[KIRK] - Kirkland's Fourth Quarter 2019 Earnings Call
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Officers
Jeff Black, SCR Partners, Investor Relations
Woody Woodward, CEO
Nicole Strain, CFO

Analysts
John Lawrence, Baraboo

Presentation

Operator: Good morning, and welcome to the Kirkland's 2019 Fourth Quarter Earnings Call. [Operator Instructions] Please note, this event is being recorded.

I would now like to turn the conference over to Jeff Black of Investor Relations at SCR. Please go ahead.

Jeff Black: Thank you. Good morning, and welcome to Kirkland's conference call to review results for the fourth quarter of fiscal 2019. On the call this morning, we have Woody Woodward, Chief Executive Officer; and Nicole Strain, Chief Financial Officer.

The results as well as the accessibility of this conference call on a listen-only basis over the Internet were announced earlier this morning in a press release that has been covered by the financial media. Except for historical information discussed during this conference call, the statements made by company management are forward-looking and made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Forward-looking statements involve known and unknown risks and uncertainties which may cause Kirkland's actual results in future periods to differ materially from forecasted results. Risks and uncertainties are more fully described in Kirkland's filings with the Securities and Exchange Commission, including the company's annual report on form 10-K filed on March 29, 2019.

I'll now turn the call over to Woody.

Woody Woodward: Thank you, Jeff.

2019 was a year of significant transformation for Kirkland's. We took bold steps to reinvigorate or assortment, realign our infrastructure and improve e-commerce, and were well along the path of implementing direct sourcing. Overall, the work supports our long-term strategy to preserve Kirkland's value DNA as we increase relevancy and improve retail fundamentals.

During 2019, we reinvented core product assortments and added new categories that make us more important to the Kirkland's loyal customer base. We addressed supply chain flow and invested in our omnichannel platform. The results we reported today reflect the depth of the transition, with plans to close 28 underperforming stores and a further reduction in operating expenses. The results also reflect encouraging progress. We achieved strong e-commerce growth in the quarter, and we had better performance in segments of the assortment, including furniture and tabletop. We ended the year with a solid balance sheet, and we believe we're well positioned to execute our vision strategy for Kirkland's.

Let me share some thoughts about our key priorities for 2020. It starts with further accelerating product development to build on what we've accomplished in 2019. Our goal is to be in the consideration set for a complete home furnishings project in addition to the finishing touches.

Let me elaborate on that. Kirkland's has historically been known as a key resource for accessories when a home decor project is near completion. We've been an ideal stop to pick up a wreath for the front door, a candle for a certain room, some finishing artwork or even some holiday decor to make your home as a happy place to live. We have a long history there, and this focus has served our customers well.

At the same time, we've been losing market share to mass merchants and online-only players with an assortment that's too narrowly focused in some cases. During 2019, we added larger furniture pieces, tabletop, rugs, beds and bedding. We've been more deliberate in our color direction and design point of view and edited assortments to tell a clearer story to the customer. We have also included occasional chairs, recliners and large scale tables to our assortment. The final add is being tested this year with upholstery.

This strategy is to get our customers thinking about us for a complete decorating project. We want to be the complete casual home decor store where, essentially, everything goes together with one point of view. That allows our customers to finish their entire room or home all within a tight budget. Our goal is to move away from being coupled with the mass merchant retailers and fit squarely as a value home retail store within the specialty world.

Our second goal is to improve omnichannel via website enhancements, incremental digital spend and an expanded online assortment. We view e-commerce as an accelerator to our overall business strategy. Our focus on buy online, pick up in store has been a big success, and we're making additional improvements in the supply chain that will help with both speed and profitability.

Third, we will continue to increase direct sourcing with the goal of increasing penetration in 2020. We're in the process of moving from a vendor base of primarily wholesalers to a worldwide direct sourcing base. We believe we can improve margins and quality as we differentiate our assortment to be more exclusive.

Fourth, we're investing in marketing spend to drive consumer acquisition and brand awareness. Our stores look and feel better than they ever have. Our assortments are clean, focused and edited to tell home decor stories. And these elements are starting to take shape with improved sales and margins. We have started to convey our brand messaging to acquiring new customers while educating our current loyal base. With traffic continuing to be a challenge, we are concentrating on growing the basket size in the average unit retail by offering unparalleled value at a price. I welcome all of you to see our stores for yourself, and let me know what you think.

Fifth, we'll continue to preserve our capital to invest in the business. We ended 2019 with over $30 million in cash and no debt under our borrowing agreement. We'll continue to evaluate the store infrastructure, and we'll focus on additional ways to optimize our expense and increase efficiency. We've accomplished a great deal, but emerging as a powerful true home furnishings brand from an accessory store takes time and patience, and that's why we've been conservative with our capital to better facilitate this transition.

