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PRESENTATION

Operator

Greetings, and welcome to the Nordstrom Fourth Quarter 2022 Earnings Conference Call. (Operator Instructions) As a reminder this conference is being recorded.

I'll turn the call over to Sara Penner, Manager of Investor Relations for Nordstrom. You may now 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. As a reminder, we are here today to discuss our business and fourth quarter performance, and we will not be taking questions on other matters.

Participating in today's call are Erik Nordstrom, Chief Executive Officer; Pete Nordstrom, President and Chief Brand Officer; and Michael Maher, Interim Chief Financial Officer, who will provide a business update and discuss the company's fourth 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. Thank you for joining us today.

For the fourth quarter, we delivered net sales of \$4.2 billion and earnings per share of \$0.74. Looking back on the fiscal year, revenue increased 5% from 2021 and adjusted EBIT margin was in line with last year at 3.3%. We saw customers starting to pull back in late June, primarily in Nordstrom

Rack, and this trend continued through the holiday season. Across both banners, the softening trend was more pronounced in customers with lower income profiles.

Given the uncertain environment, we are executing with agility. We took actions starting in Q3 to clear excess inventory and optimize our product mix. As a result, we are now in a much healthier position with inventory levels down 15% from last year and in line with 2019 levels.

While this was the right strategy to better position our inventory levels for 2023, we implemented more markdowns than we had initially planned to achieve our goal. This was compounded by the softening trend, excess inventory levels and promotional intensity in our sector. As a result, our margins were lower than expected in the fourth quarter.

Despite this, I'm pleased that our supply chain initiatives delivered efficiency and lower per unit costs in Q4, resulting in more than 200 basis points of SG&A rate improvement even with lower sales leverage and ongoing inflationary pressures. At the same time, we remain committed to driving more profitable long-term growth. We are looking across our business and operations with this clear mindset to ensure we are deploying our financial resources and talent against the opportunities where we are best positioned to win in the medium and long term.

With this in mind, we have decided to wind down our Canadian business over the next few months to simplify our operations and increase our focus on our core U.S. business. We entered Canada in 2014 because we believed it presented a compelling opportunity, and we are grateful for the many customer relationships we have built over the years. Despite our team's best efforts, including multiple initiatives to improve our outcomes, our Canadian business has not been profitable. The impact from COVID drove further losses with no realistic path to sustainable profitability.

Canada accounts for less than 3% of our total sales, and we believe we will benefit from a sharper focus on our U.S. business. Michael will provide more detail on the one-time charges related to this decision and the impact on our sales and profitability going forward.

While we are confident in our decision, it was a difficult one to make, and we recognize the personal impact on our employees. We are committed to treating our Canadian employees with fairness and respect. We are establishing an employee trust that will provide additional benefits for employees during the wind down period. I have the deepest appreciation for the talent and passion of our great team in Canada. I want to sincerely thank them for their dedication to customers and the service they have provided over the years.

More than ever, I believe Nordstrom is uniquely positioned to meet the changing needs of our customers. With our 2 powerful interconnected brands, the breadth of our products, styles and prices, and most of all, our unwavering passion for customer service, we have a durable foundation for growth. We are taking clear actions in 2023 to expand market share and improve our profitability. It starts with our loyal customer base, our greatest asset. We acquired approximately 10 million new customers in 2022 and added 2.5 million new Nordy Club members. We are committed to building on these successes while delivering on our legacy of service across physical stores and digitally as the customer experience continues to evolve to be even more omnichannel. This is critical to driving engagement and attracting more customers.

In addition to improving the customer experience, we are focused on 3 specific priorities to drive better financial performance in 2023. One, improving Nordstrom Rack performance; two, increasing our inventory productivity; and three, continuing to advance our supply chain optimization initiatives. I'll address each of these briefly, then Pete will go into more depth on some of our initiatives in support of these priorities.

Starting with Nordstrom Rack. Sales in Q4 declined 8% versus last year as we saw consumers pull back spending. We estimate that a little over half of the decrease was driven by specific actions we took to improve profitability, namely eliminating costly Rack store-based order fulfillment and raising the minimum order amount to receive free ship-to-store delivery on NordstromRack.com. These actions reduced order cancellations, simplified Rack operations and improved Rack profitability, but negatively impacted topline growth at the Rack. We also cleared out older and unproductive inventory giving us increased open-to-buy and therefore, greater flexibility to improve our merchandise assortment as we enter 2023.

