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JWN.N - Q4 2020 Nordstrom Inc Earnings Call

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OVERVIEW:

Co. reported 4Q20 YoverY sales decrease of 20% and EPS of $0.21.

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PRESENTATION

Operator

Greetings, and welcome to the Nordstrom fourth 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, Head of Investor Relations for Nordstrom. You may begin.

Trina Schurman - *Nordstrom, Inc. - Head 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 slides 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 fourth quarter performance and outlook for 2021. 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 today. Looking back at 2020, we're deeply grateful for the way our entire team navigated through these challenging times. We made meaningful progress to better serve customers, benefiting from multiyear investments that supported our transformation into additional first business.

The aggressive actions we took throughout the pandemic to increase our financial flexibility has enabled us to generate operating cash flow of more than $425 million over the past three quarters. We're confident in our ability to successfully emerge from this pandemic in a stronger position than before.

We're encouraged by the continued sequential improvement in our top line trends, including a 600 basis point increase from the third quarter when normalizing for our Anniversary event shift. We saw momentum build throughout the quarter and continuing into 2021. We had broad-based improvement across our 2 brands, Nordstrom and Nordstrom Rack, both in-store and online. Enabled by our market strategy, trends in our top 10 markets outpaced our average by 200 basis points. During the holidays, customers responded positively to our gift selection, which represented 67% of sales up 600 basis points over last year.

While we're pleased with our improving top line trends, we are not satisfied with our bottom line results. Since reopening stores in June, we faced inventory constraints throughout most of the year. Heading into the holidays, we increased our receipt plans to meet anticipated customer demand. However, we experienced delays in inventory flow that resulted in higher inventory levels at the end of the year.

Additionally, higher COVID-related labor and shipping costs contributed to earnings flow-through coming in below our expectations. We are currently taking actions to realign our inventory position, and Anne will go into additional detail on our execution and action plans.

An important component of our strategy is to increase convenience and create personal connections with customers. During the holiday season, we continued to scale digital and physical capabilities to offer greater access to our services. With pickup options at roughly 350 Nordstrom stores, Racks and Nordstrom Locals, about 10% of online orders were picked up in stores. Additionally, roughly 30% of online orders were fulfilled from stores, including Racks, which were recently enabled with this capability. These capabilities allow us to increase delivery speed, customer spend and inventory efficiencies.

We're increasing our connections with customers by strengthening our digital capabilities to offer them discovery and inspiration. Remote selling options, such as looks created by our salespeople using style boards, are resulting in outsized customer satisfaction scores, conversion and average transaction size. And we know that when customers engage with us through order pickup, alterations or styling, their overall spend increases by up to five times.

During the fourth quarter, we saw a significant improvement in customer acquisition trends, improving sequentially by roughly 15 percentage points from the prior quarter. We gained 1.8 million new customers online, a 40% increase over last year. We did this without losing sight of our existing customer where we have seen improving retention trends over the past two quarters.

Encouragingly, our Nordy Club customers continue to shop with us during the pandemic. Approximately 40% of customers are in our loyalty program, contributing 2/3 of sales. This gives us growing confidence in our ability to sustain momentum in 2021 as our Nordy Club members shop with us more frequently and spend more than our average customer.

As we laid out in our investor event last month, our brand promise of getting closer to you is the guiding principle of our growth plans going forward. Heading into 2021, we are committed to significantly expanding the breadth of who we serve and where and how we serve them. We're doing this by unlocking the full power of the digital-first platform we have built to capture market share gains, drive profitable growth and create significant value for our shareholders.

As we head into 2021, our team is dedicated to executing our strategy across our three areas of highest priority. First, winning in our most important markets. We're continuing to scale our market strategy by doubling our exposure from 10 to 20 markets by the end of March, making up 75% of our business. This includes key markets such as San Diego, Houston, Minneapolis and Miami.

Second, broadening the reach of Nordstrom Rack, which we see as a $2 billion incremental sales opportunity over time. We're focused on growing our share of the price-oriented customer segment. Our efforts are underway as we recently repositioned 70 stores by reimaging the merchandising offering and store experience.

And third, increasing the velocity of our digital business. We're focused on more effectively translating the heritage of service that defines us in this digitally connected world. This means delivering personalization at scale by creating greater linkages between digital and physical experiences. As an example, we are currently migrating NordstromRack.com, to the JWN e-commerce platform to enhance the customer experience while creating efficiencies in our infrastructure and operations.

