Genesco Inc.

Second Quarter Fiscal 2023 Earnings Conference Call

September 1, 2022

CORPORATE PARTICIPANTS

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Mimi Vaughn, *Board Chair, President and Chief Executive Officer*

Tom George, *Chief Financial Officer*

CONFERENCE CALL PARTICIPANTS

Steve Marotta, *CL King & Associates*

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PRESENTATION

Operator

Good day, everyone, and welcome to Genesco's Second Quarter Fiscal 2023 Conference Call.

Just a reminder, today's call is being recorded.

I will now turn the call over to Darryl MacQuarrie, Senior Director of FP&A. Please go ahead, sir.

Darryl MacQuarrie

Good morning, everyone, and thank you for joining us to discuss our second quarter Fiscal 2023 results.

Participants on the call expect to make forward-looking statements. These statements reflect the participants' expectations as of today, but actual results could be different. Genesco refers you to this morning's earnings release and the Company's SEC filings, including the most recent 10-K and 10-Q filings, for some of the factors, including the impact of COVID-19, supply chain issues, and the current economic environment, that could cause differences from the expectations reflected in the forward-looking statements made during the call today.

Participants also expect to refer to certain adjusted financial measures during the call. All non-GAAP financial measures referred to in the prepared remarks are reconciled to their GAAP counterparts in the attachments to this morning's press release and in schedules available on the Company's homepage under Investor Relations in the Quarterly Earnings section.

I want to remind everyone we have posted a presentation summarizing our results, that is accessible on our website.

With me on the call today is Mimi Vaughn, Board Chair, President and Chief Executive Officer, who will begin our prepared remarks with an overview of the period and the progress we are making on our strategic initiatives to drive the business this fiscal year; and Tom George, Chief Financial Officer, who will review the quarterly financials in more detail and provide guidance for Fiscal 23.

Now, I'd like to turn the call over to Mimi.

Mimi Vaughn

Thanks, Darryl. Good morning, everyone, and thank you for joining us today.

After last year's record Fiscal 22 results, we are pleased with our second quarter performance, our strong first half of this year and the longer-term direction of our business. Following a stimulus-induced spending environment in which consumers had ample disposable income to drive strong sales gains that significantly benefitted the first half of last year, we are pleased we continued to drive our business forward and maintain the large majority of those gains.

Our footwear-focused strategy is working and has created a much more resilient and fundamentally stronger business. The work we have done over the last few years to increase our digital penetration, strengthen our consumer connections, grow our footwear brands, and reduce and reshape our retail store cost structure has put the Company in a better position to both outperform in favorable economic backdrops and successfully navigate more difficult market conditions, like we are facing today.

Our second quarter performance highlights the benefits of our multi-divisional business model. Stronger than expected results at Schuh and Johnston & Murphy helped overcome some softness late in the quarter, versus expectations at Journeys, due to an increasingly challenging macro-environment which is affecting certain segments of our consumers more than others. That said, Journey's year-over-year sales trends improved meaningfully each month, in step with an improved inventory position on key brands and styles. This, combined with the strength at Schuh and J&M and careful expense control, allowed us to offset the lighter overall sales and deliver adjusted EPS that surpassed our expectations, boosted further by a favorable compensation expense adjustment Tom will discuss later.

The Schuh team did a tremendous job capitalizing on recent product and marketing initiatives, outperforming its competition in the U.K. marketplace, fueled by pent-up demand and a warm summer. At the same time, the reimagining of the J&M brand continues to attract a wider and younger audience at a time when its consumers are "returning to life" and looking to refresh their wardrobes; and across all our businesses, we have held onto the bulk of the digital gains we drove during the pandemic as we have grown this highly profitable channel.

Our progress is especially evident compared to where our business was before the pandemic began. A few key highlights of the second quarter include:

- compared with the pre-pandemic second quarter of Fiscal 20, revenue grew 10% despite having 5%, or 80 fewer stores;
- digital sales grew more than 75%, now representing 18% of total retail sales, compared to 10% in Fiscal 20;

- our branded wholesale sales increased more than 100% over the same time period, spurred by our acquisition of the Levi's business;

- gross margins were in line with our expectations despite an increasingly promotional environment in the U.S.; and

- operating income more than doubled that of Fiscal 20, leading to adjusted EPS of $0.59, versus $0.15 in the second quarter of Fiscal 20.

In addition, our business accelerated throughout the quarter, with sequential monthly improvement in retail sales compared to a year ago, as we flowed in fresh product and accomplished the significant task of re-inventorying and stimulus compares began to ease; and while at the same time investing in our business, we returned a notable amount of capital to shareholders, opportunistically repurchasing $45 million of stock during the quarter, representing about 6% of shares outstanding.

Turning now to discuss each business in more detail, beginning with Journeys.

While the second quarter started well with May and June benefitting strongly from the good work Journeys' merchants have done to re-inventory and achieve pre-pandemic inventory levels for the first time since the onset of the pandemic, sales did not further accelerate as much as we expected in July. This trend included the last two weeks of the month, which is the beginning of the back-to-school season. Sales have since re-accelerated in August and are nicely up above last year, but we expected an even sharper acceleration given our vastly improved inventory position and a normal back-to-school this year.