We are committed to improving both our top and bottom line performance at Nordstrom Rack in 3 ways. First and most importantly, we are prioritizing 100 nationally recognized strategic brands to help us drive sales and grow market share. Simply put, we know we win with customers at the Rack when we deliver great brands at great prices. We believe strong brand recognition drives outsized customer engagement, and these

brands are proven performers, many of which are not widely available in the off-price space. By increasing inventory turns at the Rack, we can increase the flow of these great brands and give customers newness each time they visit us.

Second, we are expanding our reach and convenience for customers by opening 20 new Rack stores this year. Rack stores continue to be our largest source of new customer acquisition, accounting for more than 40% of newly acquired customers in 2022. Our Rack store fleet is underpenetrated, and we have an opportunity to attract more customers and drive profitable growth through a proven model as we expand our reach with more new stores.

Third, we will drive greater engagement and higher profitability at NordstromRack.com. Our digital capabilities are unique in the off-price space, and we see opportunities to leverage our digital assets to increase engagement with our Rack customers. We will also continue to optimize the operational model for improved profitability as we did by discontinuing store-based fulfillment of NordstromRack.com orders.

Moving now to our second priority for 2023, inventory productivity. Better inventory discipline across our operation provides customers with relevant and new assortments from the world's best brands. We also have a significant opportunity to improve our earnings and returns on invested capital through increased productivity from our merchandise inventory, our largest annual investment.

The substantial disruptions and volatility in our business over the past 3 years had a significant impact on our inventory management and outcomes, including buy plans, receipt flows, stock levels, markdowns and turns. As supply chains have stabilized, we have an opportunity to return to pre-pandemic norms across these elements of our inventory management.

Finally, let's turn to our third priority of supply chain optimization. We made great progress in 2022 on our supply chain initiatives, which drove improvement in our SG&A rate despite lower sales leverage and continued inflationary pressure. Pete will provide highlights from our work in 2022. This year, we will build on our momentum to further improve the customer experience while driving greater expense efficiency. We're continuing to scale our West Coast Omnichannel Center, and we are building productivity across our network. Improvements in inventory turns and flow also continue to help reduce supply chain costs.

The past 3 years have been the most challenging and unpredictable for our industry in more than a generation. We are incredibly proud of the way our people navigated the unprecedented circumstances, while remaining true to our core values. As we enter 2023, we are ready to move forward. We have a clear set of priorities that we expect will drive improved performance in the near term while positioning us for longer-term profitable growth. We have made difficult decisions to increase our focus on executing against those priorities in our core business. We have a strong balance sheet and healthy cash flows, and we remain committed to putting the customer at the center of everything we do.

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

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

Thanks, Erik, and good afternoon, everyone.

I'd like to talk about our merchandise performance during the fourth quarter, then follow up with highlights from the work streams under each of the 3 focus areas Erik discussed.

Starting with merchandise performance. We prioritized getting to healthy inventory levels by year-end and taking additional markdowns to do so impacted our results in most categories. That said, we saw areas of strength in the quarter. We were pleased to see strength in men's apparel, which was up versus last year and at 2019 levels, particularly in dresswear as people shop for special occasions and updated their return to office looks.

At the Rack banner, beauty grew high single digits as consumers responded well to our expanded offerings with brands like MAC and Clinique. To illustrate our efforts to get to a cleaner inventory position, seasonal categories, including outerwear, sweaters and boots, had strong sell-through with ending inventory levels 30% less than prior year. After a robust start to 2022, our designer business softened in the back half, and we are reviewing our inventory positions to adjust where needed to improve productivity.

At the Nordstrom banner, we're making progress on delivering selection, relevance and inspiration to our customers by partnering with brands in alternative ways. We grew our sales through unowned inventory models by 10% over the last year, and they now make up 12% of GMV at the Nordstrom banner.

We continue to scale our Nordstrom Media Network, which grew over 50% versus last year. In the fourth quarter, we expanded our advertising offering to brands and categories adjacent to Nordstrom, launched offsite partnerships with TikTok and Pinterest and scaled on-site advertising with display ads on Nordstrom.com. Our brand partners value the opportunity to connect with our highly engaged and loyal customers with a strong return on ad spend, particularly as advertisers look to diversify their media mix.