Now, I'll turn it over to Nicole Strain, our Chief Financial Officer.

Nicole Strain: Thank you, Woody.

Before speaking to the specifics of the quarter, I would like to address some of the larger financial items impacting the fiscal year and how we see those affecting us as we move forward.

As Woody discussed, we took significant steps during the year to transition Kirkland's to a model that can generate profitable growth, and we believe we will make progress down that path in 2020. We rolled out new categories and made significant improvements in both the quality and design of our merchandise. Our full year performance in 2019 reflects margin pressure related to rebalancing our assortment to improved quality and design while still recognizing the increasingly promotional competitive environment.

During the fourth quarter, we experienced strong sell through of our holiday merchandise and had a new floor set immediately after Christmas. We ended the year with two consecutive months of positive comparable sales, with January up 6.7% and e-commerce growth pushing 40% for the quarter. In addition to the merchandise changes, our fiscal 2019 results include initiatives to streamline our model to enable us to better compete in the future. We initiated aggressive negotiations with our landlords that allowed us to improve profitability at a number of our locations, and we negotiated an exit out of locations that were unprofitable, which will be closing in the first quarter of 2020.

The majority of the benefit of the reduced occupancy costs will be realized in fiscal 2020, but much of the extent was reflected in the fourth quarter of 2019. We will continue to pursue lease negotiations throughout the remainder of our portfolio and to refine our store footprint to support an optimal omnichannel model. We stood up a second distribution center outside of Dallas, which reduced our transportation miles and generated annual net savings.

We saw a partial year benefit in fiscal 2019, but we'll realized full benefit in 2020. We will implement a new warehouse management system, which will allow us to consolidate our two distribution centers in Jackson, Tennessee, and stand up two e-commerce hubs in the first half of fiscal 2020. This will result in a reduction of distribution center costs, e-commerce shipping costs, and improved SLAs for ship-to-home orders. Again, most of the capital in the impairment charges were reflected in the fourth quarter of 2019, but benefits will begin in the first half of fiscal 2020.

We reduced operating costs by approximately $24 million when compared with 2018 across all areas of our business, which included revisiting the store operating model to prioritize labor to our high-contribution stores, reducing corporate overhead and initiating a review of all operating costs. Our fiscal 2019 results reflected approximately $10 million of those savings.

And finally, we implemented direct sourcing, which will have roughly 100 basis points of margin impact in fiscal 2020 and will have an increase in benefit on product margin as our penetration grows. Direct sourcing will also help us begin to diversify our sourcing outside of China.

Our adjusted loss per share for the year was $1.57 versus our guidance for a loss of $1.75 to $2. The table to reconcile to the most appropriate GAAP measure is included in our earnings release, which was filed premarket today. The following explanations are all on an adjusted basis.

Moving to the quarter. Net sales for the fourth quarter decreased 3.1%, or $6.7 million, compared to the fourth quarter of the prior year. The change in sales includes a comparable store sales decrease of 2.7%, made up of a 37.9% increase in e-commerce revenue, and a high single-digit decline in brick and mortar sales. And that's on top of a 3.3% combined comp decrease and a 15.3% increase in e-commerce in the prior year.

In our brick and mortar stores, soft traffic continued and was the primary driver of the comparable store sales decline. E-commerce accounted for $34.6 million in revenue during the quarter for approximately 17% of our total revenue. We saw a significant increase in transactions, which was partially offset by a decline in average ticket. For the quarter, 53% of our e-commerce sales were fulfilled in store at a higher level of profitability than direct-to-consumer sales. Both this accounting for over 30% of our e-commerce sales in the quarter allowed us to be relevant and offer solutions for last-minute holiday shoppers at a level we were unable to provide in prior years.

Gross profit margin in the fourth quarter decreased 460 basis points from the prior year to 29.8%. Merchandise margin decreased from the prior year by 330 basis points to 49.3%. And that was driven by a decrease in product margin from both product mix and incremental discounting, and we had a favorable damage adjustment in the prior year.

Outbound freight costs, which include e-commerce shipping, increased 20 basis points as a percentage of net sales due to the increase in e-com sales. Store occupancy costs decreased by $600,000 but remained flat as a percent of sales compared to the prior year quarter. Deleverage from the decline in brick and mortar sales was offset by negotiated rent savings and lower depreciation due to asset impairments during the year. We continue to believe there is significant opportunity to remove costs from our brick and mortar infrastructure from both renegotiated lease terms and closing of underperforming stores.

