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JWN.N - Q2 2020 Nordstrom Inc Earnings Call

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OVERVIEW:

Co. reported 2Q20 loss per share of $1.62 and total sales decline of 53%.

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PRESENTATION

Operator

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

At this time, I'll turn the call over to Trina Schurman, Senior Director of Investor Relations for Nordstrom. You may begin.

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

Good afternoon, and thank you for joining us. Today's earnings call will last 45 minutes and will include approximately 30 minutes for your questions.

Before we begin, I want to mention that we'll be referring to slides, which can be viewed by going to the Investor Relations section on Nordstrom.com. Our discussion may include forward-looking statements, so please refer to the slide showing our safe harbor language.

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

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

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

Good afternoon, and thank you for joining us. Before discussing the quarter, I'd like to take a moment to share our approach to managing through this current environment.

We're pleased with how we executed our plan for Q2. At the onset of the pandemic, our primary objective was protecting and enhancing liquidity. Given the uncertainty over how long our temporary store closures will last and with inventory as our biggest investment, we took decisive action to minimize risk and stabilize our business.

In the first quarter, we significantly reduced inventory levels by more than 25%, allowing us to mitigate markdowns and bring in newness for customers. As the pace of change in customer behavior continues to accelerate, we also took proactive steps to execute our strategic plans with greater speed. This included restructuring our organization and permanently closing 16 full-line stores, which contributed to overhead cost reductions of nearly 20% in the second quarter.

From a top line perspective, we achieved our expectations and identified opportunities to drive further improvement. Our streamlined operations and inventory position gave us flexibility to bring in new and relevant product. While inventories were constrained and we left some demand unmet, our decision to be prudent with our inventory plans helped deliver better-than-expected merchandise margin, earnings and operating cash flow. We exited the quarter in an advantageous position, with inventories clean and with open to buy to capture customer demand.

We increased receipts in July as we geared up for our Anniversary Sale that began on August 4. This is our largest event offering new arrivals at limited time savings. We're in the final week of the event, and results are in line with our expectations, reflecting a notable sequential improvement in Full-Price sales trends. In Off-Price, traffic remains consistent, and we're starting to see steady improvement in conversion and sales as we begin to flow in inventory receipts.

In our digital businesses, traffic grew by double digits year-over-year and sequentially improved from Q1, indicating signs of increasing customer demand. As we experienced last quarter, we had more than 50% growth in new Nordstrom customers through our digital platforms. We also increased customer engagement of contactless services such as curbside pickup and returns, which represent 1/4 of order pickup volume. In total, order pickup is approaching 15% of Nordstrom.com sales.

With our financial position strengthened, we're now pivoting to prioritize market share gains and profitable sales growth. This includes building on our heritage of service to accelerate growth initiatives. We made foundational investments in our market strategy, our Nordstrom Rack brand offering and digital capabilities to scale our business.

As we look ahead, our team is unified in executing our market strategy to deepen customer engagement with a focus on offering a seamless and personal experience however they choose to shop with us. In 5 of our top markets, we're providing customers with greater merchandise selection and faster delivery while increasing engagement through services. We're on track with our plans this year to scale our strategy to 10 total markets that account for over half of our business.

To summarize the quarter, we executed on our operating plan, delivering earnings and cash flow well ahead of our expectations. Through our inventory and expense discipline, we improved merchandise margins and achieved greater operational efficiencies on a lower cost structure. Ending the quarter with $1.3 billion in liquidity, we generated more than $185 million in operating cash flow, realigned inventory levels and reduced overhead expenses by nearly 20%.

Our Anniversary Sale is an important opportunity for us to provide a one-of-a-kind experience for our loyalty customers while introducing new customers to Nordstrom. Due to COVID-19, we moved our event from July to August to help ensure the safety and comfort of our customers and employees and to deliver the most relevant merchandise assortment.

Our approach to planning and executing Anniversary reflects how we're leveraging our customer insights and enhanced agility to drive both top line and profitability during this important period. We took actions to meet evolving customer preferences by expanding our assortment to reflect growing preference for categories focused on casualization, comfort, wellness and home. For the first time, customers could preview items through a digital catalog and build a wish list to enable them to check out faster when it was time to shop. Our customers created nearly 20 million wish lists, which was not only a great way for them to engage early, but also allowed us to adjust in real time to high demand items.

