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SIG - Q2 fiscal 2011 Results Announcement Signet Jewelers Ltd Earnings Conference Call

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PRESENTATION

Operator

Today, ladies and gentlemen, and welcome to the Signet Jewelers second-quarter results conference call. For your information, today's conference is being recorded. At this time I would like to turn the conference over to your host for today, Mr. Terry Burman. Please go ahead, sir.

Terry Burman - *Signet Jewelers Ltd. - CEO*

Thank you, operator. Good morning, everyone, and welcome to the conference call for Signet's second quarter fiscal 2011. I'm Terry Burman, Chief Executive. Joining me from London is Ron Ristau, our CFO. The presentation deck we will be talking to is available from the webcast section of the Company website, www.signetjewelers.com. Before I go through our operating review, Ron will give the Safe Harbor statement and review the financial performance. Ron?

Ron Ristau - *Signet Jewelers Ltd. - CFO*

Thank you, Terry. During today's call we will, in places, discuss Signet's business outlook and make certain forward-looking statements. Any statements that are not historical facts are subject to a number of risk and uncertainties, and actual results may differ materially. We urge you to read the risk factors and cautionary language in Signet Jewelers' annual report on Form 10-K filed with the SEC on March 30, 2010, which can be found at the Company's website at www.signetjewelers.com.

Additionally, certain financial information used during this call are considered to be non-GAAP financial measures. For a reconciliation of this information to the most directly comparable GAAP financial measures, please refer to the Company's release dated August 26, 2010, available on the latest news section of Signet's website.

We have continued to execute our strategy. By leveraging our sustainable competitive advantages and focusing on sales growth, we are lifting store productivity and driving operating margins at a time when there is little opportunity to add space. We have enhanced an already strong balance sheet, ensuring further financial flexibility, a major advantage in the sector. And, as these results demonstrate, we have made progress in achieving both our operating and financial objectives for fiscal 2011. We therefore believe we're positioned for a recovery in consumer spending when it comes, or to compete in a more challenging environment if economic growth slows.

Total sales for Signet increased to $722.8 million in the second quarter of fiscal 2011 compared to $710.8 million in the second quarter last year. Total Company comparable store sales for the quarter increased by 4.5% versus a decline of 5.3% in the prior year. In the US sales increased to $580.8 million, primarily reflecting a comparable store sales increase of 5.9% in the second quarter. In the UK, sales declined to $142 million, primarily reflecting a 0.5% decline in comparable store sales and the impact of currency fluctuations. Year-to-date, sales were $1.5328 billion compared to $1.4734 billion in the year-to-date last year. Total Company comparable store sales for the year-to-date increased by 5.2% versus a decline of 4% in the prior year.

In the US sales increased to $1.2479 billion, primarily as a result of a 6.6% increase in comparable store sales, and in the UK sales declined to $284.9 million, primarily as a result of a 0.4% decline in comparable store sales and the impact of currency fluctuations. Note that reductions in store space lowered the total as-reported sales by 0.9% in the second quarter and 0.8% in the year-to-date results.

The second quarter was another encouraging quarter, generating income before tax of $57.3 million, up 48.8%, and diluted earnings per share of $0.47, up 46.9%. Year-to-date, income before tax is $134.1 million, up 67.8%, and diluted earnings per share are $1.07, up 69.8%. The impact of exchange translation on net income was not material in either the quarter or year-to-date results. Note that the tax rate in the second quarter was 29%, reflecting a benefit from the resolution of prior-year provisions. The rate year-to-date is 30.9%, and for the full year we expect the rate to be 32.5%.

In reconciling performance we note that gross margin improved by $18.3 million in the second quarter and by 200 basis points as a percentage of sales. This was primarily due to two factors; first, an improvement in gross merchandise margin of 70 basis points, reflecting a 100-basis-point increase in the US and a decline of 30 basis points in the UK; and, second, an improved bad debt performance in the US. Selling, general and administrative expenses were $203.7 million for the second quarter, virtually unchanged from last year. As a percentage of sales, they decreased by 50 basis points compared to the second quarter of fiscal 2010.