Central distribution costs increased by 110 basis points as a percent of sales compared to the prior year mainly due to a change in the methodology of capitalizing distribution costs. Operating expenses for the fourth quarter, excluding depreciation and impairment, were 24.3%

of sales compared to 24.6% of sales in the prior year quarter for a decrease of $2.2 million. Store operating expenses increased 35 basis points as a percent of store sales primarily due to the deleverage of store labor.

E-commerce expenses decreased 170 basis points as a percent of e-com sales due to operating leverage on fixed costs. And corporate expenses remained consistent as a percent of sales to the prior year quarter. Depreciation and amortization decreased 10 basis points. We recorded an impairment charge of $12 million in the quarter. Of the impairment charge, $5.6 million related to store impairment, $4.7 million to impaired software projects and $1.7 million to store fixture and DC impairment. These charges were excluded from adjusted income per share.

The valuation allowance recorded in the third quarter continued to impact our tax rate, which was 4.7% for the fourth quarter of 2019 compared to 27% in the fourth quarter of 2018. The favorable impact of the lower tax rate is normalized in adjusted earnings per share.

For the quarter, we had a net loss of $0.35 per diluted share for income of $0.59 adjusted compared to net income of $0.95 per diluted share in the prior year quarter for $0.97 adjusted.

And moving on to the balance sheet and cash flow statement. At the end of the quarter, we had $30.1 million of cash compared to $57.9 million in the prior year period. We repaid all borrowings on our revolving line of credit during the quarter. The year-over-year decrease in cash was driven primarily by the decline in operating performance, capital expenditures and share repurchases in the first half of the year. We ended the year with $61 million of availability on our credit facility. Our inventory balance at the end of Q4 was $94.7 million, which was an increase of approximately 12% over the prior year period. The inventory increase includes funding the new product categories released early in the third quarter as well as inventory from softer sales in some nonseasonal categories.

There is minimal risk of obsolete seasonal inventory as we effectively move through all seasonal products during the quarter. Further, we directed excess clearance and overstock inventory to the store closings in the first quarter of 2020. Year-to-date cash used by operations was $8.3 million compared to cash generated of $22.3 million in the prior year. The decrease is due to the decline in operating performance and changes in working capital. Capital expenditures were $15.7 million compared to $28.8 million in the prior year and were driven primarily by investments in supply chain, e-commerce and store additions and remodels.

As we look forward to fiscal 2020, our goal is to continue to execute on our long-term plan to become the home decor destination of choice for value shoppers and to transition our infrastructure to support the merchandise strategy, allow our customers to have a seamless purchase wherever she chooses to shop and return to profitability. We expect the sales trend to improve versus 2019 as we benefit from further assortment improvements, continued momentum and e-commerce, marketing spend and the closing of underperforming stores. We expect to generate marginally positive EBITDA in fiscal 2020 driven by stabilization in our gross margin and expense controls.

Gross margin should benefit from the initiative to reduce store occupancy costs, a more efficient supply chain and our direct sourcing program, offset by an increase in e-commerce shipping as the online mix of our business grows. We will see the benefit of the $24 million in cost reductions relative to 2018 in a reduction of operating expenses as a percent of sales of approximately 150 basis points, and that's after funding incremental marketing spend directed towards customer acquisition.

From a capital perspective, we will continue to focus on the conservation of cash to ensure we have the runway to implement the initiatives needed to return our business to prior levels of profitability. We expect to generate approximately $5 million of cash in fiscal 2020 and expect borrowings on our credit facility within the third quarter and to be repaid within the quarter. Capital expenditures will be in the range of $10 million to $15 million with us managing to the low end unless our business improves faster than expected, which will allow us to expedite additional projects in the back half of the year.

And finally, this outlook does not contemplate either the supply chain or demand risk from COVID-19. We are watching both closely and will react as needed but are not providing any estimated impact at this time.

And now, I'll turn it back to Woody for some final comments.

Woody Woodward: Thanks, Nicole.

I want to end by saying a priority of the organization is the safety and wellness of our employees, who work so hard every day to make Kirkland's a special shopping experience, and our customers who are visiting our stores. We're following the guidance from the CDC as well as state and local public health agencies to respond to the rapidly evolving situation with coronavirus. While there's uncertainty in the near term, we feel good about our strategy we have in place. And we're well capitalized to continue to transform the business in 2020 and beyond.

With that, I'll turn it over for any questions you may have. Thank you.

Questions & Answers

Operator: We will now begin the question-and-answer session. [Operator Instructions] Our first question today comes from John Lawrence of Baraboo.

