time goes on, too.

Operator

Next is Paul Trussell with Deutsche Bank.

Paul Trussell - *Deutsche Bank AG, Research Division - Research Analyst*

You spoke to the Off-Price business having some better execution. During the quarter, obviously, turning positive on the top line, but also having some better-than-expected bottom line results. Could you just discuss that a bit more?

Erik B. Nordstrom - *Nordstrom, Inc. - Co-President, Principal Executive Officer & Director*

Sure. I'll start with -- we went into the year, seeing actually more opportunity on the bottom line than the top line. We have plenty of initiatives around both. But we've had good performance, profitability-wise in Off-Price all through the year. By the third quarter, the top line really changed its trajectory. And it really is broad-based. I mean, it starts with having sales increases on less inventory, and Anne touched on this. In Off-Price, in particular, being fluid, so you can be opportunistic for buys in the marketplace. And I think, in particular, the environment we're in right now, there's great merchandise at great prices out there if you have the open to buy to get after it. Our team certainly did that. The result of that is we have more newness in our mix. It's more seasonally relevant. And again, we're seeing faster turns and higher margins. There's elements in the store and execution that we've seen conversion improvements. There's elements online, our Rack.com and HauteLook business, through digital marketing, again through the merchandise offer, through flash events, really across the board, improvements in traffic and conversion.

Paul Trussell - *Deutsche Bank AG, Research Division - Research Analyst*

And just a quick follow-up on the updated outlook. Is the adjustment to EBIT and EPS solely a reflection of exceeding your own expectations for the third quarter? Or has there been any adjustments made to your prior view for the fourth quarter? And I noticed that the interest expense, I think, is -- remains guided towards $110 million, but you've only done $66 million to date. Maybe just touch on the outlook, please?

Anne L. Bramman - *Nordstrom, Inc. - CFO & Principal Accounting Officer*

Sure, absolutely. So as you mentioned, we did tighten the bottom end of our range. And it really is an output from what we exceeded in our own expectations for the quarter. So our view has not changed in the fourth quarter. As you've heard from the Q&A and from our opening commentary, we are executing, and the levers that we've been pulling and the drivers that we have in our business, we're continuing to deliver on what we set out for the second half of the year. As far as the interest expense, you're right, it -- the fourth quarter does top. I'd just remind you that we do have large capital projects, we do capitalize interest. And I think you guys are aware, we opened a very large investment in New York in Q3, so as that comes online, that interest would not be capitalized as going forward.

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Operator

Next is Jay Sole with UBS.

Jay Daniel Sole - *UBS Investment Bank, Research Division - Executive Director and Equity Research Analyst of Softlines & Luxury*

Just on the New York store, do you feel like it's opened up at, like, say, 100% of the productivity that you'll see? Or do you expect that there'll be a ramp-up period of a year or 2? And then secondly, Anne, on just the SG&A saves. By the end of 4Q, will the company have realized all -- will the run rate of savings be like completely realized, so if it's like $200 million or $210 million, whatever it's going to be, will that be it? Or will there probably be more going into Q1?

Anne L. Bramman - *Nordstrom, Inc. - CFO & Principal Accounting Officer*

Great. Let me take the SG&A first and then Pete, why don't you take New York. So on the SG&A, there will be a tail going into 2020. We haven't quantified that, and we'll include those as part of our 2020 guidance at the end of next quarter. What I would say more broadly though, is that we are continuing to look for opportunities to drive productivity and efficiencies in our business. I think you've heard us talk about this quite a bit, but particularly with the generational investments as they continue to scale, we'll get more flow-through on that. And we're also looking, as you know, we've been making a lot of investments in our digital capabilities. So we continue to look for ways to gain scale and productivity in those areas as well going forward. So I would say we've had a very strong operating discipline on this year, and I would say we're not done.