Now on to our initiatives. As Erik mentioned, we're focused on improving Rack performance. And one of the initiatives to drive sales and faster inventory turn is prioritizing 100 strategic brands that are well known and loved across the U.S. but also have room to grow in the off-price space.

Strategic brands have better productivity than other brands in terms of average selling price and monthly sell-through. These include many brands we carry at the Nordstrom banner. As we previously mentioned, 90% of the top 50 brands at Nordstrom are also carried at Nordstrom Rack. Looking forward, our healthier inventory levels provide us an open-to-buy position and we are leaning into strategic brands.

While these brands accounted for half of Rack sales in 2022, they make up 60% of our on-order for the first half of '23. We're still on track to have the Rack assortment in a good place by mid-'23. With more open-to-buy and access to great brands, especially in the current environment, we are well positioned to deliver a more constant stream of newness and improve inventory flow.

Our second initiative at Rack is to expand our reach with new stores as part of our Closer to You strategy. We are encouraged by the results of our 3 newest stores, which have exceeded our expectations and performed better than the fleet average in terms of sales productivity. This proof point gives us further confidence in the product mix we're working towards and the opportunity for improvement in our overall Rack business through greater focus on strategic brands, newness and inventory flow.

The third initiative with Rack is driving greater customer engagement and profitability at NordstromRack.com. By increasing the penetration of strategic brands online and leveraging our digital marketing capabilities, we will drive traffic and sales both at NordstromRack.com and in our stores. We also continue to drive omnichannel engagement across banners. For example, 1 in 5 Nordstrom.com, buy online, pick up in store orders are actually picked up at our Rack stores, after we launched this service just 3 years ago.

The second area of focus across both banners is increasing our inventory productivity. This started with entering 2023 in a healthier inventory position. Looking forward, we have conservative buy plans in place, consistent with our outlook for continued macroeconomic pressure on consumer spending. We are also maintaining increased reserves against our buy plans, which enables us to be opportunistic in-season, and we are planning for faster inventory turns with an increase of at least 10% over 2022 to drive newness and flow while also increasing the return on our inventory investment.

We are also enhancing our capabilities to manage inventory with greater precision at the unit level through investments in RFID and the shift to cost accounting for internal merchandising. These capabilities will help us deliver a fresh and relevant assortment at the store level for our customers. It will also improve our ability to buy, allocate and track merchandise across our network, provide us greater visibility into profitability at the unit level, increase efficiency and reduce shrinkage.

Our third focus area, continuing to enhance our supply chain capabilities, is also an essential part of our Closer to You strategy. We built momentum throughout 2022 on several initiatives to improve the customer experience and our profitability despite ongoing cost pressures. I'll highlight a few.

We made significant progress in optimizing our unit flow from suppliers to customers by both changing some of our ordering practices as well as partnering with suppliers on shipment standards, and we'll be rolling this out further this year. We improved productivity and throughput in our distribution and fulfillment centers by more than 20% through better unit flow, focusing on team member retention and leveraging data for scheduling and training.

Lastly, we increased delivery speed from click to delivery overall. For instance, our share of orders delivered within 4 days or less is up 40% from last year. These actions will continue to improve the customer experience, increase sell-through and reduce markdowns by allowing us to place the right assortment with the right depth closer to the customer. We expect to see further benefits from these efforts as well as from additional supply chain actions throughout 2023.

In closing, we are entering 2023 positioned for increased agility and are focused on our key priorities for improving the customer experience and our profitability. We especially want to thank our team for their ongoing commitment to helping our customers feel good and look their best.

With that, I'll turn it over to Michael to discuss our financial results.

Michael W. Maher - Nordstrom, Inc. - Senior VP, CAO, Interim CFO & Treasurer

Thank you, Pete.

I'll begin with our fourth quarter results and then walk through our outlook for fiscal 2023.

For the fourth quarter, we reported earnings per share of \$0.74. Net sales and GMV each decreased 4%. For the full year, total revenue, net sales and GMV were all up 5%.

In Q4, Nordstrom banner sales decreased 2% and GMV decreased 3% versus last year. Nordstrom Rack sales decreased 8%, with a little over half of this decrease attributable to the elimination of Rack store fulfillment starting in the third quarter. Digital sales decreased 13% this quarter including an estimated 500 basis point impact from eliminating Rack store fulfillment and sunsetting Trunk Club earlier in 2022.