Tight expense control across the enterprise combined with leverage on selling expenses more than made up for a nonrecurring $6 million benefit to expenses in the second quarter of fiscal 2010 from the change in the vacation entitlement policy. Other operating income was $27.2 million in the second quarter, down $1.7 million on last year, a 30-basis-point negative impact on operating margin. The reduction primarily reflected the adverse impact from the amendments to the Truth in Lending Act this year. Net interest paid decreased by $2.1 million or 0.3% of sales in the second quarter, reflecting the repayment of debt in the first quarter and income before income tax increased by $18.8 million or 48.8% in the second quarter to $57.3 million.

Turning to the year-to-date, operating margins improved by $49.8 million or 300 basis points. In the components, gross margin improved $59.1 million or 260 basis points, primarily in the US division. Selling, general and administrative expenses were lower by $5.6 million, adding 90 basis points to operating margin due to tight expense control. And offsetting these improvements, there was a 50-basis-point or $3.7 million decline in other operating income, mainly as a result of the adverse impact from amendments to the Truth in Lending Act. Net interest expense declined by $4.4 million or 0.3% of sales, and income before tax increased $54.2 million or 67.8% to $134.1 million.

In the first half, free cash flow was $240.2 million against $277.5 million in the comparable period in fiscal 2010 with the increase in adjusted net income offset by a smaller working capital improvement than last year. In the year-to-date results, inventories were down by $40.3 million, reflecting seasonality, better than expected trading year-to-date, the impact of store closures and timing differences that are expected to reverse somewhat in subsequent quarters. This was an improvement, but it was $76.3 million less than in fiscal 2010, as last year we reduced inventory by a total of $226.5 million for the year.

Receivables were down by $59.7 million, consistent with last year, the reductions reflecting the seasonal pattern of sales; and net cash flows used in investing activities used $14.4 million, down from $17.5 million in fiscal 2010. So, as a result, net cash at the end of the quarter was $231.4 million compared with net debt of $200.5 million a year ago.

Thank you. I'll now hand it back to Terry.

Terry Burman - *Signet Jewelers Ltd. - CEO*

Thanks, Ron. We'll look first at the US businesses. Jared was again the standout performer in the second quarter. Same-store sales of 14% year-to-date increased being 14.9%. We believe this reflects the bounce back in spending by upper middle market consumer and merchandising initiatives, including the rollout of the Pandora range to nearly all stores at the end of the third quarter last year. Kay had a 2.6% same-store sales increase for the quarter and 3.5% for the year-to-date. Performance differential between Kay and our regional brands was about 1.5%, in line with the first quarter.

Second quarter average selling price excluding the charm bracelet category was up 5% for Kay, little changed for the regionals; it was up 6.9% for Jared. Overall, US same-store sales increased by 5.9% in the quarter and by 6.6% year-to-date, an encouraging performance in a difficult environment.

In the US division sales were up 5.1% in the quarter and 6% year-to-date. While the economic environment was better than last year, it has remained challenging. Therefore, we believe that the main factors driving our performance are specific to Signet and its competitive strengths. Operating income in the quarter was $63.3 million, up 25.6%. Year-to-date, it was up 44.6% to $154.4 million. The operating margin increased by 180 basis points in the quarter and by 330 basis points year to date.

We have continued to strengthen our competitive position and drive sales by supporting our highly motivated sales staff with our ongoing training programs, through merchandising initiatives such as the continued development of differentiated ranges, rollout of Pandora and the build-a-ring feature on the Jared website, which has helped to drive bridal sales, and by increasing our share of voice on national television. At the same time, many competitors are under financial pressure, which we believe has adversely impacted their operational execution.

We also believe that we continue to take advantage of the capacity withdrawal from this sector, which we estimate to be above the long-term trend although below last year's level. Sales growth, proactive management of merchandise margin, tight cost control and a lower net bad debt charge to sales ratio were again a powerful combination in driving operating income.

This graph shows the second-quarter net bad debt to US sales ratio, the collection rate for the last 10 years. The absolute level of the ratio in the quarter is no guide to the full year due to the seasonal nature of our sales and net bad debt charge. However, the change on the comparable quarter in the prior year is meaningful. Second-quarter US net bad debt to sales ratio improved by 130 basis points, reflecting both higher sales and an improvement in the receivable performance which was also seen in many of the other key indicators of receivable management. The average monthly collection rate was unchanged from the comparable quarter last year. We have one more quarter where the comparative was increasing sharply last year, but in the fourth quarter we began to comp against an improved trend.

