Signet Group
Signet Group Investor Day
September 12, 2005
1:30 p.m.

Terry Burman, Group Chief Executive & CEO, U.S. Division:

Welcome to Signet Group Investor Day. I'm Terry Burman. I'm Group Chief Executive and also Chief Executive of Signet's U.S. Division. With me are Walker Boyd, our Group Finance Director; Mark Light, our President and Chief Operating Officer of our U.S. Division; and Tim Jackson is here, who is our Director of Investor Relations. I'll first look at the overall group performance and UK strategy. Next I'll review the U.S. market and our strategy there. Then I'll hand over to Mark to go through our U.S. growth plans and operations. Afterward there will be an opportunity for questions and answers followed by a visit to our new Kay metropolitan store on 34th Street.

First however I would ask you to note the Safe Harbor statement that's in your presentation and on the screen, if you can read it this fast. Take time afterward to fully absorb that.

Signet has a number of attractions for U.S. investors. Our capitalization of about $3.4 billion is similar to well followed U.S. specialty retailers such as Abercrombie & Fitch, Williams-Sonoma, Foot Locker and Saks, Incorporated. Our P/E is about 13.5 against an average for U.S. specialty retailers of 20.8. Our dividend yield of around 3% is above the U.S. average. Signet has a record of consistent performance and is the largest specialty jewelry retailer in the world with around 70% of the Group's sales and profit generated here in the U.S.

The U.S. account for about 50% of world diamond jewelry sales, and the highest per capita spend on jewelry of any country, offering significant growth opportunity for Signet. We believe we have sustainable competitive advantages and sector leading expansion plans. We also have leading well recognized brands in each of our respective markets.

Kay is the number one brand by sales in the middle market and Jared is the leader in the off-mall category killer sector. We anticipate that Jared will be, by sales, a top five jewelry brand this year. In the U.S. we have almost 1200 stores, a 3.6% share of the total jewelry market.

In the U.K, which accounts for about 30% of Group sales, we have some 600 stores and a 17% share of the total jewelry market. H.Samuel and Ernest Jones are the two leading specialty jewelry brands in the U.K.

Over time we've established competitive advantages that would take other companies years of development to emulate. For example: our leading diamond direct sourcing capability gives us a supply chain advantage which is crystallized through the superior quality of our sales staff; store staff are critical in jewelry retailing, as every piece is under lock and key and has to be presented the customer; we have at least one certified diamontologist in every store; our marketing budgets are the largest and most effective in our industry, meaning we are best able to communicate with customers; and we have a high quality store portfolio, reflecting strict real estate criteria and a consistent investment program.

Our culture of continuous improvement means we fully test new initiatives before rolling them out, and continue to test new ideas to make them even better.

Last year Group comp store sales were up 5% in line with the 5-year average. The stability of the Group's performance is helped by operating in two geographic areas. The U.S. Division was up 5.9% on a comp store basis, and saw sales increase above the average of the past five years.

The U.K. Division comp store sales were up 3%, reflecting a retail market that became increasingly challenging as the year progressed. In both markets, we outperformed our main competition.

The group continues to deliver stable growth across a range of financial measures. These four graphs demonstrate our five-year record to the 29th of January, 2005. Consistent comp store sales, space growth and good cost and margin control are reflected in the 11% increase in earnings per share at consistent exchange rate. In fiscal 2005, we were slightly ahead of the average. Our operating margins remain industry leading and increased further last year. Return on capital employed remains in the 23 to 26% range.

Turning to the interim results.
Group total sales were up 5.6%, like to like sales by 3.3%. The period clearly illustrated the benefit derived from the 70% U.S / 30% U.K. sales mix. The adverse movement of the U.S. dollar exchange rate from $1.83 to $1.86 had less of an impact on results than in recent announcements.

Profit before tax rose to 52.1 million pounds, up by 5.7% at constant exchange rates. Earnings per share grew to 2p. The board has approved a 10% increase in the interim dividend.

Now I'd like to review the U.K. business.

The U.K. has a broader merchandise mix than the U.S, with significant gold and watch components. Diamond participation was up to 28% in fiscal 2005. H.Samuel is the largest chain of specialty retail jewelers in the U.K. and targets the middle market. It is located in virtually every medium and large retail center. Ernest Jones, the second largest specialty retail jewelry chain, targets the upper middle market and is represented in most large retail centers.

Signet has a leading 17% market share of the fragmented 3.6 billion-pound U.K. jewelry industry, offering significant scale benefit. The next largest specialty chain after Ernest Jones has about 170 stores and there are only two other chains with more than 100 stores. Independents retain a significant market share.

Signet's U.K. growth strategy is to build on our competitive strengths to further increase diamond sales, thus increasing store productivity by lifting the average transaction value and so leveraging the cost base.

This strategy has been underpinned by the growth of the diamond market, estimated by DeBeers to have been 7% per annum over the last five years. Signet's diamond sales have increased by about 15% per annum over the same period, with the diamond mix increasing by about one and a half percent per annum.