These strategic priorities are enabled by our digital-first merchandising approach. We are extending beyond our traditional wholesale model to increase selection, reduce risk and share in the benefits with our strategic brand partners. For instance, yesterday, we announced our partnership with Tonal, the smartest home gym and personal trainer, to expand their retail footprint to 40 Nordstrom stores this month. In terms of other partnerships, we also see meaningful opportunities to deepen our relationship with ASOS and Topshop to broaden our distribution and drive growth.

We're grateful for our team's efforts to strengthen our financial flexibility and accelerate our strategic priorities to serve customers in new and differentiated ways. These actions have put us in a strong position to capitalize on our market share opportunity as customer demand recovers. While the timing and pace of demand recovery remain uncertain, we see potential to reach $17 billion in revenues at expanded EBIT margins of more than 6% over the next three to five years.

In closing, we have two powerful brands, Nordstrom and Nordstrom Rack as well as highly integrated digital and physical assets, fantastic brand partners, and employees who are truly unmatched when it comes to their commitment to the customer. We're confident in our direction and look forward to sharing our progress in the quarters ahead.

With that, I'll turn it over to Anne to discuss our financial results in greater detail.

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

Thanks, Erik. We're pleased to deliver another quarter of sequential improvement in sales through the actions we're taking to unlock the full potential of our digital-first platform. We're also proud of our team's efforts to generate another quarter of positive earnings and operating cash flow in what remains a very uncertain environment. We continue to satisfy our customers' desire for digital shopping experiences, accelerating online penetration across both Nordstrom and Nordstrom Rack, even as our store sales continue to recover. Overall, we have seen strong customer response to our initiatives to evolve our operating model, positioning us well to drive market share gains while improving profitability, returns and cash flow generation.

That said, the quarter was not without its challenges, and there were unanticipated headwinds that limited our ability to flow our improving revenue momentum to the bottom line, which I will discuss in detail shortly. We also exited the quarter with excess inventory that we are working quickly to address. Overall, we are confident in our ability to support a continued recovery in both demand and profitability. And we remain focused on executing our long-term growth strategy.

For the fourth quarter, we reported positive earnings per share of $0.21, which included an income tax benefit related to the CARES Act. Earnings before interest and taxes were $30 million. We continue to be in a strong financial position, fully paying down our revolver and ending the quarter with $1.5 billion in liquidity, including $700 million in cash. We delivered a third consecutive quarter of positive operating cash flow, generating more than $425 million over the past three quarters. For the year, our expense savings well exceeded our targeted range of $370 million to $420 million, primarily from rebasing our cost structure. More than $300 million of realized savings are considered permanent overhead reductions.

Our fourth quarter sales decrease of 20% slightly exceeded expectations. This reflected improvement in sales throughout the quarter across both Nordstrom and Nordstrom Rack, with momentum as we head into 2021. Digital demand was strong. With sales growing 24% over last year and representing 54% of total sales. Sales trends continued to improve, increasing by 6 percentage points compared to the third quarter after normalizing for the Anniversary shift. Notably, we saw strong sequential improvement at both Nordstrom, up 5 percentage points; and Nordstrom Rack, up 9 percentage points.

From a merchandise perspective, we saw a strong response to our focus on gifting items, expanding our offering in categories of highest demand. We delivered double-digit sales growth in both Home and Active and had strong results in Beauty, Kids and Designer handbags and shoes.

Overall, we're encouraged by the sequential improvement in our top line trends, giving us increased confidence in our pivot to market share capture, and a return to profitable growth in 2021. That said, we are not satisfied with the flow-through to the bottom line from our improving revenue momentum. EBIT margin was down 590 basis points from last year versus our expectation for a decline of approximately 500 basis points.

There were three key factors that contributed to greater pressure on margins in the quarter, most of which we expect to be temporary and reverse as we progress through 2021. First, merchandise margins were lower than expected. Our decision to take a stronger inventory stance for Holiday, combined with delays in inventory flow over the course of the quarter, resulted in higher-than-anticipated markdowns.

Second, we experienced higher-than-expected selling and labor expense, primarily due to premium pay related to COVID-19 and higher costs associated with product fulfillment. Strong growth in e-commerce and the ramp of new capabilities at Nordstrom Rack, led to some fulfillment inefficiencies that have been clearly identified and are not expected to recur going forward.

