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JWN.N - Q3 2020 Nordstrom Inc Earnings Call

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OVERVIEW:

Co. reported 3Q20 EPS of $0.34. Expects 4Q20 sales to decrease in low-20s percentage range.

CORPORATE PARTICIPANTS

Anne L. Bramman *Nordstrom, Inc. - CFO*

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

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

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

CONFERENCE CALL PARTICIPANTS

Aatish Shah *BMO Capital Markets Equity Research - Senior Associate*

Charles P. Grom *Gordon Haskett Research Advisors - MD & Senior Analyst of Retail*

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

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

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

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

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

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

Robert Scott Drbul *Guggenheim Securities, LLC, Research Division - Senior MD*

Sarah Goldberg *Robert W. Baird & Co. Incorporated, Research Division - Research Analyst*

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

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, Head of Investor Relations for Nordstrom. You may begin.

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

Good afternoon, and thank you for joining us. Today's earnings call will last 45 minutes and will include approximately 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 on nordstrom.com. Our discussion may include forward-looking statements, so please refer to the slides showing our safe harbor language.

Participating in today's call are Erik Nordstrom, Chief Executive Officer; and Anne Bramman, Chief Financial Officer, who will provide a business update and discuss the company's third quarter performance for 2020. Joining during the Q&A session will be Pete Nordstrom, President of Nordstrom, Inc. and Chief Brand Officer.

With that, I'll turn the call over to Erik.

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

Good afternoon, and thank you for joining us today. Before diving into the details of the quarter, I'd like to highlight our priorities that we continue to navigate through this dynamic environment.

Since the founding of our company, our focus has always been on the customer. Fast-forward over 100 years, that's never been more important. In this moment of retail disruption, the key to success is moving with speed and flexibility to adapt to the rapid changes in customer expectations. We're thankful for our team's ability to quickly pivot to serve customers in new ways, positioning us well to capture market share and generate value for our shareholders in the years to come. To that end, we will continue to amplify the potential of both Nordstrom and Nordstrom Rack brands with an emphasis on accelerating growth and improving returns.

To achieve these goals, our focus is on fulfilling our customers' needs for both convenience and connection by offering a seamless and personal experience everywhere they shop. As we look across the business, we prioritized 3 areas where there is significant potential for growth.

First, we're building on the success of our market strategy, which we now consider our company blueprint on how we operate to better serve customers on their terms, gain market share and increase inventory efficiencies. By linking our digital and physical asset at the market level, we're able to offer customers up to 7x more merchandise selection with 2-day delivery or next-day order pickup. We have now reached scale in 10 of our top markets, which account for more than half of our sales, and we'll continue to roll out our strategy across our top markets.

Another component of our market strategy is to provide customers with more convenient access to our services. We know that when customers engage with us through order pickup, alterations or styling, their overall spend increases by up to 5x. In October, we expanded our capabilities, so customers can now pick up their nordstrom.com, nordstromrack.com and HauteLook orders at nearly 350 Nordstrom and Nordstrom Rack locations in the United States. In addition, we recently opened a fourth local Nordstrom neighborhood service hub in the Los Angeles market with a fifth location opening later this year.

Second, we're continuing to leverage digital and physical assets to fuel growth of our Nordstrom Rack brand, making up 1/3 of our business today. We have further opportunities to meet the needs of a broader customer segment. There are significant synergies between our 2 brands. The Rack serves as an important pipeline to our Nordstrom Full-Price business, bringing in 7 million new customers in 2019. Additionally, more than 1/3 of our Rack customers cross-shop to Nordstrom, which leads to higher overall customer spend.

We're also competitively positioned as the only off-price retailer with a significant digital platform. In the third quarter, online represented 40% of Nordstrom Rack sales. Since 2019, we generated nearly 3.5 million downloads of our Nordstrom Rack app, our highest converting channel. Another point of difference is our end-to-end approach to leveraging our strong vendor relationships across our ecosystem to provide customers with the best brands. In fact, more than 80% of our top 200 brands in Nordstrom are also carried at the Rack.