Peter E. Nordstrom - *Nordstrom, Inc. - Co-President & Director*

Yes, this is Pete. Relative to New York and the productivity and what to expect going forward, and one of the benefits that Erik and I have, is being around a long time. And I think between the 2 of us, we've seen, probably, I don't know, 80 store openings in our time. And as a result of that, we have really good context and analogs around how to expect the maturity of stores and how long that takes. Now granted, New York's got its own thing, but I think in terms of being able to grow into its full potential, we've got a few years there to be able to do that. We're not rationalizing or settling for something, anything less than the best we can possibly do between now and then. But it's safe to say that, even off to a great start, everything that we fully anticipate that we will grow over the next, call it, 3-or-so years into more of a mature position. And there's still things to be learned there. There's a lot of improvements that we can make, and customers getting to know us better, so it all feels super promising right now.

Jay Daniel Sole - *UBS Investment Bank, Research Division - Executive Director and Equity Research Analyst of Softlines & Luxury*

Got it. And then maybe I can just ask 1 more on the Full-Price stores because it sounds like you said digital was up 7%, overall Full-Price was down 4%. You closed about 6 stores year-over-year. Sort of, what kind of contribution was closing the stores to that overall sales growth number for the Full-Price stores? For the Full-Price business in total? Because otherwise, it looks like the Full-Price stores were down like high singles and sort of wondering if that's like the real run rate, or if that's sort of a combination of different factors that don't really represent the comp, which is obviously something that people are going to think about?

Anne L. Bramman - *Nordstrom, Inc. - CFO & Principal Accounting Officer*

Yes. So let me just -- so the digital sales number that we gave was for total JWN, so that includes, beyond our Full-Price, it also includes our Off-Price business as well. We did call out that we saw demand improvement throughout the quarter, particularly in nordstrom.com. And so as we -- when we look at closing stores, we -- I think we've talked to you guys about how we look at this, but it's generally at the end of an operating covenant or operating model, we look at the return we get as we invest in that store. We also look what's going on in that market. We look at what's going on in that mall. So typically, the stores that get closed are pretty small volume stores, and so it's not a significant impact to the top line overall for the company. I would also remind you that our stores, all of our stores are cash flow positive. So from a contribution margin, they actually -- we don't have any that would be -- are cash flow negative, even the ones that we close.

Erik B. Nordstrom - *Nordstrom, Inc. - Co-President, Principal Executive Officer & Director*

Yes, I would just -- this is Erik. I would just add to it and connect it to our market strategy. We're early days on it, but we're seeing so far, when we can connect our whole market's worth of inventory. Proportionally, the small stores benefit the most. And I think it makes sense. It's the biggest increase in inventory, what's available for next-day delivery or next-day buy in store, buy online, pickup in store. So I think the point there is, is we're learning a lot. And the fate of small stores is not sealed or determined. And it's part of what we're excited about with our market strategy is, the convenience, the kind of intimacy of a smaller store that customers like, if we can materially change the selections available to them, then those stores could be on a different trajectory. And so we still need to play that out and see what happens there.

Operator

Next is Connor Konicke with Robert W. Baird.

Connor Wilson Konicke - *Robert W. Baird & Co. Incorporated, Research Division - Research Analyst*

This is Connor on for Mark. I know you touched on the Anniversary event in the prepared remarks, but any more color there and maybe some of the key learnings you can take into the holiday quarter?

Peter E. Nordstrom - *Nordstrom, Inc. - Co-President & Director*

Yes, this is Pete. I think it's another example of where we use objective data and analysis to make smarter decisions. We've been doing the Anniversary thing for a long time. And you would think that, that practical experience, would give us all we need, but the changing landscape, relative to how much more online business we've done in the past, and it is -- and it grows disproportionately, and we have more online business. At that time, if that happens, and the Anniversary also happens at holiday, that it impacts really the profitability of the event. So it felt great that we went into it with a plan and to improve really the bottom line performance, and that has worked. I will tell you that we weren't able to get after this plan early enough to fully impact, I think, what's possible with that event. So I think the good news is that event went very well, and there's a lot of reason to believe that we will be able to improve upon it again for next year because we have the full year to be able to plan for it. And so I think what that implies for holiday, there's a lot of similarities in that they're time-bound events. And there's very specific actions related to price in the category that are applicable from anniversary to the holiday time. So we believe that we've got some proof there that we're on the right track and with the right strategy and it's nice to see kind of how our teams respond to all that. And their confidence about how to attack holiday and get Anniversary next year, on the heels of what was a successful Anniversary. So it's all been positive so far.