Third, we saw higher-than-planned outbound freight expense due to carrier surcharges and costs associated with our decision to mitigate carrier shipping constraints by shifting to higher cost shipping options.

Versus last year, our overall SG&A rate deleveraged by 470 basis points, largely due to lower sales volume and higher labor and shipping associated with COVID-19. These costs were partially offset by continued benefits from rebasing our cost structure, which led to a reduction in Q4 overhead costs of approximately 15% from the prior year. Roughly 300 basis points of these expenses are not expected to recur this year.

From an inventory perspective, we increased our receipt plan for the quarter. Much of this inventory came in later than expected, which resulted in not being able to fully support demand during the holidays and higher inventory levels exiting the year. Most of this inventory reflected current receipts and nonseasonal merchandise with improved availability of replenishment items and relevant products with extended selling seasons.

We are taking action to mitigate the impact of seasonal and underperforming merchandise categories, particularly in apparel, including cancellation of orders, return to vendor and clearance activity where appropriate. Importantly, we are quickly building additional flexibility into our buying plans in the first half. We plan to cut our sales-to-inventory spread in half by the end of the first quarter with inventory realigned at Nordstrom Rack. We expect inventory levels for our Nordstrom brand to be fully realigned in the second quarter after normalizing for the Anniversary shift.

Looking ahead to 2021, given the continued uncertainty with respect to COVID-19, we remain prepared for a range of scenarios to ensure that we can sustain and grow our business. Based on the assumption that our stores will remain open over the course of the year, we expect to deliver revenue growth of more than 25%, with digital representing approximately 50% of sales.

Given expectations for improving gross margin and moderated cost pressures over the course of the year, we expect to deliver EBIT margin of approximately 3% of sales. Our income tax rate is expected to be around 27% for the year.

This guidance contemplates some pressure in gross margin as we work to align inventory in the first quarter. A moderation in COVID-19-related labor and freight pressure as the year progresses and lapping of 300 basis points of nonrecurring costs in the fourth quarter. Should the pace of demand recovery accelerate, or COVID-19 related costs moderate more quickly than currently anticipated, we do see a path to delivering operating margin of approximately 3.5% for the year.

For the first half, EBIT is expected to be approximately breakeven, reflecting roughly 45% of total year sales. This contemplates the shift of the Anniversary event to begin in July this year with one week falling into the third quarter.

From a capital allocation perspective, we're planning CapEx at normalized levels of 3% to 4% of sales to support investments in technology and supply chain capabilities. We also expect to reduce our leverage ratio to approximately three times and to be able to return cash to shareholders by the end of the year.

We made meaningful progress to support the recovery in demand in the fourth quarter. Now as we head into 2021, the strength of our financial position enables us to reinvest in our long-term growth strategy. We are confident in our ability to deliver profitable sales growth as demand recovers.

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

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

Thank you, Anne. Before we get started with Q&A, we would appreciate it if you can limit to one question to allow everyone a chance to ask a question. We'll now move to the Q&A session.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question is coming from Ed Yruma with KeyBanc Capital Markets.

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

I guess, first, just on the inventory commentary. I guess as you think about the back half, obviously, lots of discussion about reopening. Has the experience in the fourth quarter changed some of the inventory plans you might have around that? And have you embedded more conservatism?

And then as a bigger-picture question, if you could just give us a little bit of insight into some of these strategic partnerships Tonal sounds exciting, but kind of how you see them playing a role in the longer term growth?

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

Okay, thanks, Ed, for your question. Pete, why don't you start with the partnerships, and then I can talk about some of the inventory thinking in the first half of the year?

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

Yes. Thanks. The partnership thing has been evolving subject that's happening as we see. It's been going on for a while. And I think the pandemic has given us all an opportunity to rethink how this all works, in the spirit of being more agile, making things better. And so there's a lot of good things to talk about there.

I would say point -- there's probably one particular example that we're super enthusiastic about, and that's our partnership with ASOS. As you know, ASOS has just recently bought the Topshop, Topman brand, which as you likely know, is a very big and important vendor for us. So that was important to us that this landed with someone that we have a lot of confidence in.

So first of all, we've got a lot of confidence that ASOS is going to be very capable of investing and elevating this brand and to reach its full potential. So there's a big opportunity for us. As you may have read as they're counting on their relationship with us to realize the full value of this investment.

And towards that end, it gives us a huge opportunity in North America, specifically, to really own this business, and we think there's a lot of upside to that.

