Value City

4th Quarter Earnings

Conference Call

April 1, 2004
6:00 AM

Operator (Joe)

Thanks for holding, ladies and gentlemen, and welcome to the Retail Ventures' 2003 4th Quarter Earnings Conference Call. During the presentation all lines will be on a listen-only mode. There will be an opportunity to ask questions and instructions will be given at that time. Thank you for your attention, I now turn the time over to your host, Mr. John Rossler.

John Rossler, President and CEO

Thank you, Joe, and welcome to Retail Ventures' 4th Quarter Fiscal 2003 Conference Call. I'm John Rossler, President and CEO. With me today is Ed Kozlowski, our Chief Operating Officer, and Jim McGrady, our Chief Financial Officer. Before proceeding, I would like to restate for you the company's policy with respect to forward-looking information pursuant to the Private Securities Litigation Reform Act of 1995. Statements made in the course of this call that are not purely historical, such as statements regarding the company's or management's intentions, expectations, or projections for the future are forward-looking statements. Actual results could materially differ from the forward-looking statement. Factors that could cause or contribute to such differences include, but are not limited to, the factors and risks discussed in the company's annual report on Form 10-K for the period ended February 1, 2003 and other reports filed from time to time by the company with the Securities and Exchange Commission. Any forward-looking statements made during this call are based upon information presently available to the company, and the company assumes no obligation to update any such forward-looking statements.

Today we announce the 4th quarter and fiscal 2003 operating results. The fourth quarter was very successful, continuing to build on the progress made in the third quarter. The fourth quarter net income more than doubled from the prior year, and our net loss for the fiscal year was below our previously announced estimate. We had continued strong fourth quarter comparable store sales at DSW and Filene's Basement, and the consolidated gross profit increased two full points over the prior year. Jim will discuss more of the details a little later.

2003 got off to a slow start for Retail Ventures, as it did for most retailers, with the sluggish economy and the consumer preoccupation with the war in Iraq. However, the third and fourth quarters showed substantial improvement in operating profit over 2002, increasing by 80 percent. 2003 completed the second year of our turnaround effort toward realizing our three-year goal of returning this company to respectable profit levels. Our businesses are now well-positioned for improved results, and we expect our management group to leverage this positioning.

In Value City Department Stores we saw a positive momentum shift in the number of units sold, beginning late in the first quarter and sustained positively through back-to-school period and through our traditional holiday selling season. Unfortunately, this important step forward of increasing the number of units sold was offset by lower-than-planned average unit retail. This issue was discussed in December during our 3rd quarter conference call. Initiatives have been in place for four months to improve this situation. While we have made strides in moving the average unit retail northward, we do not expect the full impact on sales to be seen until the back-to-school season, due to the length of our buying cycles. We believe the continued high-value perception of our product offering presents a clear opportunity to generate a higher average unit retail from our loyal customer base.

DSW continues to show strong improvement as a growth retailer. DSW enjoyed the best comp store sales of any major footwear retailer in 2003. We have leveraged these strong comps in 2003 through improved gross profit as well. We expect strong comp stores sales increases in the low mid-single-digits for the first half of 2004. We plan to open 35 new stores in 2004, with nine units in the first quarter. We expect continued favorable leverage in the comp stores operating structure, but anticipate a slight offset from increased pre-opening expenses in 2004 due to the increase in the number of store openings.

Filene's Basement strategy used the year 2003 as a recalibrating year by returning to its legendary roots of using event-based marketing to promote its "best brands for less" offering. The consumer has responded favorably, and the Basement is now positioned for successful growth going forward, with sales comps showing significant improvement during the final two quarters of fiscal 2003 and into the beginning of 2004. Filene's Basement opened one unit in 2003, which to date has exceeded its sales expectations. Filene's Basement is planning to open four stores in 2004, three of which will open in the first quarter. Having reestablished its market position in 2003, we expect gross margin improvement in 2004, specifically from improved IMU and controlled markdowns.