The graph shows the year-to-date net bad debt to US sales ratio and the collection rate for the last 10 years. Again, the improvement for the year-to-date is clearly shown.

Turning now to the second half, we continue to expect our US gross merchandise margin in fiscal 2011 to be broadly similar to that of fiscal 2010 as an increase in average inventory cost in the second half equals out the impact of pricing decisions which drove margin benefit in the first two quarters. Diamond costs have been increasing from last year's levels, accounting for about 55% of our cost of goods sold. However, recently polished diamond prices have shown some initial signs of stabilizing, all of which accounts for about 20% of our cost of goods sold, reached record highs during the second quarter. The impact of these commodity cost increases will be greatest in the fourth quarter. To protect our gross merchandise margin, we took pricing action on items with high gold content in the first quarter. Further selective price increases have been implemented in August, which is expected to impact about 25% fourth-quarter sales. With regard to price promotion activity, we plan this to be very similar to last year.

We continue to expect full-year controllable cost to be little changed from last year, but a number of expense increases are second-half weighted. For example, included in our planned costs an increase in advertising expenditure in the fourth quarter. Also, we plan some salary and merit increases. Merit impact is back-end weighted. Full-year impact of the Truth in Lending Act, now expected to be at the low end of our expectation at $15 million to $17 million, and the net adverse impact in the second half is therefore expected to be between $9 million and $11 million which reflects the timing of the introduction of the changes in regulations in February and August. (technical difficulty) the second half, we do not have a $3.4 million benefit from the change in vacation policy entitlement that we had in the comparable period last year. The other factor that could result in a cost variance [if] sales come in above plan.

In summary, the US division has had a good start to the year. The economic outlook is challenging and uncertain. We believe that we are able to respond to challenging conditions in a timely manner, as there is limited risk to our inventory from seasonal fashion changes, we have a flexible supply chain due to our relationship with vendors and the strength of our balance sheet. Sector leading systems enable us to identify changes in trends early. We have an experienced management team that understands how best to respond and to implement effectively.

We have continued to focus on enhancing our competitive advantages, such as vendors bringing their best programs to us before offering them to competitors, providing opportunity for us to negotiate exclusive distribution agreements, the effective use of national television advertising to drive store brand awareness, differentiated product, particularly as we are now the only specialty retail jeweler using this form of marketing on any scale and, most importantly, continue to successfully recruit, train and retain superior store chains.

Our sector-leading operating capabilities and strong balance sheet enable our talented management team to focus on preparing for the upcoming holiday season. Therefore, we believe we're positioned to gain further profitable market share.

Just before leaving the US division, I want to update you on the space outlook. We are ready, willing and have the capital to be able to invest in new space. However, very few suitable sites are currently available that meet our required investment return. Therefore, we do not anticipate any significant new space in fiscal 2011. Given the continued closure of regional stores, this is likely to result in a space reduction of about 2% in the current year.

Turning now to the UK business, same-store sales declined by 0.5% in the second quarter, very similar to the first quarter, with H.Samuel down 1.2% and Ernest Jones up 0.2%. While Ernest Jones was stronger than H.Samuel, it did have an easier comp. Average selling price in the quarter excluding the charm bracelet category rose at H.Samuel 11.3% and at Ernest Jones by 9.3%. This primarily reflected price increases implemented to offset higher cost of goods sold. There was some trading down within product categories, and there was a lower level of transactions.

UK operating income was $4.7 million, up $3.7 million. Year-to-date operating income was $3.3 million, a $3.6 million improvement. UK economic environment remained challenging. In terms of sales, the business has held its own compared to the other non-food category, based on the British Retail Consortium figures. Charm bracelets performed well in both H.Samuel and Ernest Jones. We believe that we have continued to strengthen our competitive position by focusing on staff training, for example, a program that we introduced last year was shortlisted for an award from the government-sponsored national training agency, offering our customers unique and exciting products, enhancing the H.Samuel and Ernest Jones websites, which were already the leading specialty websites in the UK.