There is significant scope to further increase the diamond mix particularly given the division's access to Signet's U.S. best practice. Our diamond direct sourcing capability continues to develop and we have exclusive distribution rights in the U.K. for our successful Leo and Forever diamond brands. We have sector leading training programs and are developing television advertising. A major initiative is a new store design better suited to selling diamonds. This was tested in the three years to 2003 and last year we began to roll out the format.

The new store format allows for much greater interaction between the customer and the sales associate, critical to selling diamond jewelry successfully. Here's an example of a refurbished mall site in Thurrock, which is a large regional mall close to London, which shows the dramatic difference in appearance. The window-based display is replaced by showcases, which give greater prominence and access to the diamond merchandise. This allows the sales associate to present choice within the merchandise range much more easily. The refurbished stores have produced an uplift in comp store sales which justify the investment, with increases in diamond participation and average transaction values. By Christmas 2005, about 45% of U.K. sales are expected to come from stores that are trading in this format.

The efficacy of our strategy is highlighted in these four charts. Over the last five years, diamond participation has increased from 22% to 28% which has helped lift the average selling price in sales per store. This has leveraged the cost base and resulted in operating margins moving up from around 12% over 15%.

We are at a relatively early stage of implementing a number of major initiatives in merchandising, staff training, marketing and real estate, and there remains much more to go for in our U.K. business.

Turning to trading this year.
In February there was a marked deterioration in the general retail environment in the U.K. and trading conditions remain very difficult. Comp store sales were down by 7.8% in the first half and this reflected an operating loss of 2.4 million pounds. Due to the seasonality of the business this does not reflect anticipated full-year results. Current analyst's forecasts are for double-digit operating margins and return on capital of over 30%.

Against this background we have slightly improved gross margins. As both diamond participation and average selling price increased further in the first half, we believe it is right to continue to implement our proven strategy building a strong competitive position for when the consumer begin to recover. We have tightly managed costs, our gross margins, and our cash flow.

Now I'll turn to the U.S. Division.
Over 40% of sales are in the year-round bridal and anniversary category. The other major driver is gift giving, particularly at Christmas, Valentine's Day and Mother's Day. We target the middle market consumer with an average household income for our mall customer of about $65,000, and for our Jared customer of about $85,000. In fiscal 2005, the average price of an item sold in a mall store was around $290, and in Jared $640.

Although about 70% of our sales in the U.S. are diamond jewelry, we're not a luxury goods retailer but rather a specialty retailer of bridal products and fashion accessories.

The total U.S. jewelry market is about $57 billion, and has been growing at about 6% per annum. The market is split 50/50 between general retailers and the specialty sector and this has remained stable over the medium term. However, there has been movement on both sides. For example, among the general retailers the mass merchant stores such as Wal-Mart, have taken share and catalog showroom retailers have exited the market. Within the specialty sector, independent jewelers still account for over 70%.

The U.S. consumer environment is stable at the moment. Superior sales growth is being achieved by retailers that are consistently successful in execution of the key retail disciplines. Within the jewelry sector it's particularly important to focus on customer service.

Commodity cost increases have been putting pressure on jewelers' gross margins. Therefore, supply chain efficiency is essential, which favors larger retailers, particularly those like us that have a developed direct sourcing capability. The achievement of consistently superior like for like sale growth results in operating leverage. Successful retailers are then able to invest in new store space to achieve further sales growth and reinforce their competitive advantages.

Sector consolidation is taking place as weaker retailers exit the sector. Our long-term market share gains are driven by both superior like for like sales and space growth. The consistency of strategy and excellence in execution, together with our culture of continuous improvement has developed a record of building on our competitive advantages and establishing best practice. Our space growth includes new formats which enable us to consistently expand and to take advantage of fast growing retail venues and not be dependent on traditional regional malls. In particular, our off mall expansion means that more and more we are competing against the smaller chains and independent jewelers, who account for over 70% of the specialty market, which increases the pressure for sector consolidation.

Illustrating this consolidation, you can see from the slide the long-term decline in the number of specialty jewelry firms of about one and a half percent per annum. That equates to about 400 stores per year.

Signet has consistently outperformed its quoted middle market specialty jewelry competitors. This has been driven primarily by the mall stores which currently make up over 75% of the comp store sales base.

Over the last seven years, Signet has increased the number of its stores by about 50% and store space has almost doubled. Since 2000, Signet's space expansion is in marked contrast to the other leading middle market specialty operators, which have shown little if any increase in space.

These trends are reflected in market share movement. Over the last five years, both Signet and Zale Corporation have significantly increased their share at the expense of smaller chains and independents. Signet has gained market share at nearly twice the rate of Zale Corp. During that same period, a number of major chains have consolidated their operations. Reeds was taken private in 2004, and has reduced its number of stores by about 20% to 90. Friedman's and its associate Crescent Jewelers are now in Chapter 11 bankruptcy, and both are significantly reducing their store numbers. Samuel's, with approximately 170 stores five years ago, is now private and has also meaningfully reduced its number of stores.