For holiday, we plan to continue to build on last year's success, with an emphasis on expanding our assortment of giftable products with greater breadth at lower prices and across categories. We're focused on making it festive and easy for customers to shop by emphasizing our convenience services and experiences in stores and online. Using an approach similar to what has been successful in Anniversary, we will continue to leverage data to inform our assortment and categories that are resonating with our customers.

Our unique business model is a competitive advantage. We are building on the strengths of our Nordstrom and Nordstrom Rack brands seamlessly across stores and online to serve customers on their terms through a combination of convenience and connection. We expect to deepen our relationships with existing customers and attract new ones, driving market share gains and profitable growth.

We have also worked for the last several years to create a more flexible organization. With the resetting of our base cost structure, we have become leaner and more efficient. When combined with the capital structure that provides a strong foundation for reinvestment, we are well-positioned to respond quickly to a period of accelerated change in customer behavior. We look forward to providing additional details on our growth strategy at our virtual investor event later this year.

Finally, I want to thank our entire team for their dedication and commitment to our customers. Our brand is defined by the exceptional service that we strive to provide for customers. Thanks to the hard work of our people throughout the company, we believe we will successfully emerge from this pandemic in an even stronger position to serve customers.

I'll now turn it over to Anne to provide additional insights into our financial results.

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

Thanks, Erik. As we continue on our recovery path, we're confident in our ability to deliver sequential improvement in our business. Our capital structure and liquidity position provide a strong foundation as we build on the success of our market strategy and further leverage our strategic investments to drive sustainable long-term growth.

For Q2, we reported a loss per share of $1.62, an EBIT loss of $370 million, including COVID-19-related charges of $0.08 or $23 million, primarily associated with corporate asset impairments. Earnings, cash and liquidity came in well ahead of our expectations driven by improved merchandise margins and significant reductions in our overhead costs.

We benefited from the continued progress we are making on permanently reducing our cost structure. In addition to planned expense savings of $200 million to $250 million at the beginning of the year, we're continuing to execute cash savings across expense, CapEx and working capital of more than $500 million net of COVID-19-related expenses. Tracking ahead of our plans, we realized $420 million in cash savings year-to-date.

Turning to our financial position. We ended the quarter with $1.3 billion in liquidity, including $1 billion in cash. Despite our stores being closed for roughly 50% of the days in Q2, we generated operating cash flow of more than $185 million, enabling us to pay down $300 million on a revolving line of credit. From a capital allocation perspective, our long-term financial principles remain the same. While we reduce our annual CapEx plans by roughly 30%, we're continuing to invest in technology and supply chain to provide a seamless digital and physical customer experience and drive profitable growth.

Turning to sales. Our Q2 decrease of 53%, reflected extended store closures in our East and West Coast markets that have been more impacted by COVID-19. Our results also included a timing shift of approximately 10 percentage points from moving the entire Anniversary event from Q2 into Q3.

Overall, sales were in line with expectations. Full-Price sales decreased 58% or in the mid-40s range when excluding the Anniversary shift. Off-Price sales decreased 43%. Across both businesses, top-performing categories included home, kidswear, accessories, beauty and active.

Our initial store reopening trends improved from May into June and were slightly above our expectations. In addition, we had fewer merchandise returns than we expected, which benefited sales and merchandise margins. From a store traffic perspective, while we saw deceleration in July with the surge in COVID-19 cases in several of our larger markets, overall traffic trends have stabilized and improved.

Our digital sales decrease of 5% was impacted by the Anniversary shift. Excluding this shift, digital sales grew approximately 20%, reflecting a benefit from lower merchandise returns. Conversion and demand trends were suppressed as a result of the constraints on inventory flow that Erik mentioned.

Moving to gross profit. Our rate was 21%, down from 35% last year due to planned markdowns and deleverage on lower sales volume. Merchandise margin trends exceeded our expectations and improved relative to the first quarter. We attribute this to our efforts to significantly reduce inventory levels in Q1 to mitigate markdowns on out-of-season merchandise. We exited Q2 in a clean position, with the inventory decrease in line with sales when excluding the Anniversary shift.