Gross profit as a percentage of net sales decreased 525 basis points, primarily due to higher markdowns as we prioritized rightsizing inventory to start fiscal 2023 in a healthier position. Ending inventory decreased 15% from a year ago compared to a 4% decrease in fourth quarter sales. We remain committed to a disciplined approach to inventory management in 2023 with a goal of improving turns by at least 10%.

Despite lower sales than last year, total SG&A as a percentage of net sales decreased 240 basis points in the fourth quarter, primarily due to supply chain expense efficiencies. As with last quarter, we're pleased with the progress we made on our supply chain optimization initiatives despite labor and transportation cost pressures. We expect these initiatives will continue to deliver significant benefits in 2023.

EBIT margin was 4.5% for the fourth quarter. For the year, EBIT margin was 3.1%, and adjusted EBIT margin was 3.3%. We have a strong balance sheet and financial position, ending the fourth quarter with \$1.5 billion in available liquidity, including the full \$800 million available on our revolving line of credit.

Turning to our 2023 outlook, I'll start by discussing the macroeconomic backdrop and the related assumptions underlying our guidance. We expect that elevated inflation and rising interest rates will continue to weigh on consumer spending, especially in the first half of the year. We also anticipate continuing inflationary pressure on our expenses, especially labor and transportation costs. However, we also expect global supply chain disruptions to continue to dissipate, benefiting inbound freight costs and inventory flow.

Taking these factors into consideration, for fiscal 2023, we expect revenue to decline 4% to 6% versus 2022. This outlook includes 2 significant items worth calling out. The first is 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. The second is 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 to the fourth quarter.

Next, I'll highlight 3 factors that shape our outlook between the first and the second half of 2023. Year-over-year sales comparisons will be more difficult in the first half against our stronger first half in 2022, with more favorable comparisons expected in the second half. In addition, 1 week of the Anniversary Sale will shift from the second quarter into the third quarter this year. This will negatively impact second quarter sales and positively impact third quarter sales by approximately 200 basis points.

We expect improvements in our business to build into the second half, especially in the Rack as our merchandise assortment continues to improve and we open new stores. We will also lap the impact of discontinuing Rack store fulfillment of online orders beginning in the third quarter. As a result of these factors, we expect revenue to decrease by a low double-digit percentage in the first half and to increase by a low single-digit percentage in the second half versus 2022.

We expect the wind down of our Canadian operations to result in one-time pretax charges of \$300 million to \$350 million in the first quarter of 2023, primarily related to the write-off of our investment in Nordstrom Canada. These charges will reduce our first quarter and full year earnings per share by approximately \$1.40 to \$1.60. Excluding these charges, we expect an 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 from our focus on inventory productivity, especially in the second half of the year when compared to the elevated markdowns we took in 2022. The wind down of Canadian operations will also improve EBIT, excluding onetime charges, by approximately \$35 million, with most of the associated 20 basis points of EBIT margin improvement reflected in buying and occupancy costs as part of our gross profit margin.

Continued progress on our supply chain optimization initiatives will help partially mitigate SG&A expense deleverage resulting from lower sales and inflationary cost pressures. Given the previously mentioned sales and gross margin trends, we expect EBIT margin increases in the second half of the year, offsetting decreases from lower sales in the first half of the year. Our plan assumes that first quarter EBIT will be roughly breakeven.

Our effective tax rate is expected to be approximately 32% for the fiscal year which includes an estimated 500 basis point impact from the one-time Canada charges. Our tax rate excluding this impact is expected to be approximately 27%. We expect earnings per share of \$0.20 to \$0.80. Excluding charges related to the wind down of Canadian operations, we expect adjusted earnings per share of \$1.80 to \$2.20. Our earnings per share projections exclude the impact of share repurchases, if any.

Shifting to capital allocation, our priorities remain unchanged. Our first priority is investing in the business to better serve our customers and support long-term growth. We are planning capital expenditures of 3% to 4% of net sales, primarily for investments in supply chain and technology capabilities.

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. We ended the year at 3.1x and continue to target a leverage ratio below 2.5x.

We continue to return cash to shareholders. Earlier this week, our board of directors declared a quarterly cash dividend of \$0.19 per share. In addition, during fiscal 2022, we repurchased approximately \$62 million of our stock at an average price of \$22 per share. We have \$438 million remaining on our current share repurchase authorization. We will continue to take a measured approach to share repurchases aligning with our cash flow and market conditions.