This profitable growth in market share is reflected in our financial performance. Over the last five years, sales growth has increased by an average of 9%, and operating profit by 11%. Operating margin has increased to 13% and return on capital employed remains in the 20 to 23% region.

This performance has been achieved by focus on our competitive advantages across the fundamental disciplines of retail. And now Mark will review our U.S. operations in detail and pick up many of these points.

Mark Light, President & COO, U.S. Division:

Thank you, Terry.
Our typical customer is making a purchase with considerable emotional content and has limited product knowledge. Every product and in particular every diamond, has its own unique characteristics. The merchandise is all under lock and key so the sales associate is crucial to the selling process, which makes customer service a critical differentiator. Research has shown that the factors most important to jewelry customers are the selection of merchandise available and trust in the sales associate and the retailer, with price being of lesser importance.

To ensure the quality of service we offer, we take only the best and the brightest people and leverage our industry leading practices with a focus on training and continuous improvement. We clearly communicate expected standards of performance and behavior, and give each member of the staff the opportunity to grow. There's a clear delineation between our stores that focus on our customers, and our home office which is there to support and monitor the stores.

The development of sales associate is center on selling skills and building product knowledge. Store managers are promoted from within, and having identified suitable candidates, they receive support to become team leaders and to be profit-focused. We're not only training sales managers; we are training business people. They are given monthly P&Ls and have an understanding of the key elements that they can influence. Ongoing training and career support is provided, for example, through our annual managers' meeting, and courses for high volume stores, and Jared stores. There's central support through the development of courses and training materials for field use, as well as specialist courses run at the home office.

Now looking in a little more detail at the development of sales associates, which starts with the initial 90-day induction program for customer service standards, then all associates are encouraged to become certified diamontologist as recognized by the independent Diamond Council of America. We now require all store managers to be diamontologists. At the end of the first half we had 50% more certified diamontologists than a year ago. In addition, Signet provides continuous selling skills training through division-wide programs. Before leaving customer service, I want to share with you a quote from one of the U.S. trade journals that was published in August based on a personal shopping trip. The article is entitled "Miracle on 34th Street" and it refers to our new metropolitan store that you will see later today. I'll read the last line of the quote. "Watch your backs, independents. Whatever Kay is doing in its sales training programs, it has the customer service segment nailed." That is quoted by the editor in chief of Professional Jeweler. You'll find the full article at the back of your presentation, and it speaks to our competitive advantage in the stores.

Staff recruitment is a key responsibility of store and district managers. We look for people with the right attitude rather than with jewelry experience. Our industry leading training and career development programs are competitive advantages in attracting people. Given the pace of our new store space growth recruiting staff is very important. Therefore, to supplement activity at store level we now have established a central function, started to use web-based practices and begun a drive a design function to attract college graduates.

A unique practice at Signet is the adherence to our daily store standards. Each associate knows the day to day targets needed to achieve success. These are their key controllables over which they have direct influence, such as sales, other revenue services, and multiple unit transactions. These standards are tracked every day by the computer and displayed in the back room of the store. Staff are helped to achieve their goals by coaching from store managers and through peer support.

The incentive programs are also industry leading. Monthly commission is based on a mix of individual and store performance, encouraging the staff to work as a team. Store managers also receive sales commission but a far more important element of their incentive compensation is their profit bonus. We're the only chain jeweler that gives its managers the opportunity to earn an annual bonus based on the profitability of their store. District managers are incentivized by key performance indicators such as recruitment levels, training and, of course, sales. All of our field staff are strongly incentivized with 20 to 25% of store payroll that is performance-based.

Turning to merchandising. Once the buyers have selected which product to test, we put the merchandise into 25 to 200 stores for a period of 60 to 90 days across different size stores and market demographics. We then monitor its performance and based on the consumers' response or the ‘pull’ and the gross margin return on investment, we decide whether to expand or terminate the program. We're able to do this as jewelry fashions change slowly over time. Our size and industry leading systems enable to us trial and refine every product and program. Very few competitors have the scale to do so. Testing also helps us develop products with specific features and benefit that the sales associate can explain and sell to the customer. While there's a core product range that is supported by advertising and runs across each of Kay, the regional brands and Jared, we also centrally adjust the merchandise range by store, reflecting demographic, regional and economic variations. As a result we can maximize sales and minimize mistakes.

Our average selling price has been steadily increasing over the last three years, and in the first half it was up a further 12.6%. This has been a proactive strategy contributing to comp store sales growth. Our customers have responded to our higher price initiatives such as larger and better quality diamonds, and the premium Leo diamond brand. The three-stone jewelry range and the Swiss watch initiative have also lifted the average selling price.