There are 2 main efforts underway to capitalize on the growth potential we see at the Rack, expanding our price points, particularly for lower prices, and better connecting our online and our physical stores, which will significantly increase selection. For more than 10 years, our Nordstrom Full-Price business has been able to use all sources of inventory across stores and fulfillment centers by having a single view of inventory.

In October, we launched these capabilities in Nordstrom Rack, enabling online order pickup, expanded selection and store fulfillment. We added 30,000 more customer choices online, and nearly 1/4 of our online orders are fulfilled from stores. Additionally, we're already seeing strong customer response with more than 10% of online orders being picked up at Rack stores.

Our third driver of growth is to increase the velocity of our digital business. In 2019, digital made up 33% of sales and accelerated to 54% this year. We view this as a fundamental shift in shopping behavior, and we are well positioned to support our customers across both Nordstrom and Rack with a scalable platform that has been built to support many years of growth.

We also know that we must translate the heritage of service that defines us more effectively in this digitally connected world. This means delivering personalization at scale by creating greater linkages between the digital and the physical experience.

During the quarter, virtual styling accounted for roughly 30% of all styling appointments, and sales from personalized looks created by our salespeople tripled in volume from the second quarter. Going forward, we see opportunities to further leverage these digital capabilities to increase the connection between our salespeople and customers.

At the heart of our value proposition is this principle of 'Closer to You,' which is how our market strategy comes to life in helping customers feel good and look their best. It describes not just who we are but also where we are going and how we will continue to set the standard for product, service and loyalty in this digital-first world. This is how we will ensure that we offer more than just product and convenience from shopping with us, but also true and meaningful connection, which for us is the differentiator between good service and great service.

Against this backdrop, we're pleased with our results in the third quarter. Our ongoing inventory and expense discipline, combined with the immediate actions taken early in the pandemic, have set us up well heading into Holiday, and most importantly, positions us for a strong performance in 2021 and beyond. The steps we took in the first half of the year to strengthen our financial flexibility enabled us to deliver positive EBIT in the third quarter of more than $100 million, earnings per share of $0.34 and operating cash flow of more than $150 million, all of which exceeded our expectations. We also improved merchandise margin trends and continue to see benefits from rebasing our cost structure.

We exited the third quarter with a high-quality mix of inventory, positioning us well to serve customers for Holiday and heading into the new year. Our focus remains on providing the best brands that our customers want, combined with the high level of service they expect.

We continue to leverage the close relationships we have with our strategic partners, including leading brands like Nike and Tory Burch, global luxury partners like LVMH and emerging brands like Good American. While we're continuing to amplify categories that are relevant with customers during the pandemic, we believe that over the medium to long term, there will be pent-up customer demand, particularly around occasions like travel or in-person social events. We're well positioned to meet their needs and capitalize on the opportunity to gain market share.

Our brand promise of getting 'closer to you' is the guiding principle of our growth plans going forward. Our direction is clear, and our team is dedicated to executing on our strategy to support profitable growth across our 3 areas of highest priority: owning our most important markets, fueling the growth of Nordstrom Rack and increasing the velocity of our digital business. We are confident that we will successfully emerge from this pandemic in an even stronger position to serve our customers and generate value for our shareholders.

Our team looks forward to discussing our plans with you in more detail at our virtual investor event planned for February 4.

With that, I'll turn it over to Anne to discuss financial performance in more detail.

Anne L. Bramman - *Nordstrom, Inc. - CFO*

Thanks, Erik. We're pleased with our third quarter results, which benefited from the immediate actions we took earlier this year to accelerate our strategic plans, rebase our cost structure and continue our inventory discipline. We're proud of our team's collective efforts to generate positive earnings and cash flow as we continue our path towards sales recovery.