In summary, over the past two years, Retail Ventures has undertaken a number of change initiatives, which have resulted in the creation of a portfolio with strong brands, each with its own unique and compelling position. We are starting to see the results of this effort. Our principal goal for 2004 is to leverage these positions and continue the momentum experienced during the third and fourth quarters of 2003. Thank you. I will now ask Jim McGrady to proceed with the financial review.

<u>Jim McGrady, Chief Financial Officer</u>

Thank you, John, good morning everyone and, again, welcome to the discussion of fourth quarter 2003 and the fiscal year results. As John mentioned, we announced a fourth quarter profit of $11.5 million, compared with the profit in the prior year quarter of $5.3 million. Our diluted earnings per share were 25 cents in the quarter versus 12 cents in the prior year quarter. For the fiscal year, we're reporting a loss of $4.4 million, compared to the prior year loss of $3.7 million and, as a reminder, that includes the cumulative effect of an accounting change and the expenses that were associated with the refinancing of our debt facility back in 2002. The diluted loss per share for each respective year is 13 and 11 cents. Total sales for the fourth quarter increased $41.7 million, or about 6.1 percent, to $720.4 million from the prior year of $678.8 million.

Comp store sales for the quarter increased two percent. By business segment for the quarter these were: Value City had a decline of 1.3 percent, DSW was positive 11 percent, Filene's Basement was positive 8.1 percent. And, again, that, in summary is two percent.

Value City's comp quarterly sales decreased in non-hard lines by about 1.2 percent and in apparel by 3.1 percent. Jewelry increased 12.7 percent for the period. The apparel divisions of men's and ladies' had decreases of 6.4 percent and 3.9 percent, respectively, while we saw an improvement in the children's business of 6.4 percent. Shoe sales at the Value City operations were a positive 2.3 percent for the quarter. Our DSW sales were $181.5 million, and that's a 26 percent increase in the quarter, which includes a net increase of 16 stores and 53 additional leased shoe departments, along with the comparable store increase that we mentioned earlier of 11 percent. For the year-to-date period, comp store sales increased 5.6 percent at DSW, and rose to $772.6 million for the year-to-date period, and that includes the new stores in the leased department.

Filene's Basement sales increased 12.9 percent for the quarter to $89.1 million, and comparable sales increased 8.1 percent. For the year-to-date, our comp store sales at Filene's increased 2.6 percent, to $316.9 million, and that includes the one new Filene's

Basement store that John mentioned we opened during the year. In the fourth quarter, gross profits as a percentage of sales increased by 200 full basis points to 39.8 percent from the previous year's quarter of 37.8 percent. The total gross profit increased by $30.3 million, to $286.5 million, due to higher IMUs and lower markdowns in our DSW segment and the change in the merchandise strategy at Filene's resulting in, again, lower markdowns.

These positive items were negatively impacted by a lower IMU and markup at reduced sales in the Value City segment. For the year-to-date period, the gross profit percentage increased 40 basis points, to 38.6 percent from the prior 38.2 percent. Gross profit by segment in the fourth quarter was 39.7 percent at Value City, 43.4 percent at DSW, 32.9 percent for Filene's and, again, 39.8 overall.

Our total SG&A expenses for the comparative quarters increased $21.7 million to $260.7 million, and as a percentage of sales increased from 35.2 to 36.2. For the year-to-date period, our SG&A increased $65.3 million, to $978.2 million, or 37.7 percent of sales, compared to $912.9 million, or 37.3 percent of sales in the prior year. The 16 new DSW stores added approximately $14.4 million in SG&A expense, while the new single Filene's Basement added approximately $4 million of SG&A. SG&A as a percent of sales by division in the fourth quarter was at Department Stores, 34.4 percent; DSW, 41.9; Filene's Basement, 33.5, and again, the total was 36.2 for the quarter. Our operating profit by segment in the quarter at Value City was $24.1 million; at DSW was

$2.9 million, and at Filene's was $72,000; again, the total for the quarter was $27.2 million.