In SG&A, expenses decreased approximately 33% from last year when excluding COVID-19-related charges. This was primarily driven by lower sales volume and reduced overhead costs of nearly 20%. Most of the reductions to our cost structure are permanent, positioning us well for improved EBIT flow-through.

As we head into the second half of the year, we're continuing to take a flexible and prudent approach to planning our business. Given the highly uncertain environment, we are prepared for a range of scenarios to ensure we can sustain and grow our business. We're confident in our ability to continue developing critical enablers of the customer experience while maintaining the ability to adjust quickly. Based on current trends and our inventory plans, we're expecting sequential and gradual improvement in sales, earnings and cash flow in the back half of the year. These expectations incorporate the Anniversary shift, our stores remaining open, a continuation of increased inventory receipts in Full-Price and a steady flow of inventory receipts in Off-Price that began this month.

In closing, our actions to shore up our financial position in the first half of 2020 allow us to head into the second half of this year and prepare for 2021 from a position of strength. We have accelerated our long-term strategic plans by optimizing the mix of physical and digital assets and increasing our agility through a leaner and more efficient organization. We've made meaningful reductions to our cost structure, enabling us to drive higher profitability during our sales recovery. Over the near and medium term, we're focused on reinvesting in our strategic growth priorities to deliver a best-in-class customer experience while maintaining a strong balance sheet. As we emerge from this disruptive period, our ambition is for Nordstrom to be positioned as a retail winner by gaining market share and driving profitable growth.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

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

(Operator Instructions) Thanks.

Operator

Your first question comes from the line of Omar Saad with Evercore ISI.

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

I know you guys are one of the most digitally-sophisticated retailers out there, plus 20% e-com digital growth excluding the Anniversary Sale shift is impressive. Do you think that the growth in that business is being constrained more by the inventory and logistics constraints you're talking about? Or is it more the lower exposure you guys have in the merchandising to home and athletic and active, which seems to be the kind of the hottest categories that are out there right now? And are there plans to kind of shift the merchandising accordingly? Or do you think there's going to be a rebound in fashion in kind of your core areas of strength?

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

Omar, thank you for the question. So Erik, why don't you take the first piece on the digital components of what we saw? And then Pete, maybe you can talk a little bit about how we're thinking about the assortment.

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

Yeah. Hey, Omar. Yes, certainly, the inventory subjects cut across stores and online. Those subjects include flow, but they also include, I think, to your point of how we're invested by category.

There's no doubt that the pandemic significantly shifted demand by categories, and one of the aspects that we really feel great about our performance over the last quarter is not just the overall inventory dollar reduction but where those dollars are invested. Anniversary Sale reflects a significant adjustment in where we place our inventory dollars to get into those categories that are hotter, and it's [certainly] (corrected by company after the call) categories like grocery and home that's has been successful for retailers since last quarter. But within what we sell, we have a home business that's growing nicely. There are plenty of categories that we've been able to adjust our investment, and we're seeing great signals from customers and can adjust into that.

So there is some effect of inventory in our digital businesses, certainly. And as flow improves, and it is improving in the last couple of weeks, it gives us confidence going forward, that coupled with the investments we've made in digital, not only in our site but also the digital connections to our physical assets.

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

Yes. I'll give a little color on just what's happening relative to the product. And we've been on the path for a while about the casualization generally of America, what's happening with our customers. So that's -- it's not surprising that we find that to be an amplified situation right now, so we pivoted to have more of a casual offer.

And I think the good news for us is we have quite a bit of breadth to our product offering in the first place, and it allows us a lot of flexibility, the fact that we're leaning into this digital first. We're getting a lot of very clear signals about what's relevant and meaningful to our customers in this moment. So to Erik's point, we were able to make some adjustments even at a really late date with our Anniversary offering. And again, you talked about clear signals, I mean we're seeing it, and we're having some outsized performance in things like active and home and what have you, and it gives us a lot of confidence on what's going to happen here going in the second half of the year because we are in such a clean inventory position. It gives us that flexibility and the opportunity to respond in a way that's customer first.