We are seeing some evidence of the Journeys consumer getting squeezed by inflation, making fewer trips to the mall, waiting for tax-free events to shop, delaying purchases until the time of need and trading down to more affordable price-point footwear.

The strength of Journeys' vendor relationships and the breadth of its assortment have allowed the team to quickly pivot its current offering to more accessibly-priced product that aligns with the current more budget-conscious consumer. While we anticipated stronger store traffic, our motivated store associates have made the most of each customer crossing the lease line, driving improved conversion and higher transaction size, helped by higher ASPs, as we ended the quarter.

I've been describing the current fashion cycle as shifting away from fashion athletic more into casual, which plays into Journeys' strengths, and casual continued its ascent in Q2 as a bigger part of the assortment. Although markdown and promotional actions have increased from essentially none last year, clean inventory and more full price selling delivered both better than expected and higher Journeys gross margins, compared with pre-pandemic times.

Over in the U.K., Schuh's strong second quarter capped a great first half for the business. The U.K. retail market has experienced major disruption during COVID, with extended lockdown periods and many retail bankruptcies reshaping the landscape. The Schuh team has made the most of this disruption, utilizing its advanced digital offering to drive online and out-executing when stores were open. Schuh is also reaping the benefits of better product, brand purpose and marketing strategies. Driving the stellar Q2 performance was a better inventory position that included increased access to higher-tiered styles from several key vendors, coupled with pent-up demand, as young people enjoyed the warm summer weather and dressed fashionably for summer activities.

Schuh sales continue to exceed expectations on both a constant currency and reported basis despite the considerable decline of the pound versus the dollar. Constant currency revenue hit a Q2 record, up 9% compared to last year and up 14% over pre-pandemic sales, as strong demand fueled consumer spending despite historic levels of inflation. Operating income also grew adjusting for last year's rent and other COVID credits. Like Journeys, Schuh's strength is its ability to deliver the fashion brands desired by its youth consumer, and casual was up as a greater percentage of the mix, as well, led by sandal growth and helped by higher prices.

Moving on to discuss our brands, we're incredibly excited about the potential of Johnston & Murphy as we reposition the brand for growth. Our efforts to reimagine J&M for a more casual, more comfortable, post-pandemic environment is delivering outstanding results, with Q2 sales up 22% compared to last year and operating income more than double pre-pandemic levels. Operating income was also up over last year, adjusting for last year's sizeable pickup from inventory reserve reversals. Growth stemmed from all channels this quarter with stores up 13% year-over-year, direct up 16% and wholesale up nearly 60%. With return to the office figures well below 50%, the brand is experiencing this growth from a shift in strategy, from not just the footwear consumers need for work, but for footwear and apparel they desire for everyday life, driving market share gains. As a measure of this progress, nine of the top 10 SKUs in J&M's DTC business in Q2 were casual and casual athletic styles. Intensified consumer messaging and fresh and continuous streams of new and innovative product with technology differentiating J&M's offering are driving this growth.

Rounding out our brand review, our Licensed Brands team has wholly remade this division since the start of the pandemic by adding attractive licenses led by Levi's, acquiring more robust product and sourcing capabilities, and diversifying distribution with a focus on more moderate-priced retail channels. This transformation was evident with an operating profit this quarter, compared to an operating loss in Q2 of fiscal 20. While its consumer has also been affected by the inflationary environment and we are currently in the midst of Levi's distribution repositioning, we see an exciting run for this business going forward.

Shifting now to the current quarter, back-to-school in the U.S. has delivered positive results so far, and we were pleased to see the pickup in August over July's slower start. However, our expectations for increases for the season and back half over last year for Journeys were even higher, at high-single digit growth. Given how low we were on inventory and out of stock on core items throughout the back half of last year, we believe we left significant sales on the table and had planned to capture the upside during this year's back-to-school and holiday seasons. In addition to the behavior I described for the Journeys customer in reaction to the increasingly difficult macro-environment, we are seeing customers come out and shop when there's a reason to buy and retreat to conserve cash during the in-between periods.

Therefore, we're modifying our guidance for the back half, in large part, to reflect the trends we're currently seeing in Journeys, which while positive over last year, are lower than our original forecasts. Both the higher-income J&M consumer and the Schuh consumer have exhibited resilience in their shopping appetites backed up by lifts in traffic over last year. We anticipate these patterns will largely persist, although we have tempered expectations to account for the increasingly difficult economy that may impact Schuh consumers in the U.K. Our fresh inventory will be a positive and we believe the strength of our concepts positions us well to get more than our fair share of consumer demand, especially when the customer has a reason to shop. We can manage inventory by adjusting receipts as needed and do not believe we will need additional markdowns to keep inventories right-sized.

Based on this more conservative back half outlook, we now expect adjusted Fiscal 23 earnings per share to be between $6.25 and $7.00. Somewhere close to the middle of the range is where we anticipate the year will come in.