Our interest expense for the quarter decreased by $1.2 million to $8.3 million. The components of this is we had an increase in our weighted average borrowings, which was offset by a decrease of about 146 basis points in the weighted average borrowing rate we had, and this was due to the availability of lower market rates on our LIBOR loans. For the fiscal year, interest expense increased $2.1 million to $34.6 million. Our weighted average borrowings increased over the year by about $26.1 million, and the weighted aver borrowing rate increased through the year by about 70 basis points.

During the current year, we established evaluation allowance for our deferred taxed assets of about $1.5 million. The reserve reflects a reduction in the estimated amount for future tax deductions, and this is primarily for state and local taxes and a little bit of an excess contribution carried forward. Our tax rate for the current year was 27.9 percent, and was affected by the permanent difference in the amortization of our warrants issued in connection with the 2002 refinancing, and it also was affected by the valuation reserve.

As we turn and look at our balance sheet, our inventory total was $420.3 million at the end of the year, compared to $389.8 million last year. This is an increase of about 7.8 percent. The total increase includes approximately $11.3 million for the new DSW stores, approximately $5.5 million for the lease departments, and $2.1 million for our new Filene's Basement store. Net working capital at the end of the year was

$234.9 million, compared with $181.4 million in the prior year. Our current ratio was 1.9 and 1.6, respectively, in each of the past two years. Net cash used for capital expenditures was approximately $68.7 million this year, while depreciation and amortization totaled $57 million, and this is in contrast to $60.3 million in the prior year.

EBITDA in the fourth quarter was $42.5 million versus 34.9 last year. And fiscal year 2003 EBITDA was $85.4 million versus last year's 90.9. Availability under our secured credit facility was $120 million at the end of the year, and is presently about $161 million.

That ends the review of the historical numbers, and now we're going to turn and look forward to 2004. As John mentioned, we anticipate that we will open 35 DSW and four Filene's Basement stores. Capital expenditures for our store-opening program is estimated to be about 27 to $30 million. The total cap-ex in 2004 is planned between 53 to $56 million. Depreciation and amortization is expected between 59 to $61 million next year. Our EPS expectations for the year is in the range of 30 to 35 cents per diluted share. By quarter, we expect earnings per share to be in these ranges: In the first quarter, a loss of 20 to 25 cents per share, improving to a breakeven in the second quarter, and earnings of 15 to 20 cents in the third quarter, and 25 to 30 cents in the fourth quarter.

These estimates are based on a comparable sales increase in the mid single-digit range, with total sales up in the high-single to low double-digit range. We expect gross margin to improve by 25 to 30 basis points compared to 2003, and this improvement will result from an improved IMU and AUR at Value City, plus the full-year effect of our market repositioning at Filene's Basement. The expectation is that DSW will maintain its 2003 margin rate.

The SG&A expense rate is expected to decrease by about 10 basis points versus the prior year. This includes the impact of pre-opening expenses for our store programs. We expect interest expense to be about 33 to $35 million, and our tax rate should be in the area of 40 to 41 percent for the year.

That concludes, at this point in time, the financial review, and our forward-looking 2004 review. And at this time, I would like to ask Joe if he would kindly open up the lines for questions.

<u>Operator</u>

Thank you. To ask a question, please press a "1" followed a "4" on your touchtone. If for any reason you wish to retract your question, press a "1" followed by a "3". All questions will be taken in the order that they are received. You will be placed back in the conference following your question. Once again, for questions or comments, press a "1" followed by a "4". And our first question or comment comes from Mr. David Mann.

<u>David Mann</u>

Yes, good morning. Congratulations on some of your turnaround efforts.

Jim McGrady

Thanks. How are you doing?

David Mann

Good morning. I guess a couple questions. First of all, on the gross margin strength that you saw, can you just walk through, were there any other benefits or factors that helped gross margin, such as shrink? And can you also talk a little bit about some of the initiatives you're doing at Value City to try and improve the average unit retail?