Operator

Your next question comes from the line of Ed Yruma with KeyBanc Capital Markets.

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

I guess on Rack, given that there seems to be excess inventory really across the industry, can you kind of help us understand what buys have looked like if you've been able to be opportunistic?

And just one quick housekeeping question. The return-reserve liability, was that a reversal in the second quarter? And I guess how does -- are there any implications for the third quarter?

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

Yes. So Erik, why don't you take the Rack question, and I'll do the sales -- return-reserve.

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

Sure. So we really look at our total business as being connected and synergistic, so we have this robust Off-Price business that has both stores and online component, but it's not a stand-alone business. The roots of our Rack business is in more efficiently clearing out inventory from our Full-Price business, allowing us to flow in new merchandise. So this is certainly a time for us to leverage that capability, that asset, to look at our inventory health overall across our company, and our Rack team played a huge part in getting us into the clean inventory position that we enjoy being in right now.

As far as access to product, it's been a little spotty. There's no doubt that our vendor base has pulled back during the pandemic, and it takes a closer collaboration with our vendor partners in many cases to get the flow that we want.

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

Yes. So on the return-reserve, as you know, we go through a process every quarter and we look at what digital sales we have, and we use data and analytics to have predictive models, what gets returned. That's what we record as a net sales item. And so as we saw this through the quarter, we did see the returns coming in less than what we had anticipated, but we do a true-up of that every quarter and look at forward pieces of what's been filled digitally as well.

Operator

Next is Oliver Chen with Cowen.

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

As we approach holiday in the back half, how would you characterize some of the main differences in your strategy given how impressive the environment is with your holiday planning? And in the context of that question, value and affordability are really important to the consumer. So what are your thoughts on best positioning your business with that mindset as well?

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

So Pete, why don't you take that and talk about how we're thinking about the holiday offering?

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

Yes. I think what's really encouraging for us relative to holiday is a continuation of a plan that we've executed on and learned from last year, and that was to be more relevant in gift-giving categories, and that has to do with exactly what we're selling, but it's also the price points as well.

So we -- before the pandemic came in, we had a pretty clear path of where we thought we could be successful there. And I think particularly in this moment when there's more sales being done digitally, we have the opportunity to expand our offer because you're not limited by floor space and things like that on the floor, so I think it actually lends itself well to being opportunistic around the holiday time around gift-giving.

So that's going to happen. And then again, the whole idea about relevant products for customers just along the themes of casualization and active and wellness and what have you and the clear signals that we're getting. We feel like -- we don't have all the time in the world, but we have some time where we can amend what we have going on, and the fact that we're open to buying and in a good inventory position is super positive.

Operator

Next is Simeon Siegel with BMO Capital Markets.

Simeon Avram Siegel - *BMO Capital Markets Equity Research - Analyst*

Everyone, hope you and your family are doing well through this. Anne, nice job on the sequential merch margin improvement. How were the merch margins year-over-year? And then what's the expected merch margin impact from the Anniversary Sale timing shift between 2Q and 3Q? And then just could you help frame the lean inventory between what you pulled back intentionally given the expected trends versus maybe more of the external supply constraint and where you expect inventory to go for the rest of the year?

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

Yes. So let me just take a step back and talk about this in broad context. So we have planned the markdowns, and from a margin perspective, that came in better than we anticipated, certainly more markdowns than we had last year, but definitely, the merchandise side of it came in better simply because we got through so much inventory that was seasonal in Q1 and we think got more value out of that inventory. And then we're very prudent on the inventory choices that we've made for Q2, partially because we really want to make sure we were set up in the transition period for fall in the second half of the year.

As we think about the shift in Anniversary, and we're not giving a lot of -- we're not giving forward guidance, what I will say is more broadly, we expect given flow and given the shift in Anniversary and given the fact that stores -- we're planning for stores to be open in the second half that we expect sequential improvement, both top line from a margin perspective and from a cash perspective in the second half of the year.