We remain confident that our footwear-focused strategy will continue to create value as we navigate this inflationary period and exit from it. Driving this strategy are six strategic pillars that emphasize continued investment in digital and omnichannel, deepening our consumer insights, driving product innovation, reshaping our cost base and pursuing synergistic acquisitions, all to transform and meaningfully grow our business. You heard how several initiatives positively impacted second quarter results and I would like to briefly highlight a few others.

Starting with pillar two, maximize the relationship between physical and digital channels, we are advancing Journeys' off-mall strategy. This initiative was developed to take advantage of the pronounced shift in traffic to more local neighborhood, community and power shopping centers. Journeys consumer research also told us its target consumers visit local non-mall shopping centers several times per month and enjoy shopping closer to home. After piloting and analyzing results of some initial locations, we signed more than 25 of these off-mall sites which are larger than our mall stores and can carry a full assortment of adult and kids product. We opened five of these locations so far and plan on opening another 10 by fiscal year end. Given that Journeys is predominately mall-based, we believe this is a meaningful opportunity. At Schuh, we opened a new distribution center in Ireland to better support omnichannel sales there, which also improves the profits of our Irish operations post-Brexit.

Under pillar three, build deeper consumer insights to strengthen customer relationships and brand equity, Schuh is generating positive success with its new loyalty program, THE SCHUH CLUB. This program combines online and store purchases together and allows Schuh to deliver increased personalization for an enhanced customer experience by recognizing and rewarding Schuh's most loyal customers. This program has seen greater success than initially expected, with just under 750,000 signups since fully launching in April and is now set to exceed the 1 million sign-ups targeted for the year. The ability to now recognize more customers at the point of sale has resulted in data capture doubling since the launch of THE SCHUH CLUB, giving us a richer set of first-party data. Total spend for CLUB members accounts for almost 30% of total company sales currently, with members making purchases at an average order value 14% higher than the average. Johnston & Murphy's Insider Program, launched last year, is seeing similar success, with 75% of new customers signing up.

Journeys is enhancing brand equity by elevating self-expression through the lens of youth culture and has significantly ramped up its collaborations with content creators across social and streaming platforms, resulting in higher engagement and awareness on multiple channels, including TikTok and Instagram. One of the most significant elements of this campaign is a partnership with Karl Jacobs of Mr. Beast fame as Journeys' Creative Ambassador to activate exclusive content to engage his combined reach of 28 million followers across various social platforms. These activations introduce Journeys to Karl's gaming community in a creative and authentic way. In an effort to place Journeys top of mind just before back-to-school, Journeys leveraged its music strategy as the presenting sponsor of the Sad Summer Festival, with events in 18 key markets. Journeys' increased investment in digital and social are showing gains in brand awareness and intent to shop. Based on its most recent customer research this summer among 13- to 22-year-olds, Journeys remains a top shopping destination, significantly outpacing other footwear retailers, as more "welcoming, cool, fun and a place to discover new brands and styles."

Under pillar four, intensify product innovation and trend insight efforts, J&M's product innovation strategy has driven substantial growth in the casual athletic category, doubling its size in the DTC channel to almost 40%, thanks in large part to the Amherst and Activate collections. In fact, the number one Amherst style sold more than double the pairs as our number one dress shoe, further highlighting that this strategic shift into casual and casual athletic has been dramatic and is resonating with the consumer.

In summary, we're making meaningful progress across our businesses and strategic initiatives to be the destination for our consumers' favorite fashion footwear.

Beyond this, we're proud of progress we've made on ESG. We published an inaugural ESG report on Genesco.com outlining our most recent ESG work, policies and metrics. We continue to incorporate ESG as a factor in key operating decisions, such as redesigning and reducing shoe box sizes and participating in energy reduction programs at the store level. We're committed to do more and look forward to posting you on future progress.

To close now, we, as a company, are very good at navigating challenges and will manage through this period of high inflation and a pressured consumer, much in the way we managed and emerged from the pandemic, a stronger and more profitable company. At the core of this are our incredible people, and I'd like to thank you for our strong start to the year. Your determination and ingenuity allow us to consistently out-execute through dynamic and choppy environments, and I look forward to continued success with you during the remainder of this year.

I will now turn the call over to Tom.

Tom George

Thanks, Mimi.

As Mimi discussed, we were pleased with our performance during the quarter, especially our ability to drive profits ahead of expectations in the current climate. We have a solid foundation to not only navigate the current challenging environment, but, also, we continue to be confident in the ability of our footwear-focused strategy to drive strong results over time.

Consolidated revenue in Q2 was $535 million, down 4% to last year, as we continued to anniversary the significant stimulus distributed a year ago and we experienced foreign exchange pressure from the strengthening dollar. On a constant currency basis, sales were down 1%. As a reminder, Journeys' consumer benefited most from the prior year government stimulus. On a comp basis, Journeys total comp was down 8%. Schuh total comps increased 9%, driven by stores. J&M continued its strength versus last year in both stores and digital, with total comps up 17%. Overall, total company comps were down 2% for the quarter, with store comps down 2% and direct comps down 3%.