Operator

Next is Tracy Kogan with Citi.

Tracy Jill Kogan - *Citigroup Inc, Research Division - VP*

I was wondering if you could talk about the performance of your stores in Canada, both the full-line stores and the Rack stores. And how they performed relative to your expectations? And then also, what do the 4-wall margins look like there compared to the U.S.? And then I just wanted to have a quick follow-up on something you said about using your Rack locations in your local strategy. I was wondering if you could give more color on that.

Anne L. Bramman - *Nordstrom, Inc. - CFO & Principal Accounting Officer*

Yes. So I'll take some of the Canada questions, then Erik, do you want to take the Rack conversation? So in general, we report Canada as part of our generational investments. So we don't specifically break out, for example, Canada, we aren't going to break out New York in particular, and then we had, the other 2 of our generational investments, our nordstromrack, Hautelook.com as well as Trunk Club. And so what I would say is in general, when we look at our generational investments for the year, they are absolutely in line with our expectations that we laid out earlier this year from both a top and a bottom line perspective.

Tracy Jill Kogan - *Citigroup Inc, Research Division - VP*

Is there anything specifically you could say about the Canada stores relative to your expectations, just broadly?

Anne L. Bramman - *Nordstrom, Inc. - CFO & Principal Accounting Officer*

Yes. So again, I would just revert you back to our generational investments and that they're progressing as we -- and we've also talked about the fact that we're continuing to get scale and leverage in those investments as we continue to grow.

Erik B. Nordstrom - *Nordstrom, Inc. - Co-President, Principal Executive Officer & Director*

Yes. To add a little color to my comment on store -- the role our Rack stores can play with our market strategy. We did, in New York -- I'd step back and say, we approached New York as expanding our market capabilities versus opening a 4-wall store. Now that flagship store is a tremendous asset to add to the market. But it's, as we mentioned, Manhattan is our largest market for online sales. We opened 2 local service hubs. We had 2 Rack stores there, as well as a Trunk Club clubhouse. So we've been expanding for a bit now of having express returns in Rack stores, where customers can return Full-Price merchandise. And in New York, we expand that to not only be able to do returns from any of our businesses, but to do order pickups from any of our businesses. So nordstrom.com, buy online, pickup in store, and we have alterations available as well. The response to that has exceeded our expectations. We thought (inaudible) would be good. It's been especially good, so we're putting a plan together to roll that out to more Racks, and we'll share that with you once we have that set. The -- another piece I would just remind you, again, it's -- like everything, it starts with giving customers things they like. And a lot of customers, the convenience of going into a Rack, they really appreciate. But on the business side, getting customer engagement across channels drives a lot of value. When a customer goes from engaging with us in 1 of our businesses to 2, their spend with us increases 4x. And if we get engagement in all 4, that's full-line stores, nordstrom.com, Rack stores, rack.com, their spend goes up 11x. So there's a lot of value there that we're excited about.

Operator

Next is Michael Binetti with Crédit Suisse.

Michael Charles Binetti - *Crédit Suisse AG, Research Division - Research Analyst*

Congrats on a nice quarter and on New York. Anne, I think you originally described second half sales to accelerate by 400 basis points and fairly evenly split between 4 initiatives, New York being 1 of them. It sounds like you now expect New York to be about 150 basis points, if I heard you right. And it sounds like you saw Rack accelerate a little more than what you were thinking in the quarter, you seem pleased there. The compares get easier in the compares in Rack physical stores since we have that -- those data points last year, get a couple of hundred basis points easier. So the momentum in a few key areas here is maybe better than you thought. Any new takes you tried to embrace as you looked at the year that kept you from raising the target in fourth quarter per your comments earlier, given the momentum in the business there?