From an inventory perspective, again, we were very prudent in how we thought about this. Our plan was, quite frankly, to just focus on preserving cash and liquidity and really looking at how to best manage the biggest investment and risk that we have, which is in inventory, primarily seasonal inventory, and we were really pleased with how we executed against that.

Operator

Next is Sarah Goldberg with Baird.

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

I just wanted to ask on the timing of the holiday season. We've heard some other retailers discuss expectations for an earlier start, and I was curious what your thoughts are there and how you're planning for that.

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

Pete, can you want talk a little bit about how we're thinking about setting holidays?

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

Yes. We've had this long-held tradition that we don't decorate our stores until after Thanksgiving, and that's -- it may be the thing that we get more positive comments about from customers than anything else we do, but that doesn't mean that we shouldn't be in a position of selling customers what they want when they want it, and I think it's pretty clear that there's an opportunity for us to sell gifts prior to Thanksgiving. And so when we talk about an extension of the -- what we've learned already from our gift-giving strategy last year, that was one of the key takeaways. So we're going to be bringing in gift offerings before Thanksgiving and having it clear to customers that we have that. So again, I think it represents a pivot to growth and the opportunity that we have that makes us feel good about how we can bend the curve and the trend that we've been living with here for the past few months.

Operator

Next is Paul Trussell with Deutsche Bank.

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

Yes. Wanted to just maybe better understand how you were -- had you kind of planned the Anniversary Sale on a year-over-year basis? And maybe just talk in a bit more detail on the learnings and what you've seen so far.

And then in addition, you have a slide discussing the market strategy, just be curious on any other color that you could provide on how execution is going, anything in terms of performance of the 2019 markets that were converted and just where you are in the process on the 2020 class.

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

Paul, so there was a couple of questions in that. I think we're going to focus on the planned Anniversary Sale learnings, and I think what we're really going to focus on is how we thought about this from a category perspective and some of the learnings that we're seeing on that. Pete, do you want to take that?

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

Yes, I do. This was a year when whatever we may have done in the past from a legacy perspective, Anniversary got turned on its ear, and I give our team a lot of credit for being nimble and thinking about it in different ways. So as we were working to rightsize our inventory, we also scrambled to do what we can to bring in relevant categories. And as I've mentioned before, it's just a confirmation of the casualization trend that's happening broadly. And as you look at our results so far, sales is not over, but there's so many clear signals about the brands that are performing well and the type of classifications and categories that I would say probably the biggest benefit we get -- well, there's 2 big benefits of what's happening in Anniversary. First of all, the fact that we're selling through at a higher rate than we've ever sold through before sets us up super well from a profitability standpoint as we get in Half 2. That's number one. But secondly, you're also getting a clear signal from customers about, again, just relevant categories, brands and products. And so while Anniversary isn't always a perfect indicator of what's going to happen in Half 2, I think what we're learning now, it gives us, again, increased confidence that we're on the right track about how we can amplify categories like active and home and wellness that relates like to a lot of the beauty that we carry.

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

Erik, do you want to give some color on the market strategy?

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

Yes. Obviously, COVID has added a lot of bumpiness, to put it mildly, to our business. But it has been clear for some time that where we have rolled out market strategy, those markets have outperformed our other markets. So we rolled out 5 markets of our top 10 the back half of last year. We are on pace to roll out 5 more in the back half of this year. And it's -- I would say that the pandemic is just, to clarify, that this is the right strategy. It was working pre-COVID, but it is the right strategy in giving customers greater inventory choice, faster delivery, more ways of obtaining their product and engaging in services that we know really resonate with our customers.

Operator

Next is Dana Telsey with Telsey Advisory Group.

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

I hope everyone is safe and healthy. As you reopened the stores of both the full-line and the Rack stores, and now that there's been a period that they've been open, pent-up demand has been satisfied, what's the biggest difference you're seeing between the 2 concepts? And what are you seeing in terms of the regions which do have spikes in COVID? And just lastly, with the store closures that are going on, are you seeing the transfer of sales like you had expected?

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

So Erik, do you want to talk a little bit about what we're seeing in inventory performance in Rack?