Pound sterling costs were down with tight control being kept on expenses, which mitigated sales challenges.

As for the trading outlook, as in the US, the economic outlook in the UK is challenging. Gross merchandise margin expectation for fiscal 2011 continues to be somewhat below fiscal 2010's level. Pound sterling operating costs are anticipated to be slightly lower than in fiscal 2010, in line with our previous guidance.

Similarly, our expectation for the year-end change in space remains unaltered at a 2% decline. Overall, we believe the UK business is responding appropriately to the market conditions that it faces.

Stepping back and looking at Signet as a whole, we remain operationally focused on excellence, execution and on reinforcing our sustainable competitive advantages. As a result, we believe that we're positioned to gain profitable market share. Given our year-to-date net income performance, continued tight management of working capital and anticipated capital expenditure in line with guidance, we are increasing our expectation for free cash flow this year between $225 million and $275 million.

Operator, now we would be pleased to take any questions that anyone on the phone may have.

QUESTIONS AND ANSWERS

Operator

(Operator instructions) Rick Patel, Banc of America.

Rick Patel - *Banc of America - Analyst*

Can you share with us just how much diamond prices are up versus last year on your end of the quality spectrum? And is the August price increase intended to address higher diamond prices, or is that more in response to the higher gold cost that you're seeing?

Terry Burman - *Signet Jewelers Ltd. - CEO*

I'm not going to put an exact number on it because there are some competitive issues here, but the diamond prices are -- as we said on the conference call, they are above our last year's price, but they are still below our 2008 peak. The price increases are in response to a combination of a little higher than expected diamond prices, but primarily in response to significantly higher gold cost. Most of the price increases have come in categories that have a heavy, heavy gold component.

Rick Patel - *Banc of America - Analyst*

And is it safe to assume that you have the flexibility to raise prices again later this year or early next if costs continue to rise?

Terry Burman - *Signet Jewelers Ltd. - CEO*

I wouldn't expect us to raise prices again this year. Next year -- we will look at the whole situation next year, including our expectation for diamond and gold prices, but it's too early to do that right now. We'll take a good, hard look at it as we move through the fourth quarter and make any decisions that we have to make in January.

Rick Patel - *Banc of America - Analyst*

All right, and then, can you talk about the product performance for new launches like Color Obsessions, Charmed Memories and Neil Lane? Are they tracking as well as you would like? And how should we think about the rollout of those brands to more stores by the holiday season?

Terry Burman - *Signet Jewelers Ltd. - CEO*

We are rolling out Color Obsessions and Charmed Memories to all stores for the fall season. Neil Lane -- it's a little too early to start stressing that. The reason that we don't like to discuss it at this point -- again, competitively we just don't want to outline our game plan and our results and have our competitors be able to take advantage of that information. Neil Lane does have, and I would point out, however, that Neil Lane has a strong test going. And when I say a strong test, test in an elevated number of stores that we would normally test the program.

Rick Patel - *Banc of America - Analyst*

Great, thank you very much and good luck.

Operator

Jeff Stein, Soleil Securities.

Jeff Stein - *Soleil Securities - Analyst*

Terry, wondering, can you give us just some idea in terms of magnitude how much you intend to increase your ad spending in the fourth quarter this year?

Terry Burman - *Signet Jewelers Ltd. - CEO*

Well, as opposed to talking about the dollar increase, what I would say is that our weights are going to be at or a little above -- actually, just slightly above last year's level.

Jeff Stein - *Soleil Securities - Analyst*

As a percent of sales?

Terry Burman - *Signet Jewelers Ltd. - CEO*

As a percent of sales, it is -- are you talking about for the full year or just for the second half?

Jeff Stein - *Soleil Securities - Analyst*

Just for the second half of the year.

Terry Burman - *Signet Jewelers Ltd. - CEO*

As a percent of sales for the second half of the year, it will be up somewhat on last year.

Jeff Stein - *Soleil Securities - Analyst*

Okay, and as we look at SG&A expenses -- and I guess this one is a little bit more for Ron -- but your SG&A in dollars is about flat in the second quarter. If you were to remove the effect of currency, what kind of SG&A increase did you see year on year in the US division? And maybe you can talk a little bit about the expectation of what the run rate might be in the back half of the year.