But I think the point about the brand partnerships is ASOS is not a traditional wholesale outlet. They're retailer. So they're approaching this, knowing we have this Topshop business like, hey, look, what's the best way to do this, so it works for all of us given a clean slate. And I think, again, considering everything we've gone through a clean slate is nice to have. And we know a lot about that business and the -- and we're really motivated by their ambition, I think, by their willingness to partner in new and different ways, and we're confident that it's going to bode very well for our results.

And then the other part of that is ASOS has other brands that they have going on. There's other commercial opportunities that are available to both of us through in this relationship. And we've been in regular contact already, and I can tell you that whether it's Anne or myself or Ken, Teri or others here that have been interacting directly with their team, every interaction just builds our confidence in what we think is possible.

So I guess, as time goes on this year, we'll be able to talk more about that a bit, but I think it's going to be illustrative of what's possible together.

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

Yes. And then the second part of your question as far as how we're thinking about inventory plans for the first half of the year. As we exited in the second half of 2020, you rightfully commented that with stores reopening, it was a bit choppy as far as reopening in some of the inventory levels.

Part of the decisions we made for Q4 was to get back in stock and just basic replenishment and items that were seasonless. And so that was a very conscious decision, and we saw great customer response to that. So as we go through the first half, we feel like we're in a very good position with those inventory levels.

There was a piece of it that was more seasonal. Some of the delay in receipts as we go through the -- particularly in Q1, we're taking a number of actions to get that rightsized. But I would just say, in general, we're building more flexibility into the plans. And as we continue to see customer demand, we're ready to meet the customer where they want to shop and how they want to shop and what they want to shop for.

Operator

Next is Dana Telsey with Telsey Advisory Group.

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

As you think about the Rack business and increasing the revenues of Rack, what do you see in terms of the assortment there as we go through 2021 as compared to the core Nordstrom business? And is the opportunity for either product enhancement and collaborations there also?

And just lastly, on the real estate portfolio. Any updates to how you're thinking about openings, closings or restructuring of leases that are rental not owned?

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

Dana, this is Erik. I'll take both those. And Pete, you can chime in if -- on the assortment.

In Rack, I think it's important when you think about our Rack business that it's not a stand-alone business. It is very integrated to our model. So our model is the two brands, Nordstrom, Nordstrom Rack, and having digital and physical business. And there's -- the point that is there is a synergy to that. And Rack is particularly flexible. We make commitments closer to season. It's a much more opportunistic business. And we do see opportunities to adjust our assortment. Certainly, the hot categories, some of -- through the pandemic of Active and Home, Beauty wellness, even some Kids business, we see opportunities there in our Rack business to have outsized growth there.

And again, the flexibility, even in the stores, we can move around space allocation really easily and quickly. So there's a lot of experimentation. And I think that's particularly important as you look forward in 2021, that what happens, what the customer's going to be interested in when things start to open up more, when people are returning to work or starting to travel again or going to restaurants. And that's something we've got a point of view on, but mainly, we need to be flexible. And again, we see a lot of opportunities for us to be nimble and move there.

The collaborating -- is there opportunity for collaborating in the Rack? Absolutely. When we talk to vendors, it is as a total business. All of our vendors have an Off-Price business. And we talk a lot about the synergies in our business and how that point of discovery in acquiring new customers in our Rack business works for us as a retailer and works for brands. We have a lot of data on that of customers who get introduced to a brand in a Rack business. And end up becoming a Full-Price customer of that brand. So we'll certainly work with vendors on that.

On the real estate piece, and as you know, we closed or did not reopen 16 full-line stores early in the pandemic. We don't see a lot of change in the near term there. I think our history pre-pandemic is probably the best gauge. There's -- it's always a combination of store performance and the lease obligations that we have. And so over time, I think though, as our history has been, there's a few stores a year that we don't renew the lease on, but we don't see anything major.

Operator

Next is 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 wanted to ask on the 10% in-store pickup that you achieved. That's pretty impressive. How does that compare to a year ago? And what do you think are the key obstacles to getting that higher?

And then on private label, it was one of the topics at your Investor Day, the target going from 10% to 20%. Maybe you could dive into that deeper? It was one of the areas we didn't get to ask you a follow-up question on why you think that could be an important strategy to include among all the broader initiatives that you talked about as well.