We ended the quarter with 27 fewer stores versus a year ago, as we optimize our store footprint and drive productivity in our existing store estate. Digital sales, as expected, were down versus last year; however, direct still held onto 95% of its gains on a constant currency basis and was up over 75% versus pre-pandemic on a reported basis. E-commerce sales accounted for 18% of total retail sales versus 19% last year, up from 10% in Fiscal Year '20. Wholesale was up, as strength in J&M offset the decline in Licensed Brands as we reposition the distribution mix of the Levi's brand to rely less on the value channel.

Gross margins were down 160 basis points to last year, but were in line with our expectations. The main drivers of the year-over-year change were Journeys and J&M. The expected decline in Journeys margin is due to a return to a more normalized promotional environment, as compared to essentially none last year. That said, Journeys gross margins still exceeded pre-pandemic levels. For J&M this year, we experienced increased freight and logistics costs, as well as a difficult comparison to last year, as the commencement of the brands recovery drove major reductions in inventory reserves.

In summary, by business: Journeys' gross margin was down 160 basis points; Schuh's gross margin was up 30 basis points, driven by lower e-com penetration; J&M's gross margin was down 640, basis points driven by 410 basis points of freight and logistics cost pressure and a 300-basis-point unfavorable inventory reserve reversal comparison; and Licensed Brands gross margin was down 40 basis points, driven mainly by sales mix and increased freight and logistics costs. Altogether, increased freight and logistics costs put approximately 75 basis points, or $4 million, of pressure on Q2 gross margin and were the greatest drag in our branded businesses.

Adjusted SG&A expense was 45.6%, which was 30 basis points more than last year. It is worth noting that last year we received significant one-time COVID rent credits and government relief during the quarter, to the tune of $8 million, which made this quarter a difficult comparison. Without last year's one-time credits, total SG&A and occupancy expenses leveraged 120 basis points and 40 basis points, respectively. Regarding wage pressure, the competitive environment and legislated increases in minimum or living wages continue to pressure our selling salaries, but we continue to evaluate efficiencies in this area through our workforce management system, time and traffic studies, and other automation. In summary, deleverage in occupancy, selling salaries, marketing and other expenses more than offset leverage from lower performance-based compensation and other pickups.

As a result of the revised outlook for the back half and the way our performance-based compensation program is designed, we had a reversal of a bonus accrual in Q2 this year that was bigger than our typical adjustments. It is also worth noting that small changes in year-over-year expenses can have a larger impact in our SG&A percentage in the second quarter due to the typically lower sales volumes.

Rent credits aside, we are achieving great success driving occupancy costs lower. Across the Company, for the first six months of Fiscal '23, we have negotiated 115 lease renewals and achieved a 17% reduction in straight-line rent expense, with a shorter average term of two-and-a-half years. This is on top of 192 renewals with a 17% rent reduction last year. With over 45% of our fleet coming up for renewal in the next couple of years, this continues to remain a key priority.

A good way to measure the benefits of our efforts to reshape our P&L is to compare Q2 adjusted SG&A to pre-pandemic Fiscal Year '23. Versus Fiscal Year '20, we leveraged total adjusted SG&A by 200 basis points, driven by store occupancy leverage of approximately 300 basis points, which enabled investment to drive our digital business.

In summary, first quarter adjusted operating income was $10 million, a 1.9% operating margin, compared to $21.1 million, or 3.8% last year and 1% pre-pandemic. Both the additional freight and logistic costs this year and the significant COVID rent and other credits benefit last year, that I discussed, had a considerable impact on these results.

For the quarter, our adjusted non-GAAP tax rate was 19.5%, which compares to 25.1% last year.

This all resulted in adjusted diluted earnings per share of $0.59 for the quarter, which compares to $1.05 last year and $0.15 in Fiscal '20. Our share count is down 11% to last year and roughly 19% from pre pandemic levels.

Turning now to capital allocation and balance sheet, our net cash position at the end of Q2 was negative $4 million, a $288 million decrease versus last year. During the past 12 months, our strong cash balances and strong cash flow enabled us not only to reinvest in our business for growth, but also to accomplish the formidable task of re-inventorying, and at the same time return significant capital to shareholders.

While net inventories are up $150 million year-over-year, we believe it's more meaningful to compare this year's inventory levels to pre pandemic Q2 Fiscal Year '20, since outsized stimulus demand and supply chain limitations resulted in unusually low inventories last year. Inventories in Q2 this year were $507 million, 14% higher than Fiscal '20, on a quarterly sales increase of 10%. Part of the increase at Journeys is we elected to receive and carry over some winter product which was late in arriving, as it consists of core in-line styles that will give us a head start on back-to-school and holiday sales. We are pleased with the quality and level of inventory, except for J&M, where much of the increase is in transit and we are still chasing product.

Over the last year, we repurchased 2.3 million shares, or almost 15% of outstanding shares, for $135 million, at an average price of $58.86. More recently, for the second quarter, we repurchased $45 million of stock at an average price of $54.99, and now have $55 million remaining on our current authorization.

Capital expenditures in Q2, excluding the new headquarters building, were $9 million, and depreciation and amortization was $11 million. We opened four stores and closed six during the second quarter, to end the quarter with 1,412 total stores. As a reminder, traditionally, the end of Q2 and during Q3, through the commencement of the holidays, reflect our lowest cash levels of the year, as this is the time for our peak working capital requirements.