Terry Burman - *Signet Jewelers Ltd. - CEO*

Sure. I'll let -- I'd like Ron to respond.

Ron Ristau - *Signet Jewelers Ltd. - CFO*

Well, first of all, the currency impact is de minimis, and I indicated that when I was talking about expenses, so there really is no significant currency impact to talk about. The US spending and spending in the UK is trending favorable to last year, and you would expect to -- you expect tight expense management to continue when you look into the second half. There's nothing going to change or, really, there's nothing in currency going on that's going to make us have a different outlook. The UK business has done a very good job of responding with expense management to the difficult and challenging environment they have placed, and in the US we have been able to -- even though the business is growing -- continue to keep those expenses under control and only apply incremental spending when there's something that affects us with sales increases, and of course, planned increases in advertising. (multiple speakers) so that's what I would expect as you look forward.

Jeff Stein - *Soleil Securities - Analyst*

If you remove the effect of the change in vacation policy, your expenses were actually down in the second quarter. So I'm wondering, was there any changes between Q1 and Q2, because your SG&A was up 2.5% in the first quarter, flat in the second quarter. You have an increase in marketing a little bit in Q4. I think Terry also alluded to the fact that there's going to be some merit pay increases as well.

So again, is the first quarter more indicative of the kind of year-on-year expense growth we should be looking at in the back half of the year, or is it going to be closer to zero or somewhere in between?

Ron Ristau - *Signet Jewelers Ltd. - CFO*

I think the way to look at that is we're going to be relatively consistent with what you've seen in the first half from a percentage performance perspective.

Jeff Stein - *Soleil Securities - Analyst*

Got it, and Terry, final question. Wondering if you could just make any comments at all on the status of the CEO search. Are you on track? How's it going? How many candidates have you talked to, and so on?

Terry Burman - *Signet Jewelers Ltd. - CEO*

Right, right. The search, as we said, is progressing. I really don't want to go into a blow-by-blow description of number of candidates, how often we've seen them, when we've seen them. As soon as we have something to say that's meaningful and definite, then we will announce it to the market as a whole. But it's just not appropriate in a search process to start giving a blow-by-blow description.

Operator

Bill Armstrong, C.L. King and Associates.

Bill Armstrong - *C.L. King and Associates - Analyst*

Good morning, Terry and Ron. In looking at your same-store sales and your average selling price increases, can we infer that the number of transactions was up in Jared and was down in the rest of the US as well as the UK?

Terry Burman - *Signet Jewelers Ltd. - CEO*

Well, the number of transactions in the UK was definitely down. In Jared, it was definitely up. If you start counting the charm sales, they're relatively flat in UK. The average selling price that you have is -- Ron, correct me if I'm wrong. Did we exclude the Charmed Memories from the average selling price in the mall stores?

Ron Ristau - *Signet Jewelers Ltd. - CFO*

Yes, we did.

Terry Burman - *Signet Jewelers Ltd. - CEO*

So, if you count -- I'm sorry to be going back and forth and addressing this on a different basis -- but if you count the number of transactions and include the charm sales in the mall stores in the US, you come up with about the same number of transactions. If you exclude the charm sales from the average selling price because it's got such a dramatic impact on the average selling price that we think it would be somewhat misleading.

Bill Armstrong - *C.L. King and Associates - Analyst*

So the number of transactions was flat if we include the charm sales and down if we exclude the charm sales?

Terry Burman - *Signet Jewelers Ltd. - CEO*

Yes.

Ron Ristau - *Signet Jewelers Ltd. - CFO*

Yes.

Bill Armstrong - *C.L. King and Associates - Analyst*

Is that -- okay, okay. On another topic, Truth in Lending, what has changed in that to prompt your lowering of your estimate of those costs?

Ron Ristau - *Signet Jewelers Ltd. - CFO*

Well, what's changed is that we now have actual experience and the laws have firmed up in August as to what is actually required of us. So we've just adjusted our cost estimates. We've previously thought $15 million to $20 million. We now think $15 million to $17 million. So it's really just a greater degree of certainty on our part relative to what's going to happen from a requirements perspective that has caused us to change them.