We're testing an expanded range of diamonds in some of our stores in response to customer buying patterns and to further leverage the benefits of our trained diamontologists. Another new initiative is the ‘virtual diamond vault’. This offers consumers access via an in-store computer to a supplier's database of loose diamonds. The stone is then shipped to the store within 24 hours. The virtual vault provides a much wider selection of larger, better quality stones and more cuts without inventory investment or risk.

Over the last two and a half years, the cost of both fine gold and rough diamonds, which account for roughly 60% of our cost of goods sold in the U.S. have increased by about 30%, although the cost of the quality and size stones we generally use has risen by less. While there has been pressure from commodity costs, our gross margin has declined by just 50 basis points over the past two and a half years, largely as a result of mix changes.

We've been able to offset nearly all the cost pressure by selective retail price increases and supply chain efficiencies. Historically, commodity price increases have been passed on to the consumer and given the slow inventory turn in jewelry, retailers can take time before increasing retail prices. Signet is not a price leader. We move our prices to keep them competitive.

Looking next at some of the supply chain initiatives. This is a simplified schematic of Signet's diamond supply chain. This category account for about 70% of our U.S. sales and we purchase about 55% of our merchandising using contract manufacturing. That is we buy loose polished diamonds from diamond cutters and then send them to manufacturers to mount them in settings. This reduces our sourcing costs by eliminating non-value adding intermediaries, removing the jewelry manufacturer's mark-up on the diamonds and increasing our negotiating power for manufacturers for items purchased complete. In terms of our competition, very few have the critical mass and scale to justify the necessary investment in infrastructure to do this. Size alone is not enough. The necessary skills and systems take years to develop and long-term commitment has been required to build Signet's level of expertise.

This capability has helped us to respond to the increase in rough diamond prices. We have used our buying power and expertise to identify lower cost suppliers and to move further up the supply chain. We are also entering into longer term commitments to buy polished diamonds to ensure greater certainty of supply and of pricing.

Another advantage is the development of marketing partnerships with diamond manufacturers, such as that with Leo Schachter. And we continue to consider initiatives that could allow us to achieve further efficiencies.

Marketing support is provided for all brands in proportion to their sales. Therefore, growing sales means increased marketing support. At 6.6% of sales, our gross spend before vendor contribution comfortably exceeds the sector average, and has driven brand name recognition and buying intent. Due to its scale, Kay can support national television advertising, which is the most efficient and effective form of advertising. Currently, only Kay and the Zales brand have sufficient scale to optimize the use of this medium. For the regional stores, radio support is the main form of marketing. Jared uses year-round radio advertising which is referred to as continuity programming, rather than a seasonal-based approach, but increasingly the focus is switching to local television campaigns.

Across the division, broadcast media is supported by other forms of marketing, such as catalogs, and a CRM program which has a 22 million-name database.

I will now review each of our brands in turn.
The number of Kay stores has increased by about 200 stores over the last five years, and average sales per store have increased by 17%. During fiscal 2005, Kay became the number one specialty retailer by sales. Last year it had sales of nearly $1.2 billion. Kay's advertising has been an important element in this. Since the ‘every kiss begins with Kay’ advertising campaign was introduced for Christmas 2000, there has been a very significant increase in brand awareness. This has helped drive sales, which in turn has increased the advertising budget and sales. As an example, this is an ad that ran over this past Mother's Day:

>> Plays Kay commercial <<

Mark Light, President & COO, U.S. Division:

We continue to develop opportunity to further leverage the Kay brand, with the potential to nearly double the number of Kay locations. In the mall format there is scope to expand the number to over 850 stores. We believe there could be up to 500 Kay stores in power strip and lifestyle centers and up to 50 in metropolitan locations.

The Kay off-mall trial is now in its third year of testing. The business model involves lower investment and sales than a typical mall store but has to pass the same internal rate of return hurdle as other real estate investment. The stores are achieving the required sales and we have identified the key consumer and site selection characteristics. We are now evaluating the pace at which we should roll out these stores.

This is the Kay store in Geneva Commons, a lifestyle center in Chicago. The interior has the consistent decor with that of a Kay mall store.

In the first half of the year, we opened our first two stores in metropolitan locations. These are in areas of high population density with high footfall and are larger than a typical mall store. The concept draws on our experience with Jared and has a much wider selection of diamonds, the virtual diamond vault system that I mentioned earlier, more trained diamontologists, and an expanded watch selection. These stores will require above average investment and higher sales per store than a typical mall location. The stores leverage the strong Kay brand awareness and its marketing support, while expanding the potential customer base. This format also has potential in the highest traffic malls across the country.

This is the Manhattan Kay store on 34th Street that we'll be visiting after the presentation. Internally the store has an enhanced Kay decor with product features as well as lifestyle photos, a loose diamond and semi-mount department and an on-site jewelry workshop.

The regional brands consist of 321 stores, with sales of over $450 million. While growth has not been as fast as Kay, store productivity is not far behind. We plan to open net 20 to 30 regional stores per year. National television advertising would require around 550 stores, which we can achieve over time organically. However, we are also prepared to accelerate the process by taking advantage of a bolt-on acquisition provided they meet our very demanding real estate and investment criteria. We intend to test local TV advertising for a regional brand during Christmas of 2005.