As you've heard today, we are taking significant steps to execute with agility given the continued challenging macroeconomic backdrop. We are prioritizing initiatives that will drive greater profitability through improved performance at Rack, a disciplined approach to increase inventory productivity and continued progress on our supply chain optimization efforts. We are confident in our ability to navigate through economic uncertainty and remain excited about the future of our business and our ability to deliver significant shareholder value over time.

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

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

Thank you, Michael. Before we get started with Q&A, we ask that participants please limit themselves to 1 question and 1 follow-up. We'll now move to the Q&A session.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Our first question comes from Brooke Roach with Goldman Sachs.

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

I'd love to spend a little bit more time digging in on the timeline to positive comparable sales growth at the Rack business. How are you currently forecasting Rack sales cadencing throughout the year? What are you seeing from your initial inventory rebalancing efforts? And can you provide a little bit more context on the profit impact of rightsizing the business to focus on your most important brands?

Michael W. Maher - *Nordstrom, Inc. - Senior VP, CAO, Interim CFO & Treasurer*

Yes. Thanks. This is Michael. I'll go ahead and take the shot first at the way we've contemplated the flow of revenue through the year. And then I'll let Pete talk a little bit about the inventory availability and what we're seeing on that front.

So first of all, on the topline, there's just a number of factors there to bear in mind as you think about starting the year off -- we are first and foremost being, we're lapping a much stronger first half of last year. In the first quarter, in particular, we were up 19% year-over-year in the first quarter last year. So we've just got a tougher comparison as we start the year out.

We also have, as we've talked about, as we're building our assortment of strategic brands in the Rack, we expect to get to a place where we're targeting somewhere around the middle of the year, but we expect sequential improvement as we go through the next couple of quarters. And then we're also opening new Rack stores. Those will begin here in the spring, so we'll see some benefits in the first half of the year. But it will be most pronounced as we get into the second half.

And then finally, you've just -- you've got the impact of eliminating Rack store fulfillment, which we did in the third quarter of last year. And so that results in a step-up as well when we get into the third quarter this year, and we aren't going against that headwind any further. That's sort of how Rack factors into the shape of that overall revenue guidance.

Pete, do you want to talk a little bit about the inventory positioning at Rack and what was the availability?

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

Sure. Yes. We've done a lot of work over the last couple of years to figure out our Rack strategy. And as you know, maybe 2 years ago now, we went with a bargainista strategy that had us lowering AUR a little bit to try to see if we could gather more customers that way. We did, but not enough, really, I think to offset the lower AUR. In a lot of ways, what we've learned and maybe validated something we knew all the way along, is the secret sauce for us in the off-price is the quality of the brands that we're able to offer. And that's why the whole kind of great brands, great prices thing is really where we're focused.

We know that customers come to Nordstrom Rack because they look for the brands they wouldn't typically find at other off-price retailers. We talked about 90% of the brand -- our top 50 brands in the Nordstrom banner are available in the Rack. And that's a good thing for us. But to do that well, we have to be in a lean inventory position where we could be opportunistic about the buys from those brands. And we just were in a position this last year where we had too much inventory, and that really hurt us. So we took aggressive position to get the markdowns there, to clean ourselves out, to get ourselves in a really good spot for '23 with the balance of seasonality, age and categories. And now we have open-to-buy. We're chasing into it. There's a good product to be bought out there, and it starts with these top strategic brands.

Operator

Next is Matthew Boss with JPMorgan.

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

Great. So Erik, could you elaborate on more recent trends that you're seeing maybe across income cohorts in particular. I think you cited the softening more at the lower income side. And maybe could you touch on trends that you're seeing on the designer end? And then, Michael, just in terms of the phasing of the year, could you just maybe help bridge or walk through your confidence in the phasing of revenues, front half down low double digits to the up low single digits in the back half of the year.

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

Yes, when we look at our customer cohorts, it's pretty clear that the customer across the board is challenged, and there's some softness, and I think particularly in discretionary areas, we have seen that softness more pronounced in our lower income, in our Rack business. But it's safe to say that we've seen a pullback across our customers.

For designer, I think Pete can go into that a little deeper.

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

Yes. The designer business for us, I mean, to put this in context, I think this may be the first quarterly call I've been on the last 10 years, what I didn't say designer was one of our best-performing categories last month -- or last quarter. So I think it's important we keep this in context. I mean one quarter does not a trend make here. And to put it in a different context, last year, we did more designer sales than we've ever done in the history of our company. We had double-digit increase.