Anne L. Bramman - *Nordstrom, Inc. - CFO & Principal Accounting Officer*

Yes, thanks for the question. So just to clarify, the 400 basis points, in particular, New York was 100 basis points for the second half. And so what I try to do is to give you a little bit more context of what the impact is for the fourth quarter, because the store opened like the last week of the quarter. And so primarily, the sales are in the fourth quarter piece. So I was just trying to give you some context of those different levers to it. But the overall levers, if you look at second half, haven't changed. It's 100 basis points across the 4 things that we talked about. As far as -- Rack is doing well. The business overall is doing well. But we have a lot of the quarter left. We have a lot of the year left to deliver the big holiday season. We also, in my comments, try to incorporate the fact that it's going to a competitive and highly promotional holiday season, we believe. And so we wanted to make sure that we were continuing to deliver on our expectations.

Michael Charles Binetti - *Crédit Suisse AG, Research Division - Research Analyst*

Can I follow-up then and ask you on that directly. On the merch margins, I think you said you plan them flat or up in the fourth quarter, if I got that right. Maybe you can just walk us through a few of the components. Is New York -- is the impact from New York positive to merch margins? And then maybe you could help us put some kind of a basis point quantification on how much better the margins are around the end of Anniversary Sale. You said there was lower inventories, and you didn't have to clear as much there in the third quarter. I think that goes away as a tailwind in 4Q. I guess, around the competitive space, you've heard pretty conservative assumptions on merchandise margins. So I wanted to just check and see how you built up to where you got to for fourth quarter?

Anne L. Bramman - *Nordstrom, Inc. - CFO & Principal Accounting Officer*

Yes. So we did guide that we thought merch margins would be relatively flat for the fourth quarter, and we did include into that guidance a competitive and highly promotional environment. I think you've heard from, I think, all 3 of us, given our inventory position going into the quarter and given where we've really focused on our gifting assortment and in particular, the flow and the sell-through in off-price, but also in full prices, we really have been executing the holiday strategy, leveraging the learnings and the data and analytics anniversary in the holiday. And some of the encouraging signs we're seeing, as we set our holiday early. We've incorporated all of that into our guidance and feel very comfortable where we are.

Operator

Our last question comes from Heather Balsky with Bank of America.

Heather Nicole Balsky - *BofA Merrill Lynch, Research Division - VP*

This is Heather I'm filling in for Lorraine Hutchinson. I was hoping you could dig in a little bit in terms of the profitability impact you're seeing in LA from the local strategy. What are you seeing in terms of any gross margin improvement and the SG&A leverage that you'd mentioned that you're seeing better profitability from higher sales, so just curious if you can dig into that?

Erik B. Nordstrom - *Nordstrom, Inc. - Co-President, Principal Executive Officer & Director*

Yes, I mean, directionally, it's positive. We're getting higher sell-throughs. And again, it's more efficiency of our inventory investment. We can extend that inventory investment that's in all of our stores there, and spread into demand for next-day delivery or next-day pickup in-store across all of the stores. So it's early. We need to go through a full year, certainly. But right now, we're seeing higher sell-throughs. That's encouraging. There's puts and takes on the expense part of it. But overall for us, I would say we have -- we see a significant upside in profitability. And I think part of the story of our execution of this, it goes around inventory, our biggest investment's inventory, which means that our biggest cost can be marked down. So to be able to move that merchandise around in a marketplace in almost every case, some extra handling to get an incremental sale and avoid a markdown is well worth it.

Trina Schurman - *Nordstrom, Inc. - Director of IR*

Again, 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.