Jim McGrady, Chief Financial Officer

Yeah. Actually we probably had three components that we saw that improved the margin rate for us in the fourth quarter and really throughout some of the year. We had a very strong IMU in our DSW division, which was really a key factor to us. We did also see an improved number at Filene's Basement as well, as far as IMU was concerned. We also had very good end-of-year clearance, and that helped us with our markdown reserve as we entered into fiscal 2004, you know, what we evaluate there. And we also did have a record good year for shrink results for the company. Those three things were key elements in helping us with our margin rates in the fourth quarter and also throughout the year.

You also asked, I believe, about the efforts that are going forward for the AUR at Value City. I think as we look at this, we are really taking a hard look at what our customer base is willing to support. This is a complicated formula and it's something that we really are working on it. And because of our buying cycles, it takes a pretty long period of time to really be able to perfect exactly how we're going to do that on a chain-wide basis in the Department Stores.

John Rossler, President and CEO

David, it's John, good morning. I know that most of the people that follow us know that our systems are not yet up to state-of-the-art. It has made it difficult to manage average unit retail at Value City department stores. We went for a time period, went for about a year, effectively without what I would term to be a "Chief Merchant." And it really was not until about October when we did the Retail Ventures reorganization and we put Stuart Glasser as the President and Chief Merchant position at Value City Department Stores. He's now focused 24/7 on managing that average unit retail. We didn't do it earlier in the year because he had his hands full moving our soft goods buying office to New York and what-not. But, you know, we talk an awful lot about having the right people in the right place. And what really happened last year, we kind of had an empty chair too many months of the year. But that's going to be the biggest impact on getting the average unit retail back up, is just having a Chief Merchant in place managing it everyday.

David Mann

Is the issue with average unit retail consistent across all of the categories? I know you've had some success on the hard line side. Are you seeing any progress there?

John Rossler

It was easier to bring the hard lines up to speed quicker with the buying cycle. The buying cycle on the soft goods is such it's just taken us a little bit more time.

David Mann

One question on your debt situation. Can you give any update on any refinancing efforts on some of your high-cost debt, and what kind of timetable you might see on that? And, then, is any kind of refinancing built in to the guidance that you've given?

Male Voice

First there is no refinancing that's built in to any of the guidance that we've just stated. And, I guess as an update, we really are still in the process of evaluating a lot of our options that we do have trying to make sure that this is not a bridge type of an agreement, it's something that really will be for the best in the long run for the company and everybody that's involved with it. So, I believe that we'll probably have something in place sometime during the second quarter.

David Mann

Great, thank you.

Operator

And our next question or comment comes from Mr. Lee {Baccus}.

Male Voice

Hi, Lee. How are you?

Lee Baccus

Pretty good. First, you had discussed in the past marketing efforts to bring the customer back into Value City Department Stores. Maybe you can discuss those and any success that you've had with those.

John Rossler, President and CEO

Lee, good morning, it's John. Over on the DSW side it took us a couple of years to find the key to that door, and Value City is taking us a while also. In the spring/summer season last year, we had a new electronic campaign that we felt failed. And then in the fall season, we came up with a campaign that we thought was much more brand relevant, and our market research has shown us that it's been extremely successful and improving brand awareness and bringing more traffic in. In fact, our records show that in the second half, we sold more units in 2003 versus 2002. We think that was attributable, to some extent, to our new marketing campaign.

Lee Baccus

Could you also discuss pre-opening expenses this year? You said pre-opening expenses would be up. Could you quantify that pre-opening versus last year?

Male Voice

Actually, I think overall for the entire year we're planning on about $8 million higher pre-opening expense during the year than what we had in the prior year.

Lee Bakus

Okay. Also, John, you have discussed in past conference calls your longer-term goals as far as operating profit margins. Could you update us on that?

John Rossler

Yeah. Actually, as I said, I think that longer term, as we look down the road, and I'm talking beyond actually 2004, you know, we would like to get back to somewhere around a full three percent, if not higher, pre-tax profit in the short run. And I think that that's achievable as we look around the corner beyond 2004. I know that's a long way out, but we're excited about that. I think that as we see the comp store sales and the sales growth and the store growth that we're able to achieve, that we're going to be able to start to approach that on a long-range basis. But I think, again, that next year the guidance that we gave is probably going to be something that, as we take a look and get further and further into the year here, something that we're going to have to evaluate again.