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

Thanks, Omar. Yes, we're encouraged of our store pickup. We've had online pickup in-store capabilities in our Nordstrom business for, gosh, I think, 10 years now. It's a new capability in our Rack business. And you've seen other retailers have a lot of growth there. I think that we have hit a tipping point, and that customers just like it. And it's not something we've done all our marketing with as we've added the capabilities as we have more and more inventory that's available for same-day or next-day pickup, which is part of our market strategy. We really see instant reaction to it.

So it certainly doesn't feel like we're anywhere close to the ceiling on there. I think it's clear that those delivery options, pickup options are something that isn't COVID-only subject that's a change in customer behavior that will continue. And so in general, our direction of travel is through our market strategy, how do we enable a bigger selection of customers with faster delivery. And we've been able to do that in the 10 markets so far with market strategy. We have 10 more coming in the next month and the proof points have been consistent.

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

Yes. And Omar, relative to our own-labeled products, we do have an ambitious growth plan here, and we think that the timing's great for that, and we're well prepared to do it. And the proof point to that, at least in the most recent past, have just been, as you've seen the relevant of certain categories that we have evolved and, in particular, the casualization that something we've been speaking about for a while. That speaks well to our strength in our own-label programs. A lot of it's really based on the casual part of the offer.

We already have really good businesses with high search results like the Nordstrom name specifically and like Zella brand, which is an Active brand for us. We've been extremely successful probably for the last few years, but certainly in this last year with Active being such an important category. So we think we've got a good foundation to build off.

I'd say the other thing that's true is if you look at the growth ambition we have around the Home classification, that lends itself pretty well to our own label, too. And so I think that's going to give us opportunity. So it's a combination of making sure we've got the right inputs there, that we've got the right alignment with our buying team and the people who design and produce that product for us. And I think we've achieved that. We're really clear on what we need to do together to grow this. And so we'll keep you posted as time goes on, but we're certainly set for growth.

Operator

Next is Oliver Chen from Cowen.

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

Regarding underperforming categories, could you be more specific about which ones you need to clear goods in? And as we think about the year ahead, how are you managing promotions?

I would also love more color on what you mean by flexibility in the buying plans. I feel like you've had flexibility in the past, so what's different this time? And how might you integrate closer to your drop-ship concession into rethinking inventory management going forward?

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

Yes. Okay. With the underperforming, the toughest category just broadly for us over the last year has been apparel. In particular, Mens' apparel have been pretty difficult. We got a fairly sizable business around things that are a little more work or formal-oriented, I think, relatively -- and that's a big business for us. So that is off considerably. And it's also true in Women's.

And apparel generally, fashion apparel is most perishable as well. So that's something that, obviously, is of concern to us, and we're looking at it but you heard Anne talk about the products that we have, the inventory we have, the makeup of it is largely around -- stuff that's not real seasonal, but it could be Beauty or something or replenishment items. And so that's -- that helps kind of, I think, mitigate some of the risk about what we own.

But I think it would be fair to say that the most challenged category for us is really fashion apparel. So we're just being super conservative about our plans going forward and what we're investing in there and ensuring that we're staying close to it. And when things evolve and change, as we all know it will, that we're prepared to pour on the gas there, too.

So it's a dynamic thing. And I think we've learned a lot of lessons this year about making sure we're applying the appropriate rigor and operational discipline so that we don't get ourselves in trouble, and we're doing the right thing and maintain flexibility.

With promotions, we don't really have, we don't have any different or new promotions planned. I mean even though we were somewhat over-bought, it's not about some giant markdown kind of clearance events you're going to see to clear us out. That's not the most practical, prudent way for us to solve for inventory issues, and we'll solve for those in the right way, they'll be in the best interest of the bottom line of our business. So I wouldn't expect any more promotions.

And I'll let Anne weigh on this a little bit, I guess. But with the flexibility, maybe, Anne, why don't you go ahead and start with that. I mean, I guess what I would say, you heard a little bit about the extended models that we have. And while we've always had some flexibility, I think if you're caught up in a streak wholesale relationship where you're buying the goods seven months out or something, that doesn't necessarily lend itself to great agility. And so I think the spirit of this thing is more about shared accountabilities and finding -- or defining together with the brand, what good looks like and how we can work towards that together.

So I don't know, Anne, if you want to expand on that at all.

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

Yes. So Omar, I would just add, inventory discipline has been definitely a bellwether of how we operate the business. And it's certainly something we take very seriously and there was a lot of uncertainty out there as far as how quickly the customer comes back, demand comes back, in particular, in areas like apparel. So we're just building in that flexibility of making sure that we're there to meet the customer demand but also staying very focused on the discipline around our inventory management as well, whether it's alternative models or how we buy.