So what happened to us though is that we had a very large double-digit increase trend going with our sales that dropped rather precipitously to more normalized levels. And so as a result, right now, we find ourselves with too much designer inventory in this moment. And so we're working through that, and we'll have to make some adjustments on some on-order in the near term. But these cyclical things happen in this business, and we'll be able to work through that. But I think the good news is our customers over a long period of time have showed a strong interest in the designer business, and it's something that's really important to our overall success, and we have good partnerships there, and again, continues to be an important part of our business and what our customers expect from us.

Michael W. Maher - *Nordstrom, Inc. - Senior VP, CAO, Interim CFO & Treasurer*

So Matt, you had asked about the revenue cadence between the first and the second half. So let me talk about a few factors there that led us to set the outlook out that way. So first of all, those more difficult comparisons in the first half. Not that 2019 is necessarily the perfect baseline. But if you just look at the way last year progressed relative to that, in the first half of the year, we were up mid-single digits. And in the back half of the year, we were down mid-single digits relative to 2019. So just on the current run rate, we've got an easier comparison that gives you a sense of the order of magnitude of that.

The other thing is we've talked about is those choices we made around digital sales earlier in 2022, both Rack store fulfillment and also discontinuing our Trunk Club business. So that is together worth about 200 basis points of headwind to the first half of the year, and it essentially -- it disappears in the second half. We'll be fully lapping those things.

And then the last thing is -- well, actually, 2 more things. One of them is the Rack new store openings, I mentioned will begin in the spring, but the cumulative effect of the first half won't be very big. It will be worth about 150 basis points to the second half of the year, though. And then finally,

the Anniversary timing shift, that 1 week, it's a couple of hundred basis points between Q2 and Q3. That roughly equates to about 100 basis points between half 1 and half 2. So -- you put all those things together, and it gets us to a low double-digit decrease in the first half of the year and low single-digit increase in the back half.

Operator

Next is Noah Zatzkin with KeyBanc Capital Markets.

Noah Seth Zatzkin - *KeyBanc Capital Markets Inc., Research Division - Research Analyst*

Just any color on what you've been seeing in the promotional environment exiting the year, particularly as it relates to the planned cadence of gross margin moving through the year would be helpful. Obviously, compares become easier in the back half. But with inventory in a healthier position exiting the year, just any color on puts and takes we should be thinking about would be helpful.

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

Yes. This is Pete. The biggest factor on our promotions has to do with our own inventory levels. So you saw increased markdown level in the fourth quarter for us, and that was largely of our own doing. There was regular promotional activity happening to competition that we had to respond to. But most of that was really our own things. So I think what you should see going forward to this next year is a more normal rhythm of how promotions impact our business. We can't control what's going on with the other retailers and what their inventory position is. And at a certain level, we have to be responsive to that. So we'll see how that plays out. But for now, we can tell you with a lot of confidence that we're going to return to more normal markdown cadence because our inventory is in much better position.

Michael W. Maher - *Nordstrom, Inc. - Senior VP, CAO, Interim CFO & Treasurer*

Noah, it's Michael. I'll just add to that that our outlook for gross margin assumes a more normalized level of markdowns. So not any kind of historic best or anything like that, but just a normal cadence, a normal level. We do have some remaining pockets that we expect we'll be clearing in the first half of the year. That's contemplated in there as well. But then just through greater inventory discipline and turns, we would expect, as you go against that elevated level of markdowns in the fourth quarter that we should see some meaningful improvement.

Operator

Next is Blake Anderson with Jefferies.

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

So I wanted to ask on the previous medium-term guide you provided a couple of years ago. Just thinking about the margin targets. I think you had said you could do a 4.5% margin -- operating margin if you're at least \$14.5 billion in revenue, which is what your guide implies this year. You're slightly below that on the margin guide. So how do we think about you bridging back to at least 4.5%? And then I wanted to revisit how you get back to that second target of 6% plus?

Michael W. Maher - *Nordstrom, Inc. - Senior VP, CAO, Interim CFO & Treasurer*

Yes, Blake, it's Michael. I'll take a first shot at that. We believe that those targets are -- remain achievable in a normalized environment with sort of sustainable low single-digit topline growth, we believe we can achieve better margins than we did on comparable revenue beforehand. We're not quite in a normalized environment at this point. We talked about some of the macro headwinds we're seeing right now on consumer spending

and also the inflationary pressures. But we took a meaningful amount of our overhead costs out back in 2020, as you might recall. We continue to drive meaningful efficiencies in our supply chain, which is now the largest element of our SG&A. And we've been driving down our buying and occupancy as a percentage of our sales as well, which, as you know, is a component of gross profit for us.