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

Yes. It's -- our stores didn't open up all at once. It was a very localized decision, and we did have a few close again for a small amount of time, but almost all of our stores are open now. There's some difference when there's been COVID outbreak spikes by market. But overall, the traffic trends in both Rack and full-line have been very consistent, and we're seeing slightly better traffic trends in Rack than full-line stores but not significantly so.

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

And the transfer of sales from any stores that are closing, how is that going along?

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

Dana, let me take that one. It's a little early to tell on that. I would say that there's lot of noise going on right there -- out there right now. So I think it's a little early, but certainly, our expectation is that, that transfer will happen.

Operator

Next is Matthew Boss with JPMorgan.

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

Maybe on the cadence of reopened sales performance at Full-Price, could you just elaborate a little on the magnitude of the July moderation that I think you mentioned? I think on our math, reopened stores, roughly negative 40-some percent. Just curious where you stand today on store performance in reopened locations and how best to think about the gradual improvement that you cited over the course of the remainder of the year.

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

Yes, Matt. Well, so let me take a stab at that. And then if others want to chime in, they can. So in general, we did see a moderation in traffic in July in our stores, especially in these markets that have some spikes in COVID. As we talked about, it's a little -- there's a lot of noise, especially in full-line given the shift of Anniversary. In general, for the quarter, Anniversary views, excluded that shift, was in the mid-40s, and Off-Price was down 43% in sales. And as Erik mentioned earlier that the stores really opened up in very different ways, so it wasn't like you had a big rumble, a big bang all at once. So I would say that the Off-Price did a little bit better than Full-Price for total sales but kind of still in the ballpark on it.

So as we've talked about going forward, as we've seen inventory flow in for the Rack, we're seeing traffic stabilize for our Off-Price business. We're seeing higher conversion, and people are really pleased with the inventory product. And we've also talked about the fact that we're seeing really high sell-throughs in our Anniversary Sale, higher than we've ever seen. So we're very pleased with the last couple of weeks as we see inventory flow, newness coming in and a shift in some of the categories.

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

Yes. I would just add. It's -- we have seen improved trends in the last several weeks, and it's not because traffic has changed. Traffic has been pretty darn consistent, but it is what gives us confidence that we see our top line trends improving and taking advantage of the position that our teams really worked hard to be in over the last quarter, both with our cash position, our inventory position. As we're flowing in product because we're open to buy and can, we are seeing improved top line in both full-line stores and Rack stores.

Operator

Next is Paul Lejuez with Citi.

Paul Lawrence Lejuez - *Citigroup Inc., Research Division - MD and Senior Analyst*

I wonder if you could talk about the credit revenue decline, curious if that's simply related to the sales decline. Or anything you could talk about on the portfolio, whether you're seeing higher charge-offs or maybe early paydown of balances?

And then second, what percent of your business would you say is exposed to back-to-school? And any color you could provide in terms of what you're seeing in those categories?

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

Paul, let me take the credit question, and then Pete can talk to you a little bit about back-to-school. So in general, the credit revenue is really in proportion to total retail sales being down. I would say that we're overall pleased with the strength of our portfolio, our credit portfolio. We are seeing customers pay their cards. We're seeing them staying current. And so overall, we think we've got a pretty healthy customer portfolio.

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

It's a great question about back-to-school. And again, I would rewind the tape from before COVID happened. Back-to-school is not exactly what it used to be because it used to be that kids were very specific clothes to school that were very different from what they were at any other time. And unless the kids are in private school and uniform, that's just not true.

But what happens with kids that is great and makes it a durable business is kids keep growing regardless of pandemic, regardless whether in a physical school or not. So we've had good kids results. And it's clear that if we have the relevant product for kids, there is upside potential for us in kids, and that's another place where we've gotten some clear signals.

So yes, I don't -- it's -- we have a sizable kids business, particularly we have a pretty big kid shoe business, but I don't think the physical school part of it is much of a limiting factor. It's our ability to make sure we're in relevant product as those kids grow and they need new clothes.

Operator

Next is Michael Binetti with Crédit Suisse.