During the quarter, we made meaningful advances in our digital capabilities, putting us in a stronger position to better serve customers and grow profitably. We're also encouraged by the strong customer response from our initiatives to drive both convenience and connection across our Nordstrom and Nordstrom Rack brands.

For the third quarter, we reported positive earnings per share of $0.34, which included a $0.12 tax benefit related to the CARES Act. We generated earnings before interest and taxes of more than $100 million, driven by significant improvement in flow-through from rebasing our cost structure. In addition, as a testament to the scale of our digital platform, we delivered healthy profits as online sales accelerated to 54% of our business during the quarter.

We're in a strong financial position, ending the quarter with $1.5 billion in liquidity, including $900 million in cash. We delivered operating cash flow of more than $340 million over the past 2 quarters and returned to positive free cash flow during the third quarter. The strength of our cash flow generation enabled us to pay down a total of $600 million on our revolver with $200 million outstanding at the end of the quarter. We remain committed to our long-term capital allocation principles, which include our focus on continuing reinvestment, reducing leverage and returning excess cash to shareholders.

Year-to-date, we realized cash savings of $550 million net of COVID-19-related charges across expense, CapEx and working capital. We expect to continue this momentum, tracking ahead of the high end of our targeted cash savings of $750 million for the year.

From an expense standpoint, this included $330 million in savings across our P&L, primarily from taking out roughly 20% of our overhead base, excluding occupancy costs. Going forward, this rebasing of our cost structure supports improved EBIT flow-through as we continue our sales recovery.

Overall, sales were in line with our expectations. After normalizing for the Anniversary shift, trends improved by roughly 17 percentage points relative to the second quarter. This reflected strength in our Anniversary execution, sequential improvement in both full-line and Rack store traffic trends throughout the third quarter and continued digital growth.

From a merchandise perspective, we're encouraged by our customer response to newness. Our Anniversary Sale serves as a strong proof point in our ability to amplify relevant categories, brands and trends to meet shifting customer preferences. We achieved record sell-through rates, which contributed to profitability by mitigating markdowns on excess Anniversary product.

In addition, we met our objective of rewarding our most loyal customers, with Nordy Club members contributing approximately 80% of sales during Anniversary. We also seamlessly scaled our digital platform during the event to support 60% online penetration. And nearly 1/3 of nordstrom.com units were fulfilled from full-line stores to enable faster delivery.

Our unique breadth of merchandise assortment across brands, price points and styles is a competitive advantage. This diverse product mix supports our ability to quickly respond to changing customer demand in this dynamic environment. During the quarter, we continue to see casualization, wellness and comfort trends resonate with customers. We had outsized growth in active, home and beauty, which made up more than 25% of sales. In addition, we saw continued strength in our designer business.

For the third quarter, digital sales of $1.6 billion represented 54% of our business, significantly up from 34% a year ago. Excluding the Anniversary shift impact, digital sales grew in the mid-teens range, consistent with trends in the first half of the year. In the 10 markets enabled by market strategy, order pickup sales grew 30% and accounted for 70% of the total order pickup volume.

Moving to gross profit. Our rate was down 150 basis points from last year with roughly 2/3 due to the shift in Anniversary and 1/3 from deleverage from lower sales volume. Merchandise margins exceeded our expectations due to stronger sell-through and regular price selling trends. Excluding the impact of the Anniversary shift, we ended the quarter with our inventory decrease in line with sales for the second consecutive quarter.

In SG&A, we saw modest rate deleverage of 30 basis points relative to last year. This reflected a reduction in overhead costs of nearly 20%, consistent with the first half of the year.

As we head into the fourth quarter, the quality of our inventory is strong, reflecting the right mix and improved aging relative to last year. We're seeing an increase in receipts and expect to have the freshest, most relevant product for the holidays across both Nordstrom and Nordstrom Rack. Given the increasing uncertainty in the current environment due to COVID-19, we are prepared for a range of scenarios to ensure that we can sustain and drive our business.