John Lawrence: Woody, could you -- thanks for that breakdown. Could you give us a sense of the fourth quarter? And I know this product set is evolving, but give us a sense of the things that you were really pleased about and what you thought took hold and the progress of how that goes for the first half of '20.

Woody Woodward: Okay. Thanks, John, for asking. It's our pleasure to take questions. And one of the things that happened in the fourth quarter was that November got off to a little bit of a slower start primarily because of some timing between Thanksgiving and the Christmas holiday. So we ended up negative in November. But then we came back with our first positive comp in

December in many years, which we were very pleased with. And it was primarily driven by our holiday assortments that were really well received, and some of the new categories started to take hold.

Then, we ended up in January with even more improvement with a positive 6.7% comp. We started off February in pretty good shape before all the disruption in the marketplace. So I'm pleased with the way our customers, our current and loyal customer base, is responding to new categories, with some of the clear winners being the things that have always been clear winners for us, which are our candle assortments, our holiday assortments. But some of the new categories that seem to really be working were the tabletop business, which has been very, very well received; and then to a lesser degree, our rug business has been very much what we expected. But we feel like we have more opportunity there. And then, bedding is still in development. I think it was the last category that we landed.

We've also added -- embedded in all the merchandise new categories was some edits to the assortment where we took out our apparel that we just didn't feel like reflected our efforts to become a serious home furnishings retailer. And so that was done in the fourth quarter. So we ended up with a very clean inventory going forward, like Nicole said, with very little risk because we didn't carry forward any of the seasonal products.

And now, we're landing new products which we feel like are very focused and our customers are responding to. So despite the current disruption with the coronavirus and the banking situation and stock market, we feel good. We think that we'll emerge from this with a much healthier business. And not only are we bringing along our current customer base, who seems to like our new changes, but we're also acquiring new customers. And so any other color you need on that, I'd be happy to answer.

John Lawrence: That helps. And certainly -- so we'll continue to edit the presentation. And when will all the new products -- I know you are constantly making edits in certain -- but as far as the bedding and all of that, by spring or, I would say, summer of '20, will the store look like, pretty much with all the new product, what you want it to be?

Woody Woodward: Yes. That's a good question because merchandising is an evolving process. It's a journey that you're never complete because you're always improving. But I think that we came out of Christmas this year and did a floor set right after the holidays that really took hold with our customers, and that's why we delivered such a good positive comp in January. It was fresh; it was new. So I think our stores look pretty darn good right now.

There's always the next wave of products coming. Right now, we just landed our outdoor assortment on the floor, so we're proud of the way that looks. So it's an evolution. There's still a few issues in the store that I would like to improve on, of course, but the stores are looking pretty good. Despite the current environment, they're looking really good. So please go on and take a look and let us know what you think.

John Lawrence: Right, thanks. And on that subject, as far as China's concerned at this point, any shipping issues or problems with containers as you look forward at this point?

Woody Woodward: There are, there are. We are having some slowness of some of our products coming in. We ended up the year with a little bit of extra inventory to allow us to mitigate the risk. Now, we're starting to see the factories come back online. We do build a little bit of a pad into our product flow, especially on holiday products.

So I think that we will experience some delays, but last year we also took the initiative with some of the tariffs to move and balance our assortments out of China so that we're not 100% dependent on China as we used to be. Now, we've got Vietnam up and running. We've got our business in India doing really well, and then, of course, our domestic sources. So we feel pretty good. There will be some disruption, but I don't think at this particular point it's material. But we will have to wait and see because the environment is changing so quickly.

John Lawrence: Right, thanks. Last question. Nicole, do you have a sense of -- you could give us the 28 store closures for the first quarter, the amount of sales and the amount of loss that you will be exiting out of those 28 stores?

Nicole Strain: So the 28 stores definitely represented the first pass at the stores that were EBITDA-negative on average. We had some that were significantly negative and some that were slightly positive and trending down. So total, that group accounted for roughly $1 million in loss.

But again, it was really the stores that were trending down. I think from the sales perspective, a lot of them -- it was a mixture of low-volume stores and high-volume stores that just didn't make money because the expense structure was so costly in the areas that they were. So it's first phase of us looking at our portfolio and trying to get two things, down to the most profitable stores and also the stores in the right places to support our omnichannel vision.

Operator: [Operator Instructions] There are no questions at this time. This concludes our question-and-answer session. I would like to turn the conference back over to Woody Woodward for any closing remarks.

Woody Woodward: Thank you for listening. We really appreciate it, and stay healthy.

Operator: The conference is now concluded. Thank you for attending today's presentation. You may now disconnect.