Terry Burman - *Signet Jewelers Ltd. - CEO*

There was also, Bill, a little better than expected -- than we expected -- ability to charge late charges.

Bill Armstrong - *C.L. King and Associates - Analyst*

Okay, and just to remind us, we should see that in the other income line item? Is that correct?

Ron Ristau - *Signet Jewelers Ltd. - CFO*

Yes, primarily it reflects the other income line item. That's where it flows through. There was a small impact in cost of sales, but the majority of it flows through other income.

Bill Armstrong - *C.L. King and Associates - Analyst*

So that really started to hit, or I guess it's just beginning to hit right now, and really didn't affect the first half?

Ron Ristau - *Signet Jewelers Ltd. - CFO*

No; in the first half -- the total impact in the first half was approximately $6.8 million, and we're projecting the range of $9 million to $11 million in the second half. There is some timing to that.

Bill Armstrong - *C.L. King and Associates - Analyst*

I understand, okay. Yes, that's all I have, thank you.

Operator

[Daniel Fisher], Wells Fargo.

Daniel Fisher - *Wells Fargo - Analyst*

I didn't catch exactly some of the stuff with the credit card, but I was wondering how much your ability to advance credit internally has given you a competitive advantage in the marketplace versus your competitors.

Terry Burman - *Signet Jewelers Ltd. - CEO*

We don't know what our competitors' authorization rates are. We only get one competitor, Zale's, (technical difficulty) credit sales on an annual basis give us some little clue of that. But everything you see, read and hear and that which we are hearing in the marketplace indicates that approvals from third-party credit providers like banks are down and that consumers are having a more difficult time obtaining credit for their purchases.

Our credit sales, as you can see as a percentage of total, are the same as they were last year. So we've been able to maintain our -- not our approval rates, but at least our ability to authorize credit and experience credit sales at the same rate as we have last year. So that's not an issue for us. We believe that we are taking some market share from our competitors, some probably more than others, depending on their experience with their third-party provider and what their third-party providers' policies are. But it would be different for different retailers.

The thing that we've always stressed is that carrying your own receivables and making your own receivables decisions are an important aspect of the business, as credit is so integral to the middle-market jewelry sales process. This environment that we've been in for the last couple years is a perfect example and illustration of that belief becoming very apparent to most everyone who looks at the business. That is (technical difficulty) upgrade our receivables portfolio in the best interest of our business, whereas third parties' receivable portfolios are going to be operated in the best interests of the third-party provider.

We've always said it's a competitive advantage, we maintain that it's a competitive advantage, and we think it's being illustrated right now.

Operator

David Wu, Telsey Advisory Group.

David Wu - *Telsey Advisory Group - Analyst*

I have two questions. First, can you provide any color on how sales trended through the quarter in both the US and the UK? And just secondly, with respect to advertising this holiday season, are you planning any meaningful changes as to the allocation of ad dollars between print and TV?

Terry Burman - *Signet Jewelers Ltd. - CEO*

Let's see. As far as ad dollars, they are broadly allocated the same as they were last year. And then, in terms of sales guidance in the quarter, no, we don't comment on that. The reason we report quarterly is we believe that month-to-month shifts are not necessarily indicative of our trends. We think that the quarters give a better signal to the market in terms of our trends, so we have avoided making or giving any color on individual month-to-month sales trends.

David Wu - *Telsey Advisory Group - Analyst*

Great, thank you.

Operator

Valerie Brown, AllianceBernstein.

Valerie Brown - *AllianceBernstein - Analyst*

I have two questions, the first is about Jared. I was looking at the comp number, which is quite impressive, indicating that your higher-end consumer is coming back into the jewelry market. But I was trying to understand, if you look at that year-on-year comp, that does include the charm bracelet category, I believe. And I was trying to understand what the comp is excluding the charm bracelets.

And then on credit, I wanted to better understand your approval rate and whether that has changed in the quarter and if there have been any impact from the Truth in Lending Act on top-line growth in the form of lost sales.

Terry Burman - *Signet Jewelers Ltd. - CEO*

I'll take the first question, about Pandora and charm bracelets, and then Ron will take the receivables question.