Based on our current expectations that our stores remain open, we expect to deliver continued positive EBIT and operating cash flow for the fourth quarter. Sales are expected to decrease in the low 20s percentage range, which reflects modest sequential sales improvement after normalizing for the Anniversary shift in the third quarter.

In addition, we expect fourth quarter EBIT margin to deleverage more than the third quarter, which factors in a highly promotional and competitive environment in addition to shipping surcharges and premium pay during the holidays.

In closing, we made meaningful progress to drive higher profitability and deliver strong cash flow. The strength of our financial position enables us to give customers a relevant product offering and reinvests in our strategic growth priorities to deliver a best-in-class experience. As we head into the fourth quarter in 2021, we're confident in our ability to execute on our strategy and deliver profitable sales growth.

I'd like to now turn it over to Trina for Q&A.

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

Thank you, Anne. (Operator Instructions) We will now move to the Q&A session.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of Edward Yruma with Bank of -- KeyBanc Capital Markets.

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

Some interesting commentary about thinking about pent-up apparel demand, particularly in a reopening scenario. We agree with you. When do you start planning for that? Do you expect receipts to increase as we move forward? And when do you start pivoting the assortment to kind of that going-out and travel assortment?

Anne L. Bramman - *Nordstrom, Inc. - CFO*

Ed, I'm going to have Erik address the pent-up demand question and how we're thinking about our scenario plans for '21.

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

Yes. Thanks, Ed, for the question. First off, when we talk about occasions, certainly, a lot of what we sell is built around occasions. But that doesn't mean formal parties and galas and such things. It could be as simple as a date night, going out to dinner. And as the company opens up, we think there's a lot of opportunities for us. When that happens exactly, we don't know. I think it gets clearer as time goes on.

The back half of the year looks encouraging. What we're really focused on is being nimble and flexible. There's a lot of breadth to our merchandise assortment. And the key is working with our vendors. So when it becomes clear, when things start opening up again, then we're in a position to do that because we have strength in a lot of those categories. And we certainly plan on gaining share during that time.

Operator

Next is Dana Telsey with Telsey Advisory Group.

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

As you think about the fourth quarter, just want to get some more color on the sales guidance. I think you had mentioned around -- down around 20%. What does that imply in how you're thinking about Full-Price and Off-Price channel expectations? And also, as you think about going towards 2021, how are you planning both the assortment and inventory buys?

Anne L. Bramman - *Nordstrom, Inc. - CFO*

Dana, it's Anne. I'm going to take your question on fourth quarter, and then I'm going to ask Pete to weigh in a little bit on how we're thinking about the inventory piece to this for '21.

So as I mentioned in my commentary, we gave some directional guidance that we think it's going to be in the low 20 -- or the negative 20s for top line. And we really look at it across multiple ways. And so as you know, it's a very fluid environment right now. We are really set up to respond to how the customers want to shop. We've done a lot -- we've learned a lot in April, and we make sure that we are going to be as flexible and agile as possible in order to meet the Holiday demand out there.

So the way we're thinking about it is we've got inventory out in the stores. We've got a lot of store fulfillment capabilities, both in our Rack business and our Full-Price business. And we're also really driving the curbside pickup pieces as well. So we're staying very fluid, but we're really making sure that we've got a range of scenarios to ensure that we can sustain and drive our business. Pete, do you want to weigh in?

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

Yes. With regards to our assortment for '21, I mean, I think a lot of things that both Erik and Anne have touched on are true. It really starts with us being -- putting ourselves in a position where we've got lean and efficient inventories so that we can be agile, and we've done that. And we think we're in really good shape to be able to pursue wherever this takes us.

There are a few things that we believe to be evergreen, though, kind of regardless of the pandemic. I mean, for example, just the casualization theme and trend that's been going on for a while really got accelerated and in most regards are probably here to stay. So I think to Erik's point about occasions and events, it's not so much that we're selling a bunch of ballgowns, tuxedos necessarily. But as people get out and do more socializing because the health and safety and whatever the vaccines enable us to do, that's going to help.