Operator

(Operator Instructions) Our next question is from Mark Altschwager with Baird.

Mark R. Altschwager - *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst*

Just following up on the sales guidance. So the over 25% growth this year, that implies year settles out maybe 14% or 15% below fiscal 2019 levels. Any more help on how you're thinking about the first half versus the back half on that front? I guess Q4 was down 20% versus 2019 with a few headwinds that you called out. So I'm wondering if it's fair to expect sequential improvement from that run rate kind of each quarter as you move through the year or if things might be a little bit more back-end loaded on that front.

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

Yes, Mark, let me maybe help you help guide this a little bit. So as we think about the year, we did say we are giving guidance of 25% plus on the top line piece to it. The way we're thinking about it is that the first half for the year represents about 45% of total sales. So you do -- that would imply that you would see progressive improvement throughout the year, particularly in the second half.

The other thing -- maybe this helps frame it up for you is if you look at 2019 as a baseline for pre-COVID levels, the way I think about it is we expect demand to continue to recover for the year, but we would expect a greater decline against 2019 in Q1, and then you would see improvement throughout the year. And in particular, highlighting that Q2 will have Anniversary Sale in it. Last year, it was in Q3 entirely. This year, we've got 2 weeks of Anniversary Sale in Q2 and 1 week in Q3. So as you think about the year, hopefully, that helps you kind of anchor to how we're thinking through it.

Mark R. Altschwager - *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst*

That is helpful. And just a quick follow-up there. I think, Anne, you also spoke in your prepared remarks about margin potentially getting to 3.5% if the demand accelerates faster than you're currently anticipating. Would you be able to say kind of what is the sales scenario that would get you comfortable with that margin picture?

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

Yes. So there's a number of components to it. It's -- there's some sales, but the other pieces to it are really the drivers of the EBIT piece. And so there's a couple of components to that. One, we would expect to get more leverage on sales as you go through the year, if you saw some improvement.

But also more importantly, we've baked in quite a bit of headwind of COVID expenses, things that we saw in Q4 continuing, particularly first half of the year, pressure from COVID premium pay, surcharges or charges from carriers, COVID expenses associated with that. So depending on how things recover or how quickly those costs start mitigating, that would be another lever we would pull to get to that 3.5%.

Operator

Next is Chuck Grom with Gordon Haskett.

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

I'm just wondering if you guys could just size up for us the impact on margins from what you need to do to correct inventory levels in the first quarter.

And then just as a follow-up, you spoke about improvement in your sales trends throughout the quarter, and I believe in February. I'm just wondering if you could just opine a little bit on some of the categories that you're seeing improve.

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

Yes. So Pete, do you want to talk a little bit about the categories and then I can comment on the margin component?

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

Yes. In terms of categories that are improving?

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

Yes. Yes.

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

Well, we talked about getting overbought there in the fourth quarter, and that's all winter current goods. And the good news is -- it was cold kind of late this year. So that's been helpful. We've seen an uptick actually in selling of winter. So that's good for us in this current situation.

I'd say, there's some view of things getting back to normal in some way like we've seen things like dresses and some of these things improve, but it's still pretty early in the game. I wouldn't get too far up in front of it. I think it's really -- it continues to be the same themes around casual, it's based around Active, around Home, around Beauty, Kids. You've heard about that the Designer business outside of the apparel part, for the most part, has been strong.

So I think in the near term, it's clear on where to invest. The trickier part of that is as the year goes on, trying to see how things evolve, and we're trying to get every kind of bit of objective data we can around leading indicators around when these things will evolve and change.

But I think we're in pretty good shape in terms of the proportions of our inventory. Like I mentioned before, I mean, typically, fashion apparel is the more challenging part right now, but we've been aware of that for a while.

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

So on the margin piece, we gave the guidance of a breakeven for first half. And so that did contemplate some of the, I would say, some of the margin pressure we would experience in Q1, although we're using multiple ways to mitigate the inventory situation, there is a piece of that's markdown related. So that is part of the half one. It's been contemplated in the half one guidance as far as breakeven.

And so if you think about the sales trends, those will continue to progress through the year. You've got Anniversary in Q2. And Q1, traditionally, is very small quarter for us anyway.

Operator

Next is Matthew Boss with JPMorgan.