Lee Baccus

Okay. Well, I've noticed in Q4 – I would think that by Q4 a lot of the efforts that you're taking you'd start to see some results. But, if anything, that guidance isn't that much of an increase over what you've done this year. Could you comment on your thinking there?

John Rossler, President and CEO

Yeah. Actually, as we take a look at that, there's a little bit of the big impact is obviously in the margin that's out there, and I think really, you know, we had a great quarter for margin, as you take a look at it. And I don't know if we can really improve on that substantially in the margin rate as we look forward, and I think that there is some conservatism in our fourth quarter estimates that are out there. But in fact I think that they're really, at this point in time, what we believe is achievable.

Lee Baccus

Okay. Thank you.

Operator

And our next question or comment comes from Mr. Arnold {Brief}

Arnold Brief

A few questions. Just as a quick one, on the guidance that you provided, would you tell us the number of shares that you've used when you said "fully diluted"? Is that 52 million or?

Male Voice

Yeah. Our fully diluted is approximately 52 million.

Arnold Brief

Okay. I just wanted to make sure you're using the same number you had. This is the third year of your effort to turn around, if I remember correctly, you became CEO in February of 2002.

Male Voice

Actually, Arnold, it's our second year. We've just completed our second year, and this will be the third.

Arnold Brief

Right. Right, this will be the third year.

Male Voice

Yes.

Arnold Brief

Right. And quite often in the third year, the results of a turnaround effort begin to take hold, and then accelerate in the fourth year. And this may be old hat for some people who've followed your company for longer than we have, but could you just sort of give us a rundown of what your major efforts in the last couple years sort of focused on, and how well you've come along in terms of achieving those efforts? And, finally, what you think the major effort from here is to focus? I know you've still got the IT program. So, just sort of walk us through what you tried to do, what you actually have accomplished, and what's still in front of you?

John Rossler, President and CEO

Well, Arnold, it's John. In the case of Filene's Basement, it was an acquisition back in 2000 out of Chapter 11. It had really lost itself and continued to not be on track until this year. As I had mentioned, we really returned the strategy to its legendary roots of "best brands for less." It had gotten to too low low-grade brands, and ended up in the pack with, you know, at the TJ Maxx levels, and we've tried to boost it up closer to a Loehmann's type level. And we got out of POS marketing, which was very devastating to its customer following, and its margins and we're back to the legendary event-based marketing, such as the suit sale, and the legendary bridal gown sale. We're very excited about the sales increases we see in that division now, and we're excited about the prospects for improving the margins. And –

Arnold Brief

Could I just ask one question before you go on to the other divisions? You had very good comps in Filene's in the fourth quarter, and not too much in earnings. What transpired in these?

John Rossler, President and CEO

Well, one thing happened, again, the complication of the retail formula. Heywood Wilansky, 2003 was his first year as President of that division. And the one factor, the retail formula, being initial markup, really fell short for us last year. And that's something that's been at his attention for the past few months, and that's really the area, along with controlled markdowns, that IMU is really the area where we see margin improvement in Filene's Basement.

Arnold Brief

Could you go on then?

John Rossler, President and CEO

And in the case of DSW, you know, we've continued to pound away trying to improve marketing, merchandising, and store operations. In the years going back, Arnold, in time, in the years 1999 and 2000, DSW enjoyed back-to-back years of 19 percent comp store increases. And then, in the years of 2001 and 2002, DSW had flat comps. And during those years, because we have traffic counters in the stores and we have a very sophisticated customer loyalty program, we were well aware of the fact that we were bringing in new customers during 2001 and 2002 but we were not getting credit for it on the top line. And, to a great extent, we feel that was because indulgence spending had slowed down a little bit. DSW acts a little bit like a luxury brand in that regard, where a lot of our customers come in and they do indulge in spending. So, sure enough, in the year 2003, when the market started turning around, we started seeing the indulgence spending take hold again. And, you know, it's been very good for our sales.