Looking out to the end of the fiscal year, we expect to end the year with ample cash and a balance sheet that remains a strategic asset.

Now, turning to guidance and more specifics as to how we are thinking about the business, as I said, we believe we have a solid foundation for growth and are confident in our long-term strategy. In the near term, however, we are seeing the impact inflation is having on consumer discretionary spending. Therefore, we believe it's prudent to take a more conservative approach to our back half outlook and are revising our full year guidance.

I'll first talk through the changes in our topline guidance. Our prior annual revenue guidance reflected growth of 1% to 3% over Fiscal Year '22, or a range of $2.45 billion to $2.49 billion, with the midpoint of the range the most likely scenario. We now expect full year revenue to be between down 3% and flat compared to Fiscal Year '22, or a range of approximately $2.35 billion to $2.41 billion, again, with the midpoint of the range the most likely scenario. Note that full year sales results in both our prior and current guidance are impacted negatively by about 2% due to a strong dollar and lower exchange rate.

Going into this year, while we knew we had some difficult comparisons to last year, particularly during the first half, due to stimulus, we felt that the back half provided good opportunity for growth, mainly due to the replenishment of inventories and having what consumers needed at the key selling periods of back-to-school and holiday. Driving the projected second half acceleration was high-single-digit growth at Journeys, as we believed we left a lot of sales on the table last year due to a lack of key product.

As Mimi outlined, while trends improved throughout the second quarter and the start of back-to-school, as the stimulus compares became less pronounced, they didn't reach levels contemplated in our initial projections, which we attribute primarily to the impact on the consumer from inflation. The reduction in our full year sales guidance is coming mainly from Journeys, for the reasons we have described. We have also adopted a more conservative outlook for our businesses that serve a more cost-conscious consumer, and in the U.K., where the consumer is increasingly facing economic headwinds, including higher consumer prices and higher fuel costs.

Our gross margin guidance remains unchanged and we continue to expect gross margins to be down versus last year by 60 to 80 basis points, mainly due to increased markdown activity, especially in the quarters in which markdowns typically occur, as compared to essentially no markdown and promotional activity last year. At this time, we are not expecting any additional incremental markdowns in total, as we expect to align our inventory levels consistent with our reduced sales levels.

In terms of expenses, with the decline in our sales outlook, we now expect adjusted SG&A as a percentage of sales to de-lever in the range of 50 to 90 basis points, down from the previous range of leveraging 10 basis points to deleveraging 10 basis points. Regarding overall operating expenses for Fiscal Year '23, the leverage we gain from reduced performance-based compensation is being offset by anniversarying significant one-time COVID credits, selling salary wage pressure and marketing costs. The reduction in our sales forecast makes it more challenging to leverage fixed expenses and increased selling salary costs; however, we are actively managing expenses downward and continue to work to mitigate inflationary pressures and limit the effect on profitability from the lower projected sales volume.

This all results in an expected operating margin between 4.7% to 5.1%, which is down from 6.3% in Fiscal Year '22 and up from 4.5% in Fiscal Year '20, prior to the pandemic.

EPS is now expected to range from $6.25 to $7.00 per share, down from the previous range of $7.00 to $7.75 per share, and compared to $7.62 last year and $4.58 in Fiscal Year '20. Note that this new guidance is based on a weighted average share count of approximately 12.9 million for the full year versus our prior estimate of 13.4 million, reflecting our share repurchase activity during the second quarter, but assumes no additional share repurchases for the fiscal year.

Furthermore, we expect some improvement in the tax rate at 26%, down from the prior guidance of 27%.

While we don't provide quarterly guidance, I want to provide some perspective on Q3. We expect Q3 sales to be slightly below last year, with gains in our Branded businesses offset by flattish sales at Journeys, and pressure on Schuh's top-line. We had robust sales in September and October last year at Journeys with a change in pandemic shopping patterns. We are assuming the consumer will revert to historical patterns of lower shopping activity during this time, saving dollars to spend during holiday, when we expect sales growth to be consistent with back-to-school growth.

Regarding Q3 gross margin, we expect lower gross margins compared to last year, but at about half the levels of Q2's reduction, due to higher freight and logistics costs and another difficult inventory reserve comparison last year for J&M. Note that while in total for the year we do not expect gross margin to change from prior guidance, we do expect a shift with Q3 gross margin under more pressure due to higher freight costs, which is offset in Q4. We expect there will be a fair amount of SG&A deleverage to last year in Q3, driven by lower sales, last year's one-time COVID relief, and increased marketing and selling salaries. In the end, from a basis point perspective, we expect the SG&A deleverage to be quite a bit more than the gross margin pressure. With all this, we expect Q3 operating income close to pre-pandemic Fiscal Year '20 Q3 levels, with higher EPS, compared with the same period driven, by our share repurchase activity.

To close, we are pleased with the quarter we just completed, and while we acknowledge the challenges facing consumers these days and the temporary headwinds those might pose, we remain excited about the future of our business and the strategy we are driving forward.