Jared is our fastest growing brand with 97 stores, which is equivalent to over 400 mall stores in space terms, and sales of over $400 million last year. It is an immature concept with only 28 stores having traded for five or more years. These locations are satisfying our investment criteria, with sales per store in the fifth full year of trading reaching $5.6 million and a contribution rate similar to that of the mall stores.

We're planning to open 18 stores this year, about 30% more than last year, and see the potential for over 225 Jared stores. We anticipate that Jared will be by sales a top five specialty retail jewelry brand this year.

Jared offers a unique jewelry shopping experience. It has a selection four times that of a typical mall store, has superior customer service, a children's play area, a diamond viewing room, and an on-site jewelry repair shop.

Jared has a striking design, is located in highly visible locations and has its own parking area. The quality of the store fit is high and the breadth of selection offered by Jared is also apparent.

As a destination store Jared has a higher marketing to sales ratio than a mall store, particularly in the early years of trading. As Jared is a new concept, name recognition is key, as well as establishing its great selection. The increasing emphasis on television advertising continues to boost performance, and we will have 100% support on local TV this Christmas for the first time. It is expected that Jared will have reached sufficient scale by Christmas of 2006 to justify national TV advertising, resulting in improved marketing leverage and easier entry into major markets. This is an example of a Jared TV campaign:

>> Plays Jared commercial <<

Mark Light, President & COO, U.S. Division:

It is important that infrastructure is expanded to support the sale growth. For example, we've increased the space in our distribution center by 20% and the capacity of 250,000 units per day is now 40% above the record for overnight replenishment set in 2004. This was achieved by relocating the central repair facility to a purpose built location where we now employ about 60 craftsmen, significantly increasing our productivity.

In credit a new collections software system has improved the operational efficiency. It has also brought greater flexibility to manage volume changes.

One of our core philosophies is that we test before we invest. We develop a thorough understanding of a concept and satisfy ourselves that it meets our investment criteria before we roll it out. Let's look at Jared as an example. We began testing the concept in 1993 and opened 15 stores over the next five years. Between 1999 and 2004, we opened 12 to 15 stores each year as we further refined the concept. Also in 2004, our investment model was confirmed as 28 stores traded through the five-year maturity curve. We are now looking to accelerate the roll-out of the stores and plan to open 18 Jareds in this current year. You can see from the slide that we have adopted a similar process for other store concepts and brand extensions that we are currently working on.

All pro-formas for real estate investment have to achieve a 20% internal rate of return over five years and meet strict real estate criteria before the expenditure is approved. While store immaturity dilutes both operating margin and return on capital employed, newly opened stores normally break even or make a small positive contribution in year one. Over the next three years, they enhance comp store sales growth, and as they start to leverage marketing and central overheads, operating margins and return on capital employed improve. At maturity, which for Jared is assumed to be five years, new stores have similar operating performance to the existing portfolio.

In summary, our investment criteria means that new stores should not dilute our long-term financial performance.

At this time I'd like to hand back the program to Terry.

Terry Burman, Group Chief Executive & CEO, U.S. Division:

Thanks, Mark. In closing, I'd like to pull some of the underlying themes together. Our results have been achieved by the superior execution of a superior strategy. But they also reflect some basic philosophical beliefs within our business. For example, we maintained a narrow and deep focus, so that we can be leaders in all aspects of our business. We also believe in thoroughly testing initiatives before we roll them out. This increases the likelihood of them succeeding, and eliminates the opportunity to squander resources on whims.

Our strengths lie in our superior staff, processes and systems. These have been built up over time and work within our disciplined but enthusiastic culture. The strongest characteristics of that culture are a drive to continuously improve everything we do and a belief that everything we do must be done in an excellent manner. We just do not settle for second best. We do not tolerate sloppy thinking or work from each other.

We have discussed our competitive advantages in merchandising, store operations, marketing, and real estate that we've established over the years. These drive the sales line, our industry leading operating ratios, and our growth record, and they are reason why we are well positioned for future growth.

The consistent execution of our strategy as well as our culture of continuous improvement, are due in large part to the depth, quality and commitment of our management and staff, further examples of which you'll see when we visit our store on 34th Street shortly.

So I thank you for attending the presentation and listening to that which we've had to say. We would now all be happy to answer any questions that you may have.
We do have a microphone available, so if you just raise your hand and we'll get you the mike.

<Q>: I was wondering if could you talk more about the virtual diamond vault. I guess how large is the offering and how many stores it's in, et cetera.

<A>: Sure. You're going to see a demonstration of that when we go to 34th Street. But Mark, you want to give them just the basics of that?