We work very hard on our vendor relationships, and we have found with each passing year, and we expect this to continue in the future, that our vendor partnerships will continue to help strengthen our opportunities in DSW.

The biggest challenge from a turnaround standpoint was in Value City Department Stores. And it's really, the turnaround efforts are throughout that organization. The corporate support, or our overhead structure, was far in excess of what any retail company could pay and then still be profitable. So we have made drastic reductions in the cost of the overhead support to that business.

On the retailing side, it's been a matter to try to, through market research-based knowledge, to try to come to grips better with who the customer is and what type of merchandise the customer wants. And it's kind of been two steps forward and one step back from that standpoint. We've gone a little high; we've gone a little low. We think we're zeroed-in at the right level now. We did have about a 12-month period where, as I had mentioned earlier, we did not have a person in the Chief Merchant chair, and we all sort of shared that chair on a part-time basis, and it was ineffective and allowed our average unit retail to get out of control.

We know we've been selling more units the last few months, even in the month of February we're disappointed our six percent comp store sales increase that month in February was not substantially more. It would have been, had we been able to be at the same average unit retail that we were at in February of 2003. So, you know, it took us sort of a nine-month process for the average unit retail to rear its ugly face, and it's sort of taken us six to nine months to get it back. We're staring to see the light of day now, and I can see by back-to-school season that the average unit retails will be back in place. We had gotten to a point where some of the same merchandise that our competitors offer we were far, far beneath their low offering prices, and it just is a matter of on a daily basis managing it from the point of purchase order a little better.

As I mentioned earlier, we're extremely enthused about our new marketing campaign for Value City. It did take us a while, a little bit of trial and error, but we felt we hit it real good in the fall season. We know from market research that it was very brand relevant, created more awareness, and is generating more traffic.

Arnold Brief

Okay. So at this point you feel the management is in place in all three of your operations, the management changes and everything of that nature, and the turn has been completed?

John Rossler, President and CEO

Yes. And again, the most challenging one, being Department Stores, where we're very pleased with our management structure now.

Arnold Brief

Okay. And you mentioned three percent guidance as a target. The three percent is for the company overall as opposed to Value City?

Male Voice

Yeah.

Arnold Brief

Okay, wouldn't DSW margin potential, once you get through the heavy opening expenses and the stores start to mature, be substantially higher than that?

Ed Kozlowski, Chief Operating Officer

This is Ed Kozlowski. Yeah, that would be true. One of the things that's beginning to happen now – and you talk about a turnaround – as John mentioned earlier, our complete overhead structure, back when you go all the way back to 2000, was just too high to support the store basis we had. We've been able to bring that overhead structure down over the last two years. We've spent less money in 2003 than we did in 2002, which was less than we spent in 2001, which was less money that was spent in 2000, in the aggregate. So we've been able to leverage the entire overhead, and I'm talking about from distribution all the way down through corporate expense, as an aggregate. And we've been able to leverage those costs substantially the last two years.

As we move into 2004, the other place where we're beginning to leverage and enjoying increases, some of what you saw in the third and fourth quarters, is the store operating costs. In DSW specifically – and you're correct, we are beginning on a comp base to show stronger operating profits from DSW. We believe in 2004 we will start showing strong improvement in the comp operating costs of Filene's Basement. In addition, with positive comps in 2004, Value City would begin to start to leverage its operating structure. Value City, while having a slightly negative comp for 2003, was able to maintain, at best, its store operating cost structure just by the fact of increase in wages and health care costs. So, as we move into 2004, we expect to begin to leverage at the store level in Filene's Basement and DSW, and begin to leverage in Value City as we move through the year.

The corporate operating costs are continuing to leverage in 2004 as well. And that's somewhat offset by the additional pre-opening that we're planning to have this year, I think Jim said somewhere in the neighborhood of $8 million incremental increase year over year.

Arnold Brief

Could you give us the actual numbers last year versus this year? It's up 8 million?

Male Voice

Yeah. Hold on just – go ahead, Ed, and I'll get those.