Operator, we are now ready to open the call to questions.

Operator

Thank you. Our first question is from Steve Marotto with C.L. King & Associates. Please proceed.

Steve Marotto

Good morning, Mimi, Tom and Darryl. Congratulations on the earnings beat in the second quarter. Mimi, can you talk a little bit about the move from fashion athletic towards casual at Journeys, how can you capitalize on this, do you think that you'll have the inventory associated with this shift in place by holiday, and can you talk a little bit about the ASPs between those two silos? Thanks.

Mimi Vaughn

Thanks for the question, Steve. When you think about Journeys, our skilled merchants place bets on the right product. They have lots of experience. They've made the right fashion calls over the last several cycles. That is a competitive advantage for us. Out of the last few fashion cycles, the last one we came out of is retro-athletic into casual, and casual just continues—we continue to see strength on top of strength. Teens always have fashion athletic in their closets, but when it moves to casual, it is beneficial for us, we're uniquely positioned to serve the customer here.

There is more diversification in teen fashion today. There's a reinterpretation of the '90s trends I've talked about, even a little bit of '80s, and there are just a number of brands that are popular right now that are being substituted for sandals, and other things, as we saw through the summer.

We do have the inventory in place that we need. We had it for back-to-school. In fact, we have a head-start on the holiday inventory, because we received some late items last holiday and we carried them over so that we are ready when holiday sales begin. We do shift into boots much more so in the back part of the year.

The ASP difference between the two categories, between casual athletic and casual, is, interestingly, not that different because of the mix of boots with some of the other product. We have been seeing price increases. I did talk about—we have been seeing overall ASP increases. I did talk about a shift that we're seeing with the Journeys customer into some more accessible price point products. But, overall, our overall ASPs are still up.

Steve Marotto

That's very helpful. Tom, can you talk a little bit about what total freight, incremental freight dollars are expected this year, and I'm curious how much you think that reverts next year to normal? In other words, could all of those disappear, frankly?

Tom George

Yes, for this year, in total—it's interesting—in total for the year, it's about $14 million to $15 million. Relative to last year, it's the same number, it's just sort of sequenced differently. A good amount of that is air freight, and we would expect in future periods, meaning next year and out years, that we shouldn't need that same level of air freight, so we should get a benefit in future years on air freight.

Mimi Vaughn

We're also going to see that container costs come down. They have been elevated over historical levels. We're seeing some easing on the pressure, certainly, of being able to get product onto ships, which is positive, and prices leveled out, came down a little bit, still above historical highs, but as the whole supply chain normalizes and consumer demand lets off a bit versus last year, those prices should get back down to, we hope, historical levels.

Tom George

Right, and that's a good point.

Steve Marotto

I'd like to expand on that, actually, offline. Mimi, I have one other question. I noted you had also alluded to the fact that back-to-school started a little bit later this year than what would normally be anticipated. There have been times, of course, in the last couple of years, with lots of gyrations amongst the consumer and when and where they purchase. I know it's maybe impossible to handicap at this moment, but still potentially comment on what are the odds that simply this back-to-season has a longer tail; in other words, same amount of dollars, but simply shifted, maybe, two weeks forward?

Mimi Vaughn

Sure. That's a great question, Steve. We have seen a change in consumer shopping patterns for back-to-school, absolutely, over the last couple of years, where it was a very late start, where we usually see the back-to-school season last from the last two weeks of July into August, into the first two weeks of September, so eight weeks all together. The last couple of years, we really didn't see any activity pick up. In fact, last year, we saw that the whole July/August part of the season was softer than normal, but then we picked up the volume that we didn't see in September and in October. I think last year and the year before were unusual times. I think that parents were waiting to see if kids went back to school, and then when they went back to school, if they would stay in school. We attribute those patterns to what was going on the last couple of years.

However, this year, we're seeing the same dynamic. To be conservative, we have said that in September and October, the consumer will revert to historical shopping patterns. Specifically, you know, kids want to wear new shoes back to school. They want to come back and see what their friends are wearing. We talk a lot about in-the-moment purchases. The in-the-moment purchases have gotten to be in-the-moment-at-the-last-moment purchases. So, we would be cautiously optimistic that those trends would carry over into the fall, but for guidance purposes, we haven't built it in.

The good news is that August picked up significantly. I mean, we were just really very pleased to see what a big swing we had between the end of July and into August, and that momentum is continuing and we'll see what happens through the course of the Labor Day weekend.

Steve Marotto

I have one follow-up to that. What do you attribute the swing to? Do you think that consumers have reset their expectations for food and fuel? Do you think that because gas has rolled off, there's been that pickup? What do you attribute the delta being between August and July, more on a macro level than a micro level?