So I think what we've seen so far is we've done really well with casual things across whatever the category, wellness, beauty, active and home. And there's a lot of runway there for us, I think, particularly in active and home. So I think you'll continue to see us just work there.

Operator

Next is Oliver Chen with Cowen.

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

You had really encouraging merchandise margin performance. How do you balance that against what you're prepared for with the promotional environment? And you've also historically proactively price matched when things -- when competitors had other prices. So I would love your thoughts there as well as local market strategy. And what's ahead for highlights of that as well as we think about next year in the fourth quarter?

Anne L. Bramman - *Nordstrom, Inc. - CFO*

Thanks, Oliver. So Erik, do you want to take the market strategy approach and then Pete and I can both weigh in on the margin?

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

Sure. Yes. Oliver, for our market strategy, if you recall, it was, gosh, I think over 2 years ago, we had Investor Day. We first talked about it, and we talked about it in terms of it being our future business model. It really is our business model today. It is how we operate.

What's new, in particular, just the last month, is really bringing our Off-Price business as a key part of market strategy. Number one, by connecting our store inventory, our Rack store inventory with our e-commerce business, the NordstromRack.com and HauteLook being able to do store fulfill and store pickups is a big deal for us, but it also allows us to -- for customers even to do it on Nordstrom.com order and pick up at a Rack store. So we have a lot more locations for customers to really receive the merchandise on their terms.

So we think there's a lot of runway there of not only just connecting the digital and physical parts of our business, but in leveraging the physical assets we already have. We continue to open a few local service hubs. They've performed well, but there's a lot of those services like store pickup and alterations that we're doing in our Rack stores. And so to leverage those existing assets, we think there's a lot in taking care of customers without much additional investment for us.

Anne L. Bramman - *Nordstrom, Inc. - CFO*

So Oliver, on your question on margin, what I would weigh in and say is, right now, we have probably the freshest inventory we've had in quite some time. It's really encouraging when we saw the response from the customers during Anniversary so it gave us opportunity to remix the product, both in categories and price points. And as you saw in our margins for Q3, we had a really nice sell-through at regular price.

As we think about Q4, we are anticipating a more competitive environment, particularly from promotions. And so we have baked that into some of our thinking for Q4. But we're really encouraged by the aging and the freshness and the receipt flow that we've got. So Pete, I don't know if you want to weigh in a little bit more on how you're thinking about it.

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

Yes. I mean we don't have a crystal ball on the promotional stuff. It has a lot to do with what's going on with other retailers, really out of our control. But what we do is we're prepared, and we're going to be competitively priced on anything that's the exact same stuff we carry. So it's something we're working on all the time. And part of that is making sure we have good communications with the different brand partners we have so that they may be aware of things out there.

And it's always been the same. We're paying super close attention to that. But I don't think we expect anything really super out of the ordinary or anything. We've got a good plan in place.

Operator

Next is Omar Saad with Evercore.

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

I had a question to follow up around the EBIT margin deleverage comments you made around the fourth quarter. If we think about the fourth quarter almost as a microcosm of this kind of accelerated omnichannel world that we've been heading towards and the shipping surcharges and other factors that play in as an algorithm for how e-commerce and digital profitability might look for you guys long term, help us understand what is comparable and what isn't. And what are the offsets to the surcharges and other premium costs during the holiday period? Can you use your stores as greater assets, attract consumers to stores to save some of the shipping charges? How do we think about that kind of structural profitability of that new omnichannel marketplace?

Anne L. Bramman - *Nordstrom, Inc. - CFO*

I'm going to let Erik talk a little bit more how we're thinking about the market strategy and getting more inventory efficiencies in fulfillment, and then I'll weigh in a little bit on some of the specific expense factors.