<A>: Sure. The virtual diamond vault is currently in every one of our Jared stores. It is also in about 30 mall stores that we're testing currently. And in all of our metropolitan stores. And we'll present it to you in the store today, but what happens is you have an opportunity to view an additional 2000-plus stones above and beyond our existing inventory of size and shapes and quality that we don't carry in our inventory.

<A>: It's actually linked into our vendor's inventory, and you'll see that the certificate on the diamond comes up when you -- let's say a customer comes in and we have five carat and a half stones in inventory, but for some reason we don't have the quality they want, the shape that they want, the color that they want. This gives them the opportunity to access and may pick up 15 other choices, and then a virtual loupe comes up, so after you see the certificate, then you can you can actually see a picture of the diamond and it can rotate it around, magnify it, with the virtual loupe, with the virtual diamond, and it's quite unique. The vendor developed the software on their own, and you know, just ask when you're on the store visit, make up a diamond size, shape, quality, and you'll see -- we can pull them up from that vendor's inventory, and you'll see the robust selection of merchandise that enables us to make available to the consumer.

<A>: (indiscernible) -- and our stores have an exclusive arrangement for this virtual loupe in this program.

<Q>: I guess I have two questions. The first one is the second national mall brand that you mentioned in the book. Can you just give us a little more color on that? And the second question is, there's no income statement in the book, but your operating margins in

the U.S. are twice as high as your second largest competitor. I was just curious, you know, what do you think the biggest competitive advantage is. Do you think more on the SG&A side you guys are really good at controlling the expense side, or is there something in the gross margins in thanks.

<A>: Let's see. Operating margins. What was the first question?

<Q>: What exactly is the (indiscernible) --

<A>: Right. The second national mall brand is, if you notice on some of the materials, you've got about nine regional brands that are strong in each one of their regions, as Mark discussed. We're going to be developing -- we'd like to develop them, consolidate them all under one name, and be able to advertise on national network television.

The Kay performance, the Kay brand performance, versus the performance of all those other regionals consolidated, Kay outperforms them by about a 4% compound annual growth rate over the last five years, and the primary difference that really -- the really meaningful difference between the two formats is national TV advertising. So we need a way to consolidate those and create enough mass that we can advertise on national TV and get them in -- get the regional brands in the same competitive position.

One of the steps that we have to take is to find a TV ad campaign that's as effective as "Every Kiss Begins With Kay." One of the other steps is to build a mass that we can cost effectively afford national TV advertising. So we're working on both front.

It would take about 550 stores to afford the national TV advertising, and we can do that either by opening stores, which is a slower road, or a combination of opening stores and doing some acquisitions. We have said in the past that we'd like to do an acquisition or series of acquisitions that would jump start that process to get to us that -- about 550 level. But if we can't do it that way, because we're very selective about anything that we'd acquire, we can do it by opening stores. So that's the process that we're going through in trying to create a second national mall brand.

In terms of operating margins, one of the -- one of the -- probably the primary driver of operating margins, as it is in most businesses, is productivity. So for us it's productivity per store. And our productivity per door is higher than that of any of our major competitors. There's fewer than -- as we reviewed in the presentation, that are now public so we've got fewer and fewer comparisons. So I'd say the primary differentiator is our ability to be more productivity out of our stores. But that goes to, you know, when you say is it one thing or another, better buying, better merchandising, better advertising, better -- it's all of the above. You've got to do all of those things, you've got to sell better on the floor, you've got to be more selective about your real estate, people have to be trained better, need to drive more customers through your door through better marketing and advertising, have a better selection for them and merchandising. But all that adds up to improved productivity, and that productivity is a main driver of operating margin.

<Q>: I have a guess that the reason why your multiple is lower than typical specialty retail center the U.S. is because most shares are traded in the U.K. Is there any way you can do an exchange program where we can -- if I'm a U.S.-based institution, I buy the U.K. shares because that's where the liquidity is, bring them back and exchange them for ADRs? Because if you have more shares in ADRs, or more liquidity in ADRs, you might be able to get a higher fee multiple and that might be a strategic advantage to lower your cost to capital if you're going to do these acquisitions? What are the challenges of doing that? Challenges, U.K. challenges.

<A>: (indiscernible) prospect is to go over to ADR. A liquidity in the ADR program, is somewhat -- I was wondering if one of the reasons why we couldn't (indiscernible) vendor to move to New York and belief that over the longer term we will improve liquidity through the ADR program. At the moment, yes, you can go back from (indiscernible) U.K. shares back into ADRs.

<A>: The short answer is yes, you can switch from U.K. shares or back into ADRs.

<Q>: Okay. Hi, I have two questions. The first one is on pricing. You mentioned the 12.6% in the first half, can you give us an indication of how much of that is due to pricing action and how much is due to trading up the range. And also what is the lifetime between when you see an increase in commodity prices and when you pass through the increases to your range? And secondly, if you could just give us a little more detail around the increased distribution of facility for Jared.