Mimi Vaughn

Yes, you know, interestingly, we saw that back-to-school purchasing early in the cycle for early tax freeze wasn't as strong as when we got closer to school starting. I think more people were taking vacations in the back part of the summer this year, there was a lot of pent-up demand on vacations. I think that consumers were enjoying the summer, and so just really slipped into "Wow! We've got to go back to school." I think that's a little bit of what has happened. We've seen, overall, the consumer cycle shift into consumers waiting until the last minute. I think there's just more information out there. It used to be that you'd go and you'd shop your shopping venue, shop the mall, and other places, to see what trends were in style. Well, now, you've got that in the palm of your hand and you can figure that out. You also have a lot more confidence about being able to find the inventory wherever it is. So, that has really pushed just shopping patterns closer to the time of need. This year, especially, I think that consumers were distracted enjoying the summer and that we've seen a pickup, certainly, a significant pickup, in traffic as we've gotten into August.

Steve Marotto

That's really, helpful, thank you. I'll take the balance offline.

Mimi Vaughn

Thank you.

Operator

Our next question is from Corey Tarlowe with Jefferies. Please proceed.

Corey Tarlowe

Hi, good morning, and thank you so much for taking my question. I wanted to start talking about Johnston & Murphy, given, I think, what is very clear is that you've done a tremendous job turning this business around from the start of COVID, when everything was locked down and people weren't going to the office, and now you've pivoted the business to be more casual, driving what I believe was record second quarter revenue for the segment, in spite of having fewer stores than prior years, which is incredibly impressive. So, can you just talk about what you're doing at that brand that you think is really going to drive sustainable success and growth going forward, and then maybe just touch a little bit on what we can expect from a profitability standpoint, as well?

Mimi Vaughn

Sure. Thank you for that question, Corey. The J&M customer is in a good place. We're delighted by what we are seeing from the brand right now, and have great prospects in the future for the brand. What has happened in the most recent time is that the J&M customer got used to comfort working from home, and once you experience comfort, it's hard to go back. The J&M team did, really, a terrific job during the pandemic, taking advantage of the opportunity to rethink the brand. The pandemic gave us a chance to think about how the brand could be different from a product perspective and also appeal to younger customers, and we pivoted harder into casual and comfort. It's really terrific product. There's great styling, with special technical features, proprietary chassis systems, great waterproofing, great moisture wicking, great just comfort features.

After the recession, after the Great Recession a number of years ago, we had a chance to reinvent the brand and were able to double the size of the brand, and think that there is an opportunity to do that again this time around. We have a chance to sell customers things that are not in their wardrobe, things that they need for today's lifestyle. So, they're trading in their dress shoes or their more formal shoes for hybrid product, which is great styling with lots of comfort features.

Johnston & Murphy has done such a great job repositioning. Right now, we are selling a lot of casual and casual athletic product. I talked about the top styles being casual and casual athletic. In fact, casual and dress casual are more than 90% of the footwear sold today, and so dress is getting to be a much smaller portion of the overall sales. We've complemented that with additional categories that really round out the lifestyle offering. Interestingly, we used to worry about casual just trading down price points from dress footwear, but we have actually seen that we've been able to build in great comfort and technology features, and have been able to see higher price points. So, we like the profitability profile that we see, we like the potential for increased sales.

We're spending a lot in marketing right now to let people know about some of the changes in the brand. We've just done a market research study that says that as much as we think everyone knows about Johnston & Murphy, there's lots more potential for additional consumers. So, great prospects going forward.

Corey Tarlowe

Got it, and then just on the profitability expectations for the segment?

Mimi Vaughn

This year, it's a front-half/back-half story. We were chasing a lot of product. You saw a great turnaround in sales in, really, the second and third quarter. Tom talked about the overall pressure from air freight, and that's mostly in the Johnston & Murphy segment. This year, I think profitability was up in the second quarter over pre-pandemic levels, but less than last year because of some of that air freight and the inventory reversals, but I would say that we could get back to historical—Johnston & Murphy has been as high as double-digit profitability. We went from pretty big losses during the pandemic. We're making good strides this year, and over the longer term, we think there's nothing that would prevent us from getting back to historical levels of operating margins.

Tom George

Yes, let me just reiterate what Mimi's saying. I mean, if you look at Johnston & Murphy, where our expectations are for this year relative to pre-pandemic, you'll see that we really expect the sales will be a little bit above pre-pandemic levels and we have profitability. It won't be the same as pre-pandemic, because we are investing in marketing for growth here. We've got a good opportunity to continue to grow that brand at a good pace. We've got the distribution infrastructure in place to be able to get further efficiencies from the stores. We really see down the road even more upside in efficiencies on the stores going forward, because we sell a lot of apparel, as well, and so the stores are a great opportunity for growth. Our digital business, as you've seen, is growing very well, and that's double-digit profitability on the margins, so another good thing. Then, our wholesale business, again, a good opportunity, getting a lot of traction, a lot of good sell-throughs, and there's a big wholesale opportunity for Johnston & Murphy going forward.

In the end, if we continue to invest in marketing and continue to keep the product development machine with new product, we can really grow that brand again and take a lot of share in that category, and get to even stronger profitability rates than they were pre-pandemic.

Corey Tarlowe

That's great, thanks for all the color, and then just one final one, to double-click on a comment that I think, Tom, you made. You had mentioned that you don't have any expectations for incremental promotions throughout the remainder of this year. I'm a little confused, because I think that stands in contrast to what we've heard from other retailers getting more cautious on promotions, so could you just clarify that and explain that? I want to make sure I heard that properly.