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

Yes, Omar. First of all, I think it's an important context to step back, and two things about our digital business. Number one is its scale. So we tipped over to where it's 54% of our total business is digital. So we are a majority digital business right now.

And it's important because not only the flexibility it gives us, but the efficiency it gives us. Our digital business is profitable, as shown by our third quarter results. So that gives us a lot of flexibility and a lot of strength there.

Market strategy, as we've talked about, is really how we're doing business moving forward. And part of that is providing customers more options on how they want to pick up. I mean, clearly, curbside services and order pickup is growing and really growing, I think, for any retailers that's offering it. It's particularly important right now given the uncertainty that we face with the pandemic.

And so part of -- while the uncertainty for fourth quarter, we prefer not to have, but what gives us the confidence is we're in a much better position now than we were in March when stores first closed down. We have -- our Rack stores are able to fulfill orders now. And so we really don't have any place in our ecosystem where inventory gets trapped.

And to your point, it allows us to offset some shipping expenses that maybe a point in time may not be. But I think the point for us is that we've got, number one, the scale of digital; and number two, the connection to our physical assets to be well positioned for a majority digital business.

Anne L. Bramman - *Nordstrom, Inc. - CFO*

And to add on to that, the way we thought about Q4 was what we call that were specific areas that we saw that were outside our normal digital business because, as Erik mentioned, we are getting a lot of scale and efficiencies out of the investments we've made. And you saw that in the Q3 results. So what we call that was just isolated things that we saw happening for Q4.

Operator

Our next question is from Sarah Goldberg with Baird.

Sarah Goldberg - *Robert W. Baird & Co. Incorporated, Research Division - Research Analyst*

Can you give any more insight to the trends you're seeing at Rack? Did you see traffic improvement in line with the sequential top line improvement? Or are there offsetting factors like besides the conversion?

Anne L. Bramman - *Nordstrom, Inc. - CFO*

Erik, do you want to take the conversation on Rack?

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

Sure. Yes, Sarah, the -- both our Rack and Full-Price business, we did see sequential improvement in sales and traffic over the course of the quarter.

Operator

We'll move on to our next question, which is from Paul Trussell with Deutsche Bank.

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

Question on margins, just bigger picture. Obviously, it's been a challenging year. But just curious on your take of how COVID has impacted your trajectory from a long-term margin perspective, particularly given that you have done more cost savings than originally planned. Just curious on what you think is maybe more permanent and sustainable.

Anne L. Bramman - *Nordstrom, Inc. - CFO*

Paul, I'm going to take the specific margin question. And then I think maybe, Erik, you can give a broader context on what you're seeing going forward with the business in general.

As we talked about, the digital piece to it, it has definitely been accelerating -- how customer shop has definitely accelerated, and you're seeing that we've got the scale in our business.

As we think about our margins going forward, we -- as you know, we took a lot of actions early in the year, and you're seeing that flow-through and that benefit happening. We believe that about 80% of those savings are going to be pretty permanent going into '21. So we would expect to see a better flow through in '21 and would not require the same level of sales that we had prior to COVID. So we actually think we're really well positioned.

You're also seeing this in the financial health and strength of the business and the cash flow generation as well. So we feel like we're really set up well for '21. Erik?

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

Yes. Paul, I'd say, in general, we've talked about this. COVID was less about change that no one saw coming to a -- massive acceleration of change that was already in place. And two things in particular. One, the shift to digital. So as I mentioned, our business is over half digital now. A year ago, third quarter, our business was 34% digital. So that's a big, big acceleration.

The other piece is the business model. And we have been evolving our business model. And certainly, one of the driving factors in that is not just the shift to digital, but the changing role of stores as we fill more orders out of stores and do more order pickup, having those capabilities and really having to change the organizational model that we have in stores. COVID accelerated both those things in a big way.