<A>: In terms of average price increase, breaking down that 12.6%, the average price increase for Jared and for the mall brands was about 10% for each format. But because Jared became a bigger -- because we're expanding Jared at a more rapid rate than the mall brands, Jared became a bigger percentage of the total, so that it took us from an average price increase of a little over 10% to about 12 and a half percent. The first component.

The second component would be price action versus merchandising initiative. And we are merchandising to higher -- we're just merchandising a higher price point as opposed to just raising our price points, which is also something that we're doing both of those. It’s very complex. Trying to figure out just how much of each is -- you know, which one is responsible for that 10% price increase within each format. But we believe, and we estimate that it's about 50% each. 50% merchandising initiatives, and about 50% price increases.

When you talk about the increased distribution facility for Jared, do you mean our home service distribution facility -- our warehouse facility, our distribution center? That wasn't just for Jared. That's for all of our growth. And what we did, Mark said in his presentation, we moved the repair center, which was taking up space from our distribution center, which for security purposes is below ground, so we can't push the walls out. So we do have a plan to expand it by -- there's a way we can add on to it. But before we did that, what we wanted to do is some of the space in there was being taken up by jewelers, working jewelers, who were doing repairs on merchandise. And so we moved them to a separate purpose-built facility, which by the way, increased our productivity. And we have about 60 working jewelers in the facility - and watchmakers. And then we used that, we captured that space to be able to expand our distribution facility to handle the increased volume that we're producing. So it's just a matter of recapturing that space. But we can -- part of our success is replenishing inventory very quickly. We have very robust systems that we can replenish every night. We get pick lists from the merchandise that was sold the day before by 6:00 in the morning the next day, and so in the heart of the Christmas season, for example, when merchandise is turning very fast and it's important to be in stock, we can replenish that merchandise the next day.

<Q>: If I could ask a couple of questions. First is, Penney's and Kohl's and Macy's Federated, are all pushing jewelry to a much larger extent now, particularly Penney's and Kohl's, which I know they've made inroads into Zale's market. What's the strategy because they cater to the same middle market as Kay does?

<Q>: The other question is the differential, your operating margin is phenomenal compared to Zale's. But how much is the direct sourcing providing you? Does that give you a third of the differential? Is that a meaningful point of differentiation between you and Zale's and the operating margin line?

<A>: In terms of the department stores, actually department stores have lost market share over the last ten years. So the result of that all that movement, and we're all aware of that movement within the department store sector. But the result has been a reduction in share of the -- jewelry that's being done sales volume that's being done in department stores. However, and I think we probably covered a pie chart in the presentation, where you saw that it's about 50-50 between specialty jewelers and called them general merchandisers, those not primarily engaged in jewelry. And that 50% has been consistent, 49/51, 51/49. But it's been very consistent over about the last 15 or 20 years. So there's movement within the side of that pie chart, but there's not a lot of movement from one side to the other in terms of market share.

In terms of our advantage by our greater developed direct sourcing capability, we've been doing this for decades. And direct sourcing diamonds is no easy feat. It's not something you want to do casually. You can think of some of the problems you're getting. Some of you that have toured our distribution facility understand the difficulty of controlling these. You can get a $5 million package that's no bigger than that <indicates a small pouch>. And somebody's got to sort that, grade it, keep track of it, make sure that the diamond that you send out to the setters are the diamonds that they send back, that the weight that you send out to the setters is the weight that you receive back, that the inventory remains your inventory and doesn't walk out the door. And they don't show up on metal detectors. That the merchandise that you buy is productively turned, because manufacturers, cutters and polishers want you to buy as wide as possible and we want to buy as narrow as possible because that's the merchandise that we use and those fringes can result, if you wind up with those fringes, can wind up with huge write-offs if you have to sell those off because they're not your quality.

So we've got over 20 years of developing the buying skills and it's not just buying -- you know, I'm trying to give you some feel for the complexity of this. We've spent over 20 years developing not just the buying skills but the people that have the skills to sort, grade, assign the diamonds to the merchandise, keep track of them, keep track of the diamonds. And the systems that support that so that it maintains our inventory in our hands, what we do with that competitive advantage, however, as opposed to -- and we are buying closer to the source. We're on that chart that you saw up there, we're buying much closer to the mines than -- as a proportion of our productivity in sourcing, than our competitors. And what we're doing with that is we're buying a better -- we're spending the same money to provide the consumer with a better quality piece of merchandise. So we're raising the quality level, making it much more consistent, because as you can imagine, our expertise in this area was due to our quality control. So then our competitors were providing a consistent quality of merchandise, which is a higher value. And then what we do is the reason we're emphasizing training so much because we want to be able to explain to the consumer why our quality -- that our quality is better. If you notice in our stores, there are diamond scopes in every store. And we want the customers to see our diamonds under magnification. We show them that. The reason most of our competitors don't have diamond scopes in their store to see the merchandise under magnification, is one, their quality is lesser than ours, and two, they don't have the skill set on their sales floor to be able to explain it to the consumer.