We don't break out Pandora as a percentage of our sales (technical difficulty) competitive issues.

Secondly, we don't break it out because we don't know -- there could be customers in our stores who are shifting categories. So if we just gave you the total of Pandora sales, we don't believe that that's all incremental. But basically, we just don't break it out completely. We do believe, however, that Pandora has helped boost our comparable store sales totals. Ron, if you will take the receivables?

Ron Ristau - *Signet Jewelers Ltd. - CFO*

Yes, as to the second question, on receivables, as Terry indicated, we do continue to believe it is a strong competitive advantage. We have not seen a material difference in our approval rates, and I would just point to the fact that our credit participation level remained at 56% of sales versus 56.2% of sales. So it continues to be important in driving the business. So no material changes in approval rates -- some, but nothing material.

Valerie Brown - *AllianceBernstein - Analyst*

Thank you. Yes, on top -- so, there were no sales that you sort of shut down because they were no longer profitable, given the Truth in Lending regulations?

Ron Ristau - *Signet Jewelers Ltd. - CFO*

Oh, I'm sorry. Let me answer that; I missed the question. We continue to look for -- we try to find where bad debts are coming from all the time. So we do try to refine our models and the examination of the files and people that we do grant credit to. But on an overall basis, it hasn't changed materially, although we are able to better identify where credit risks could be and are able to be more intelligent about the granting of credit, not just a natural outgrowth of our review and improvement of the process in a more stable unemployment outlook, so we can get a little better at that. Does that make sense? Does that answer your question?

Valerie Brown - *AllianceBernstein - Analyst*

Yes, thank you.

Operator

Katharine Wynne, Investec.

Katharine Wynne - *Investec - Analyst*

I just wanted to follow up on the bad debt. I obviously appreciate that the step change happened in Q4 last year, so we'll be anniversarying that in the second half. As we stand, looking ahead, would you be budgeting to maintain the current trend, or would you anticipate, given the environment, that there might be risk of some deterioration?

Ron Ristau - *Signet Jewelers Ltd. - CFO*

Well, I think what we've said about that is that we believe the comparisons in the fourth quarter get a little more difficult or the improvement -- more difficult to predict the rate of improvement in the fourth quarter because there was some improvement already occurring last year. So I think that that is a clear statement to be careful about projecting the rate that we have currently incurred through the remainder of the year. We're, certainly, cautious about that, because of that phenomenon.

Operator

(Operator instructions) Anthony Lebiedzinski, Sidoti & Company.

Anthony Lebiedzinski - *Sidoti & Company - Analyst*

I had a question on the credit participation. Do you expect that to perhaps increase over here, or do you expect that to be relatively stable? One of your online competitors cited the lack of credit availability, for instance, as a headwind to their sales. How do you see credit participation going forward?

Ron Ristau - *Signet Jewelers Ltd. - CFO*

Well, I guess I could just speak to credit participation going forward by pointing to what's been happening, and what's been happening is it has been relatively consistent. And again in the second quarter, 56% versus 56.2%, and year-to-date it has actually been flat at 53.6% of sales, which is exactly the same as last year. The availability of credit is not a headwind for us because we do manage this is an integral part of our process. So we do not face, as Terry indicated, some of the same headwinds that competitors who do not have in-house credit face at this point in time.

Anthony Lebiedzinski - *Sidoti & Company - Analyst*

And also, your jared.com website has the build-a-ring feature. I was wondering how much of your sales actually, from the fact that people would use that feature on their website and then go and pick up the ring in a store, and whether you view that as a competitive advantage, I guess, so it would be yes.

Terry Burman - *Signet Jewelers Ltd. - CEO*

Yes, we do view it as a competitive advantage. I think anytime you have a bricks-and-clicks/brick-and-mortar and an online presence, we believe that there is a competitive advantage there. When we put the build-a-ring feature on our website, sales of that category, of those diamonds in-store, also increased.

Anthony Lebiedzinski - *Sidoti & Company - Analyst*

As far as your free cash flow guidance, you increased that this morning. Can you go over the details of driving that increase?