And yes, I would say we would not be where we're at today if it wasn't for COVID. I mean that got us very focused on embracing the new world where we're a majority digital. And our store labor model, for instance, is dramatically different than it was pre-COVID. We have significant staffing in our store to handle order fulfillment and order filling, curbside services, those things. And it's actually given us much more flexibility in stores with our staffing to serve. Whether customers in the store or it's filling an order, it's just made our model much more flexible and much more efficient.

Operator

Next is Simeon Siegel with BMO Capital.

Aatish Shah - *BMO Capital Markets Equity Research - Senior Associate*

This is Aatish on for Simeon. I was just wondering if you could just give us some more detail on how you see promotional cadence for the holiday and how you see that shaping up. And then just an idea of how the return rates were in the quarter and if that shifted at all.

Anne L. Bramman - *Nordstrom, Inc. - CFO*

So Erik will get the promotional, how we're thinking about the promotional piece to it, and I can wrap up on the returns.

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

Okay. Yes, I think Pete touched on this. It's hard to know. It is responding to others. For us, within our control, number one is the quantity and the health of our inventory, which to Anne's point has really never been better. The freshest inventory, we measure that. But it's also the right category. So we feel really good about that and as well as the quantities.

So we don't see having excessive markdowns from having excessive inventory, but we won't be undersold. That's a promise we make to our customers. So we'll have to play that as it goes.

Anne L. Bramman - *Nordstrom, Inc. - CFO*

So on the sales return piece to it, it was the continuing trend that we've seen in the first half of the year. Some of it is based on price points, some of it is based on the category shift. I think the Anniversary was a great reflection of that with the highest sell-through we've ever seen, which really helped mitigate some of the potential markdowns as well as -- and helped us sustain some of our merchandise margins. So we are seeing low returns, but it's a continuing trend of what we've been seeing in the marketplace.

Operator

Next is Tracy Kogan with Citi.

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

I was hoping you guys could talk about the new customers you've added to the Nordy Club this year and whether you're seeing any difference in the demographics or any differences in what they're buying relative to your average customer.

Anne L. Bramman - *Nordstrom, Inc. - CFO*

Erik, do you want to take the question on the customer mix?

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

Sure. Well, first of all, the shift towards digital, we've had a much higher rate of customer acquisition, new customers that we just haven't had before. So it's been reported elsewhere that there is a -- customers are willing to try new retailers during this time. And life has changed so much that there's opportunities there.

So we certainly look to take advantage of that. Of course, getting them into our Nordy Club, that's a little tough, right? Usually, you don't -- someone's first experience of this does not result in signing up our loyalty program. But we think that certainly can come as it starts at the top of the funnel with new customer acquisition. And hopefully, we provide a good experience and can educate customers about the benefits of our Nordy Club.

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

And anything on the demographics? Is the customer younger that you're seeing at all, the new customer?

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

Yes, it's a little younger.

Operator

Next is Michael Binetti with Crédit Suisse.

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

Anne, I was wondering if you could help us understand a little better how you're thinking about gross margin versus SG&A in the fourth quarter, we're trying to normalize some of the SG&A for the Anniversary shift.

And then I guess, coming out of that, I guess, thinking a little more long term, you did mention with all the cost work you've done about -- you think about 80% of it will be sticky as you look to 2021. I'm wondering if that's a net number or if there are any new offsets just coming up. Mostly from the industry side, we've heard from a lot of retailers saying freight is going to be higher. You're seeing a lot of marketing investment in the fourth quarter. I'm wondering if any of those need to come back into the SG&A line as we look into early '21, please.

Anne L. Bramman - *Nordstrom, Inc. - CFO*

Yes. So we -- the way we thought about it, for the year, we're continuing to see the 20% reduction in overhead outside of occupancy, the fixed cost. As we think about our cost base going into '21, traditionally, it's been about 50% variable, 50% fixed. We think it's going to be a little bit more -- leaning more variable. Particularly as we exit Q4 into '21 as well, we should see a little bit more flow through happening -- continuing to happen.