Mimi Vaughn

Let me jump in here, and then turn it over to Tom. Lots of other retailers right now are just talking about a large amount of inventory in the pipeline and that is really dictating the need for more promotion. Where we sit in the footwear world, especially, in the parts of the market that we serve, are certainly less promotional than apparel. The scarcity in supply, coupled with the robust demand last year, let us see the best full price selling environment we've ever seen, so we're normalizing versus that for this year. But, our brands took the opportunity to rationalize allocations. We live in a highly allocated space, where there's a lot of control and a lot of scarcity of supply, in general. We've been chasing product through much of the year, we were still down 25% at the beginning of the year, so we feel that we've just gotten to the right points of inventory, where we're reinventoried properly.

So, we are certainly expecting that we'll have more markdowns this year, because the consumer was just buying anything that was available last year. We did build back in some promotional activity to just help spur demand, as we usually do this year, but what Tom is saying is that we are not seeing that we are going to have to do even more activity than we had planned in order to right-size inventories, because we feel like our inventories are in good shape.

Tom George

Yes, and I would just add to that, and even give you some perspective. Really, what I was referring to is really no change from the prior guidance in terms of promotional activity and how that may impact margins, because, what Mimi said, we've got great relationships with all our key suppliers and we work with them all the time to right-size inventories, so we can continue to protect those brands and not markdown product. From a reference point, we certainly have more—we are planning for some more markdowns this year, relative to last year, when last year was virtually no markdowns, but we're still—a lot learnings from last year—we're still planning markdowns at lower levels than pre-pandemic levels.

Corey Tarlowe

Understood, that's very helpful, and thank you so much for all the color and best of luck.

Tom George

Thank you.

Operator

Our next question is from Mitch Kummetz with Seaport Research. Please proceed.

Mitch Kummetz

Yes, thanks for taking my questions. Let me start, just a question on boots. You talked about carrying over some product, and I know that given supply chain challenges last year, there were a lot of late receipts, so I'm just trying to understand how much better your position in the category is this year versus last year. Can you say what boot penetration is for you guys in Journeys in Q3 and Q4, and, again, any way to sort of give us a sense as to how much better you feel about where your inventory is on boots going into this season, the heart of the season, this year versus last, and I have a follow-up?

Mimi Vaughn

Let me talk about last year and then contrast that to where we are this year. Last year, we really hit supply chain challenges, most pronounced in the back half of the year. In the back half of the year, we switch, as you know, Mitch, to a boot assortment from more, you know, sandal and fashion athletic assortment. Last year, we were chasing boot inventory all throughout the year. We were—or the back half of the year—we were out of stock in core styles. We felt like we left a lot of demand on the table, because we didn't have core styles. That was part of the reason that we chose to take that late arriving inventory and carry it over into this year, so we'd be better positioned at the start of the season. So, we are in a much better inventory position to begin the season, a lot of supply chain issues have worked their way through the system, and so we expect that we'll get continuous flow of product, and we expect that we will be well positioned to meet the demand in this holiday season.

Mitch Kummetz

Okay, thank you for that, and then my follow-up. On the change in the sales guidance, Tom, it sounds like the biggest piece is Journeys. I thought I heard a high-single-digit number mentioned in your discussion of them. I'm not clear as to, like, what the Journeys outlook has changed from to? Were you thinking high-singles and now you're thinking less. I didn't quite understand where that high-singles came in. Also, on the FX, I heard a 2% number, and I know that the dollar has strengthened since you guys last reported and I'm just curious, also, what your—did your FX outlook change for the year as the guidance was lowered or was not changed, and if it was changed, how much did that change by? Thanks.

Tom George

Mitch, on the FX, the outlook for the year, the impact, mainly that's, obviously, a Schuh in the U.K. impact, a little bit of a Canadian impact on the Journeys business, but, really, from a guidance-to-guidance perspective, it really didn't change much. We're looking at, for the total year impact of FX, about 2% on the total year sales.

Mimi Vaughn

I'll talk about just the overall expectations for Journeys. We had expected in our prior outlook, Mitch, high-single-digit growth, because of—it links back to what I was talking about, where we felt like we left a lot of boot and other sales on the table in the back part of the year. We are running up during this back-to-school, but more in the, I'd say, mid-single-digit range. We're expecting in our forecast that the consumer will revert to historical patterns of not very robust shopping during the back part of September and October, but that will pick up at about the same levels for the holiday season for Journeys. We had really ambitious expectations for Journeys, we like what we're seeing, but we have modified our expectations to really align with the actual performance we are achieving.

Mitch Kummetz

Okay, thank you for that clarification. Good luck.

Mimi Vaughn

Thank you.

Tom George

Thank you.

Operator

We have reached the end of our question-and-answer session. I would like to turn the conference back over to Management for closing comments.

Mimi Vaughn

Thank you for joining us. I wish everybody a great Labor Day weekend and look forward to talking to you on our next call.

Tom George

Thank you.

Operator

Thank you. This does conclude today's conference, you may disconnect your lines at this time, and thank you for your participation.