So really, the last element in that equation for us is once we're in sort of a normalized macro environment where we can generate and sustain low single-digit topline growth, we believe we're positioned to achieve those long-term EBIT margin targets.

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

Okay. And then just wanted to follow up on the Rack inventory. I mean you've talked about the excess inventory environment potentially being a benefit. Did you see that in Q4 at all? And then how much are you baking in for that this year as well?

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

We started to see it in the fourth quarter, but we really weren't in a great position to chase into it because we were still cleaning up our inventory level. So I think it's one of the things that gives us some level of confidence. I mean that switch doesn't get flipped overnight, that all of a sudden we completely transform our inventory. But again, I think it's fair to say we're open to buy going forward, and we're in a position to start receiving the newness of the brands and the balance that's going to be a good recipe for us in the Rack.

Operator

Next is Ed Yruma with Piper Sandler.

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

First, a housekeeping question. The 20 new Rack stores, I guess, how much does that contribute to sales growth in '23? And I guess just stepping back a little bit. I know that the store comp maybe was a little easier because of Omicron, but even ex some of these special items, digital seems to be underperforming. How should we think about your digital business in '23? Will it outperform the stores business or more in line? And kind of what initiatives do you have underway to kind of restore health there?

Michael W. Maher - *Nordstrom, Inc. - Senior VP, CAO, Interim CFO & Treasurer*

Ed, I'll start with the Rack new store contribution. It is approximately 100 basis points to the year, and that's going to be back half weighted.

And then as far as digital, I could talk a little bit about the trends and then let Erik speak to just more generally the outlook for our digital business. So yes, as you mentioned, we're comping Omicron in the fourth quarter of last year when we saw store traffic fall off in a pretty meaningful way in the middle of the quarter and a lot of that shift to digital. And so we saw the reverse of that in terms of the year-over-year trends this year.

I'd expect that to continue into the first half at least as we're still -- what we saw in the first half of last year, you'll probably recall there was a strong pent-up demand for getting out again. Stores were especially -- showing especially strong growth, a little bit of a retreat in the digital penetration, and then we're -- to your point, we're lapping some of the decisions that we made last year that have suppressed our digital growth, but are helping us be more profitable. So we remain a 40% digital business. We continue to see it as a meaningful part of our overall business. And I think once we're past some of those timing impacts, we should see growth normalize.

Erik, anything you want to add on that?

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

Yes. I think in digital, one piece of context, we made some decisions last year to focus on profitable growth, which hurt some of our topline digitally, in particular, stopping store fulfillment on our Rack.com orders. So about 500 basis points on our digital performance. But we do see Nordstrom.com, in particular, as a growth vehicle for us. And our focus there isn't so much about pure digital growth. It is about engagement with customers as we continue to see the customer want omnichannel capabilities, things like buy online, pick up in store. But for us, -- it's been very successful and we opened up our Rack stores to be a pickup point for Nordstrom.com orders. So not only having cross-channel capabilities but leveraging the 2 brands that we have there.

The other piece I'd call out, which is a big general area for us to work on, is around discovery. Our strength is around newness and inspiring our customers to try something new and introduce new brands to them. We've had a lot of success over the years. And it's not necessarily exclusive products, but it's brands that aren't up and aren't widely distributed. And digital is a real important part of that, of the discovery experience as more and more customers start their journeys online, even if they end up being in stores. So discovery is something that we have a lot of initiatives around this year.

Operator

Next is Chuck Grom with Gordon Haskett.

Eric Michael Cohen - Gordon Haskett Research Advisors - Analyst

This is Eric Cohen on for Chuck. You talked about the consumer being under pressure, particularly more of the Rack customer. So I guess trying to understand the acceleration in the Rack openings this year. So why doing it now when comps have been under pressure, maybe not wait until the business is a little more on steady footing?

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

It's a great question. First and foremost, our Rack stores are a great return on investment, full stop. We have a real strong track record of the return on these stores. It is a great use of capital -- it's low capital investments, low-risk investment on a proven model, and our most recent proof point to share would be our 3 recent store openings in Rack. All 3 of them are beating plan. All 3 of them are outperforming our fleet average in sales productivity and EBIT margin.