As we think about Q4, what we've baked in is some specific things around the holiday between promotional environment, which also includes a marketing campaign around that as well as we talked about earlier, the holiday labor surcharge and some of the shipping surcharges we would see for Holiday as well.

But I think I would just pivot back more broadly. In general, you're seeing a common theme in that we've got the scale in our digital business. And because of the way we've got our Nordstrom market strategy, the way we're using our physical and digital assets together, it's really giving us a lot of opportunities to serve customers, fulfill product and have it closer to the customer. So there's a lot of opportunities on efficiencies that we're continuing to execute on both in our Off-Price and Full-Price business.

Operator

Next is Chuck Grom with Gordon Haskett.

Charles P. Grom - *Gordon Haskett Research Advisors - MD & Senior Analyst of Retail*

Anne, on the fourth quarter, can you perhaps speak to the magnitude of the expected operating margin deleverage that you're expecting to see given that sales are going to be down about 20% and then it sounds like gross margins are going to be a little bit in more duress than the third quarter?

And then the follow-up would be just on the store fleet, with 54% of sales today now coming from digital channels, just trying to get a sense for how you're feeling about the store base at this point in time.

Anne L. Bramman - *Nordstrom, Inc. - CFO*

Yes. So Erik, why don't you talk about how we're thinking about our store base, and then I can circle back.

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

Yes. We announced early in the pandemic that we wouldn't reopen 16 of our full-line stores. We don't have any more to open at this point. Really how we think about it is not sort of store by store, but physical assets and really by market. So how can we leverage the assets we have and what's the right mix of assets? And that includes full-line stores, Nordstrom Locals and Rack stores.

So I don't know exactly how it's going to play out. I would say it's probably going to be different than what we have now. We really like that mix that we have, having those different capabilities with different assets and finding more ways to link them. And it gives us more ways of optimizing our physical footprint beside just looking at it as a full-line store.

Anne L. Bramman - *Nordstrom, Inc. - CFO*

So as I think about Q4 and just to clarify, we -- the -- what we talked about in the script is that sales are expected to decrease in the low 20s percentage range, which does reflect a modest sequential sales improvement after normalizing for the Anniversary shift in the third quarter. What I would also point to is that we are continuing to believe that even though we've got some deleverage in Q4, things that we've been talking about, we still expect to deliver continued positive EBIT and operating cash flow for the fourth quarter.

So while we're not giving specific pieces to this, I would just anchor the fact that we're continuing -- even with that guidance, we're expecting to have positive cash flow and positive earnings.

Operator

Our last question is from Bob Drbul with Guggenheim.

Robert Scott Drbul - *Guggenheim Securities, LLC, Research Division - Senior MD*

Just curious, if you could maybe comment, you talked about the local market strategy, but just curious how New York City is performing for you with the flagships and whether or not the traffic is there and the volume and how the customers are responding in a big market like New York.

Anne L. Bramman - *Nordstrom, Inc. - CFO*

Yes. Thanks. Pete, do you want to address the New York question?

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

Yes. I think that the worst thing for us of the New York thing is that we don't have a huge legacy in body work that we were open, what, 5 months before the pandemic hit. So I mean, I guess, in some ways, it helps that we don't have this big history built up.

But we still are big believers in that market.

I mean it remains a huge and powerful market. We talk about occasions and stuff like that. If you think about the New York market, things like tourism and people going to work and going to events, that's a big part of what drives sales there. So it hit them pretty hard.

But I think it's similar for us in pretty much any urban store we have, whether that be Chicago or Seattle or San Francisco. So it's not a total anomaly, but we've got a really great team there. And it's probably the blessing in disguise always. It's given us a lot of urgency and focus around how to connect with customers personally and improve kind of the personal sales and everything that goes with that.

So we're still big believers in New York, and we're just going to work through it. And there will be brighter days ahead for sure.

Trina Schurman - *Nordstrom, Inc. - Head 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.

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