Ron Ristau - *Signet Jewelers Ltd. - CFO*

Yes, I will. Again, as I said, the free cash flow improvement is driven by improvement -- if you look at the year-to-date report that we put out, you will see the income, the net income and the operating performance of Company is driving a big piece of that, as well as continued improvement in working capital management, primarily driven year-to-date by the inventory. So those two things are combining to give us a very, very strong position. Our free cash flow came in at $240 million versus $277 million, which year to date is a bit stronger than we originally anticipated it to be. So we are very encouraged by that, and that led to our increase in our guidance this morning.

Operator

(Operator instructions) Ben Spruntulis, Citi.

Ben Spruntulis - *Citi - Analyst*

Just a question, Terry, on your comments on the limitations on space growth, in particular, the not being able to hit your current hurdle rate. Can we just talk a little bit more about what's causing this? Is this lack of new development? Is it the quality of real estate available? Is it the toughening macro, or have you changed your hurdle rates? If you could just give us a bit of color around that.

Terry Burman - *Signet Jewelers Ltd. - CEO*

Right. Our hurdle rate remains the same as it has been for the last 15 years, is at 20% IRR on a five-year DCF basis.

There's two issues with real estate. One is, developers aren't developing many new shopping centers in this environment. Therefore, there's less space available from which to select. I've read some reports that development is 20% of that which it was about three years ago. That's anecdotal, but I read that in a real estate magazine. Whatever it is, it's less than it was in more robust times.

The second issue is the [projection] of sales, which drive -- and sales per door are the primary driver of operating margin, therefore return on investment. The amount of sales that we are predicting per store has been impacted by the severe downturn in consumer spending over the last couple of years; therefore, you can see it in our average sales per door. They are down from where they were three years ago.

So as we predict sales, profits and returns, we are predicting at a stressed level or a lower level than we would have been predicting (technical difficulty) years ago because of the macro environment. And that factor, it's just the sales factor, is the issue that has made it more difficult to hit returns.

Now, one of the -- another factor would be higher bad debt levels that we also have to build into our P&L models. Now, as the sales are recovering, the bad debts are recovering and we have other expense reduction offsets, the sales don't have to get back to the average sales per store that they were three years ago for us to clear a hurdle. But the sales need further recovery for us to be more robust in our projections and be able to open more stores.

Ben Spruntulis - *Citi - Analyst*

Thanks, that's very clear. Another question I had was on price rises in US this year. I just wanted your comments on what you are seeing from competitors, given the market is still very tough out there. Are you seeing inventory clearance? Are you seeing disruptive pricing within the competitive environment, and does that make putting through selective price rises this often -- does that make that process more difficult?

Terry Burman - *Signet Jewelers Ltd. - CEO*

No, I think, in the US and in the UK, we think our observation has been that, in general, the market has followed our price increases. Of course, we can't speak to and we don't shop every single independent jeweler. But in general, we think that the market has increased in line with the levels of increase that we've put through. And we don't see any irrational promotional activity going on. I think promotional activity, for all of us, probably for all retailers, is up above where it would have been three or four years ago. But it has not risen to the level of irrationality, and I don't think we've seen an elevated level this year over last year.

Ben Spruntulis - *Citi - Analyst*

Fantastic, just a final question from me -- just in the UK, your second-quarter costs look to be significantly down in the quarter. If you could just give some colors on the areas for those savings and whether we should expect a similar level of benefit in the second half?

Ron Ristau - *Signet Jewelers Ltd. - CFO*

Well, I think that the savings are across many aspects of the business, as they have reacted appropriately to the business environment they've been faced with. We would expect that those levels of savings would continue into the second half of the year, not that they would be exactly the same. But yes, the diligent and tight managing of expenses in the UK as a reaction to the business climate that they face is part of our ongoing approach to the business. So we should expect to see that.

Operator

(Operator instructions). As we have no further questions at this point, I'd like to hand the call back over for any additional or closing remarks. Thank you.

Terry Burman - *Signet Jewelers Ltd. - CEO*

Thank you all for your questions. We hope to see a number of you at the William Blair Emerging Growth Stock Conference in New York on Tuesday, October 5. Our next results call for the third quarter is scheduled for November 23. Thank you again for participating and good bye.

Operator

Ladies and gentlemen, that will conclude today's conference. Thank you for your participation. You may now disconnect.