So how it really comes through -- there's a margin advantage to us, but it's a small one and insignificant compared to the extra buying advantage it gives us by providing a better quality diamond.

<Q>: One last question. On Blue Nile over there, the strategy, what are you incorporating in your strategy towards selling on the Internet in a larger way?

<A>: We've just -- we don't -- in the U.S. we're not selling on the Internet right now. In the U.K. we just did, if the word is ‘turn on’ our website. Activate our e-commerce capability. Better get that jargon right! And for the week that we've had it up, it has been encouraging. But there's a long way to go. It won't be the too distinct future that we activate e-commerce for the U.S. also.

And simply, we haven't done so up to now because the market just hasn't been large enough, and if you take an anticipated market share, that we could project, on a very small market for e-commerce jewelry, it was easy to figure out we were going to lose money. And so for the last six, seven years when everybody was entering e-commerce, especially at the end of the '90s and a lot of companies have, not just in jewelry but other formats, have the write-offs to prove it, and the losses to prove it. That they entered e-commerce too soon. We didn't think that it was appropriate because it was pretty easy to figure out we were going to lose money.

Now, the market is growing to a big enough size, the whole e-commerce, and the jewelry share of it, and that which we -- our appropriate share, seems like it's getting close to the point where we can earn a profit by turning around e-commerce and like I said, we're working on developing that.

So we think that our brands will be a big advantage to us. Our TV advertising and print advertising refer consumers to Kay.com. You can see it now as it is currently a marketing site, and not too far off we'll enable an e-commerce capability.

<Q>: Just a couple of follow-ups also. I don't think you gave it, but first half like to like in the U.S, and can you divide that between Jared and Kay? Just give an idea what have the comps look like?

<A>: First half like to likes in the U.S. were 7.8 or 7.9? 7.9 -- we don't break out Jared versus the mall brands. Jared is higher than the mall brands, and it should be, frankly, because it's got more immaturity in it. And new stores comp at a higher rate than mature stores. Jared has the highest. Kay is about in line with our U.S. Division average. And has, because of those strong comps over the last year become the leading jewelry brand by volume, specialty brand by volume. The regional mall brands, as we said, are underperforming Kay. And that margin, by the way, the 4% gap, is growing. So it's the strength of TV, and that's why we're into this second national mall brand development. That's really why we're going about that.

<Q>: Do you see any cannibalization between Jared and Kay?

<A>: No. No, we don't see -- when I say any. Minimal. Very minimal. The overlap, and we track each customer that makes a purchase in our stores and the overlap between Jared stores. Customers that visited Jared store and make a purchase and mall stores within a mile of the Jared is less than 3%. So we're really competing with independents in Jared.

<Q>: Finally, as we look toward the holiday season and we're hearing troubles at Whitehall, what do you think the customer reaction is to going out of business sales? Do you usually gain market share immediately, or do you think those companies can hurt your like to likes in the short-term?

<A>: You can't run going out of business sales in malls. Your leases prohibit you from doing that. You can run huge clearance sales with huge discounts, but the mall police, not only the nature of the signing but the quality of the signing that you can put up in your stores, there can be a small blip to the extent somebody may close some stores, but I just went through a whole list of chains that have closed stores over the last few years. And they didn't -- there was no meaningful impact on our business.

<Q>: A few questions. Can you tell us in the first half comp in the U.S, if you can break out what percentage of the growth was growth of the average ticket and what number of transactions and what your gross margin was in the first half in the U.S.? And finally, the average store size for Kay and for Jared, square footage.

<A>: In terms of customer -- obviously, if our comps in each division went up -- or if our total comp is up 7.9% and our average transaction was up 12.6, we were selling higher priced units but to fewer customers. Now, in the Jared division their comp exceeded their 10%, their 10% average price increase. In the malls, as I said, their comp was about average of the U.S. Division. So if you just take the exact average, in Kay with a 7.9 and a 10%, obviously we had fewer sales. But you know, when you merchandise a higher price point, you are going to sell fewer units.

In terms of our gross margins, we don't give an exact figure for proprietary reasons, but we did say that they were slightly lower than prior year. And that was --

<A>: (indiscernible).

<A>: Did we give an exact number of ten basis points? But we don't give an absolute number of what our gross margin is. But just off 10 basis points. And that was our mix, the adverse impact of the mix change was greater than that ten basis point. So our supply

initiatives and our price increases offset the -- more than offset the commodity cost increases. It's really the mix changes that adversely impacted the gross margins. But those higher price point and that adverse mix impact are the other side of seeing the productivity increases, which help increase our operating profit in the first half by what was it, 18%, I think it was. 18, 19% U.S --

<A>: 19%.

<A>: 19% in dollar terms. So that was positive. And you had a third question, which I forgot.

<Q>: Size of your stores.

<A>: Store size. Mark?

<A>: The average Kay store is about 1400 square feet. And the average Jared store about 5900 square feet.

<A>: So, any other questions? Okay, thank you again for your attention