And part of that, if you step back a little bit, off-price in particular, has a real requirement around convenience. And the discovery process in off-price for a lot of customers lends itself to stores. So having more stores provides a lot more convenience. And it sure seems clear to us that our fleet is underpenetrated. You look at our store count compared to others out there, we see a lot of room for growth there.

The other piece I just would call out is what Rack stores do to our ecosystem. Rack stores remain the largest source of new customer acquisition for us. It's more than 40% of our new customer acquisition occurred in Rack stores. So there's just a lot of goodness all around for us to open Rack stores.

Michael W. Maher - Nordstrom, Inc. - Senior VP, CAO, Interim CFO & Treasurer

Eric, one other thing I would just add to underscore Erik's comment about Rack stores being a great investment. They're a low capital investment, which you said. Just to highlight that, though, our cumulative investment this year in Rack new store openings is going to be less than 15% of our total capital expenditure plan. So we feel really good about making that commitment and getting the returns Erik talked about.

Eric Michael Cohen - *Gordon Haskett Research Advisors - Analyst*

Great. When you look at sort of the credit card business, your portfolio, just on talks of increasing delinquencies, are you seeing anything with your customers in there? And anything in the portfolio that sort of shapes the way how you think the consumer is going to spend in 2023?

Michael W. Maher - *Nordstrom, Inc. - Senior VP, CAO, Interim CFO & Treasurer*

Yes. Well, what we've seen in terms of our credit card portfolio is similar to what we've seen sort of more broadly reported out there with larger card issuers. In general, we see consumers pulling back a little bit on discretionary categories. We see the credit metrics declining a little bit from where they were last year. But just for context, as a reminder, they were at historically good levels last year, coming out of COVID with stimulus money and excess savings, consumers paid down balances, charge-offs and delinquencies were at historic lows. And we're back to something more normalized now, but actually still better for us than pre-pandemic levels. So what we're seeing now and what we expect to see and was contemplated in our '23 guidance is that with higher balances, we'll get higher finance charge and fee income. That will be offset by some higher loss rates. Overall, we think credit revenue will be a similar percentage of our total revenue.

Operator

Our last question comes from Oliver Chen with TD Cowen.

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

Erik, Pete and Michael, regarding inventory, how should we think about inventory growth relative to sales growth in the next few quarters? Also, as you mentioned, there's a big opportunity to increase inventory turns. Which categories do you see the most opportunity? And then you also mentioned the cost method of accounting for inventory and switching from the retail to the cost method. That sounds like it could be very customer-centric and helpful. Would love more information on timing and how that may or may not impact agility and decision-making in terms of understanding the gross margin return on inventory profile.

Michael W. Maher - *Nordstrom, Inc. - Senior VP, CAO, Interim CFO & Treasurer*

Thanks, Oliver, for the question.

I'll start, and then I'm going to let Pete chime in as well. First of all, in terms of the inventory versus sales growth. Yes, with the 10% or better improvement in turn, you should expect inventory levels to be lower than sales. Whatever kind of change in sales we see, we should be better than that in terms of inventory. I'll let Pete speak to the specific categories where we think we have the most opportunity.

But real quickly before I turn it over to him, I just want add to address the cost method. We've made that switch for internal merchandising. We absolutely agree. It gives us the opportunity to be much more item-focused and precise in the way we're managing our inventory, which is good for customers, as you said. Do just want to clarify, though, that you won't -- there is no change to our external reporting. We remain on the retail method for our financial accounting and external reporting. So you won't see any impact to our reported gross margin.

Pete, do you want to add to that?

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

Yes. With turn, I mean, I think the blanket answer is we have room to improve across the board but if I'm to choose or probably the biggest opportunity is I'd say the Rack all up, across all categories, I'd say probably particularly in apparel. There's a version of that also in the Nordstrom banner, I would say, apparel is probably the one.

And the reason I'd say that is probably the most perishable stuff that we have in terms of its seasonality and what have you. So there's opportunity across the board. And what we've done is we've gone back in context through historical best and turns and how that impacts our markdown rates and our margins and really not use last year as a guide, but really kind of starting at the all-time best that we had and planning accordingly. And so yes, again, I think the answer is across the board.

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, and we thank you for your participation.

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