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

I think just 2 quick ones. I think you mentioned that returned product was a bit lower than normal and helped revenues and merchandise margins in the quarter. Can you help us understand how much that contributed maybe versus last year and maybe if you think there are any parts of that, that are structural versus just COVID-related behavior changes that could be more temporary? And if any of that could remain low like new categories that you guys are pushing harder into that could be less likely to be returned or anything?

And then I wanted to ask you about the -- I guess on the digital business. When you think of the KPIs of some of the digital-only businesses report like order growth rates, average order values, unit per transactions, when you look through the lens of those metrics, how would you help us understand the 5% reported digital decline versus the 50% new customer growth rates? What are some of the biggest differences in the profile of the new customers versus your loyal customers that help us think about how that new customer, I guess, grows up with you?

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

Yes. So I'm going to take a quick stab with the return question you had, and then I think what Erik can do is just talk in general about how we think about our digital business and what we're seeing in the new customer acquisition side.

In the return product, it's -- we're seeing -- we're not seeing the inventory come back. It did help sales, it helped margin. It actually hurt inventory because we had anticipated that inventory was going to come in. We would take the markdown on it, but we would have more -- you would sell it again in that process. So the good news is it was better from a sales perspective. The offset to that was that we didn't have as much inventory coming back in as we thought we would.

From a category perspective, that is the other piece that we are seeing, is that with different price points and in certain categories like active, it tends to be categories that customers return less. And so it's early days as we read through those return metrics of that data, but that is something that we are keenly watching. Erik, do you want to go a little bit about how we think of the digital business?

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

Yes. I mean there's no doubt the funnel is different than pre-COVID. There's clearly a lot of customers shopping online. We didn't do much online shopping pre-COVID. There's also a big difference in categories and a big difference in price. So the result of that, our units per transaction are up, our average unit price is down, and some of that is a reflection of, I think, clearing out of inventory. Some of it is a shift in categories that we think will last a little longer than just Q2. But the encouraging thing for us is the engagement. If we can get new customers in, engage with them really regardless of what their transaction is, we feel really good that we can continue that engagement, be it online or in stores or increasingly services like buy-online, pick up in store or our quickly growing curbside services.

Operator

Next is Chuck Grom with Gordon Haskett.

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

Just the inventory levels are in great shape here than 24%. Just wondering if you guys can just hold our hands on the gross margin line and think about the puts and takes, particularly the shift to the Anniversary and also the fourth quarter with the holiday.

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

Chuck, so thanks for the (inaudible) inventory. We feel really good about where we finished the quarter as we continue to bring newness in for Anniversary Sale and for our Off-Price business.

From a gross margin perspective in Q2, it was -- some of it -- a lot of it was related to -- about half of it was related to sales deleverage versus last year and the other half is related to markdowns. Because we feel like we're in a really good position going forward, we would continue to expect to see improvement in our margin structure in the second half of the year.

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

Great. Thanks, Chuck. We'll now take one more question.

Operator

Our final question comes from the line of Bob Drbul with Guggenheim Securities.

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

I guess the question that I have is, can you talk a little bit about how you're operating the (inaudible) in New York and the New York stores and just really how those are trending over the last few months? That would be helpful.

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

Erik, do you want to take the New York questions?

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

Sure. Just make sure I heard it, it broke a couple of bits. Your question is how we're operating in New York?

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

Yes. Just how it's -- how your New York stores are performing and really sort of how you're handling the trends and the marketing.

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

Yes. I would say, in general, our big urban stores, in general, have been harder hit by COVID than other areas. And I've seen other retailers mention that, the more densely-populated areas have had a bigger drop-off in traffic. So New York is not unusual in that. It's kind of right in the middle of that group of stores for us. What we are pleased with New York is we have more capabilities in that we have our market strategy rolled out there to leverage the whole market inventory that we own there and connect with customers in any of our full-line stores, in the 2 Rack stores that we have on the island as well as the 2 Nordstrom local locations there. So that flexibility in order pickup and returns is proving very beneficial in New York.

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

Again, thank you for joining today's call. A replay, along with the slide presentation and prepared remarks, will be available for 1 year on our website. Thank you for your interest in Nordstrom.

Operator

This concludes today's teleconference. You may disconnect your lines at this time. Thank you for your participation.