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

On gross margin, so beyond the impact of the inventory actions in the first quarter that you just spoke to, I guess, any headwinds that you see constraining merchandise margins relative to 2019 pre-pandemic levels this year?

And then my second question on the same topic is as we then think about beyond this year, the change that you're making in terms of digital inventory relative to the wholesale model in the past, is there any reason as we think about merchandise margins going forward? I guess, how best to peg it to any historical levels or how best to think about gross margin going forward when we put all the pieces together?

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

Yes, Matt, thanks for the question. I think as we think through the different pieces of the financials, for us it's really anchoring on the top line and the EBIT pieces because there's a number of puts and takes throughout the P&L.

As far as margin -- gross margin, in particular, for the year, as I mentioned earlier, we believe or we see that when you start getting a little bit more top line, you actually start leveraging more, you get less deleverage in the lines, right, in gross margin and also in SG&A. So as we go through that, we would expect to see some continued improvement in the gross margin line that contemplates the merch margin pieces to this as well.

The -- on the digital side, there are a bunch of puts and takes. And so the way I would think about it is 2021 is definitely the road to recovery. It is definitely in line with our targets that we laid out for the next three to five years, and it certainly gets us to the journey to achieving those targets from both the top line and EBIT rate and a return to invested capital for shareholders.

Operator

Our next question comes from Tracy Kogan with Citigroup.

Tracy Jill Kogan - *Citigroup Inc., Research Division - VP*

I just wanted to clarify first. Did you guys talk about your sales trends quarter-to-date? Or when you talked about sales trends continuing to improve, did you just mean January?

And then secondly, I was wondering if you could talk about the inventory levels and also the margin pressure expectations between full-line and Rack. Is it more isolated to one division or the other? Is it really across the board?

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

Yes, Tracy. So on the sales trend, what we talked about in the quarter was sequential improvement throughout the quarter. So as you think about the quarter, it's November, December and January, and we saw sequential improvement each month in the quarter. So we were continuing to see customer demand actually continue to get better throughout those three months.

We have not talked about what's going on in this quarter. We typically don't do -- give commentary on what's happening in the current quarter. But hopefully, that helps you -- gives you some perspective on what we continue to see improvements in both the Rack business and the Nordstrom brand business as well.

As far as the inventory levels and the margin pressure, let me reframe this for you. We have opportunities in both brands. We expect that the Nordstrom Rack business will be back in line by the end of Q1. It's typically a business that's shorter in buy cycle, you have more closeouts, you've got more capability to be more flexible in how you're doing your buys. And then by early Q2, we expect to be back in line in the Nordstrom brand from an inventory position.

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

We'll now take one more question.

Operator

Our last question comes from Simeon Siegel with BMO Capital Markets.

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

Great. Congrats on the Tonal announcement. Very exciting. Anything you can share on the partnership or maybe speak to how you picked Tonal, et cetera, whether this begins a meaningful shift, now you're approaching Active, whether this is more of an opportunity opportunistic one-off?

And then, Anne, sorry, I don't know if I missed it, did you or could you quantify merch margin in Q4? And then within the comments you made for the full year, any help on thinking about the cadence of gross margin?

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

Yes. This is Pete. I mean speaking to the Tonal thing, what I think that's reflective of is the merchant kind of orientation that our team has. And giving them the empowerment and the accountability to chasing the things that are really working well.

And so the business increasingly, is less about a whole legacy view about how we plan in the future, but it's more trying to think about clean slate and how we can pursue the categories and the products that our customers are most interested in. So I give that credit to our Active team looking for opportunities out there to enhance our authority in this subject in this category and classification. And I think Tonal is a way where we can do that. We clearly have a shared customer between those two companies, and they've got a willingness to try something with us and as do we with them. So these are the kinds of things we love doing.

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

As far as the question on margin in particular, I think there's a couple of things to keep in mind. One, we're expecting to see sequential improvement through the year on top line, which will help deleverage component to it. The second is we would -- we are expecting to see a gradual improvement in some of the headwinds that we see with some of the COVID expenses throughout the year.

And then last, I just want to remind you that we've got our supply chain outbound shipping costs in our SG&A. And so as we think about the whole business, we really look at the whole thing from a contribution margin or an EBIT perspective as well. So we would expect to see gradual improvement throughout the year.

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

Again, thank you for joining today's call. A replay along with the slide presentation and prepared remarks will be available for one 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.