Ed Kozlowski, Chief Operating Officer

Okay. And all of this has been accomplished with, you know, as John mentioned earlier, we've had very, very poor systems. And we've been in the process of replacing those systems one at a time. so we've been able to gain corporate leverage while replacing systems. To date, what we have accomplished in DSW, we have a new point-of-sale system that was installed in the very beginning of 2003. In addition to that, we put a new planning and allocation system in the fall of 2003, and we're beginning to see the benefits. Now, we felt that we would see the benefits in putting the right goods at the right place, first; and then secondly, our ability to understand our markdown structure even greater. And we don't believe we will start to enjoy those benefits until the fall of 2004.

In Value City Department Stores we're in the process right as we speak, and we have right now about 40 of the 116 stores completed in new point-of-sale equipment and also new store operating systems as well. This will enable us to, when we finally install the new merchandising system, a new planning and allocation in Value City at the beginning of 2005 for all the systems to finally talk to one another.

We brought up, in the very beginning of this first quarter, our jewelry division on the new JDA as well as the Manhattan system, and that has gone very well as far as new installs go. This will be the first of the three divisions, and then soft lines and hard lines will follow in early 2005. We brought jewelry up early because one of the things we want to do is make sure we have all the bugs worked out of the system, all the right reporting structures, so that these systems do talk with one another, and that the results will be better information to manage the company by. And so we're going to take that balance of 2004 to get that installed exactly as we want it so that when we bring in the larger two divisions we have a very smooth transition.

Arnold Brief

Okay. As I gather, just as a broader brush kind of thing, you've made some major cuts in overhead, but that total SG&A ratio is still, I think, extraordinarily high for a retailer. And one of the reasons, I gather, is that you've taken the money you've saved in the cost-cutting procedures and put them back into marketing and the IT systems, so that the real benefit isn't so much from a lower expense ratio; the real benefit will be as these marketing and IT systems provide you information that you'll drive the sales and leverage your SG&A down as the sales go up. Is that sort of a summary of what's been going on?

John Rossler, President and CEO

I would say that's a very good summary, and that's our expectation and –

Arnold Brief

So, from our standpoint, the risk and reward is both in hoping that the IT systems and the marketing programs start to drive sales so that we can see that leverage. That's "on the come," kind of, so to speak.

Male Voice

Right. Right.

Arnold Brief

And we have seen better sales in both Filene's and DSW for the last four or five months.

Male Voice

Right. And that, again, I think that has a lot to do with, at the Filene's side, it really is, as John said, that we finally have got the full effect of Heywood Wilansky's positioning of the merchandising there and the merchandising strategy that's been put in place. And DSW is just a strong consumer desire for the product. You know, you had asked earlier what the numbers were, Arnold, on the pre-opening. It's about 4.9 in 2003, and it will be close to 13 in 2004.

Arnold Brief

Okay. And last question. I'll give somebody else a turn. On DSW, if you look further out, not 2004, not necessary '05, but maybe two or three years down the road when all the efforts of a turnaround should really be in place, although I don't really consider DSW a turnaround, but what would be a goal or an operating margin that you think this company, on a model that's running the way it should be running, is this a company that can do a five percent operating margin two or three years down the road?

Male Voice

I think two, three years down the road that that is a possibility, yes.

Arnold Brief

Okay. I'll give somebody else a turn and get back in line.

Operator

And our next question or comment comes from Mr. Jonas Garstell

Jonas Garstell

Hi. A couple of questions. I don't know if I missed it or if you didn't give it. Value City Department Stores year-to-date, what are their comps running?

Male Voice

Year-to-date in comp stores at Value City were negative 0.7, DSW was a positive 5.6, Filene's was positive 2.6, and overall it was positive 1.2, Jonas.

Jonas Garstell

Do you have how that compares to last year?

Male Voice

Yeah. Last year, Department Stores was negative 5.1, DSW was negative 0.1, and the Basement was 0.3 positive, and overall last year it was a negative 3.5.

Jonas Garstell

Okay.

Male Voice

Yeah, that's '03 versus '02.

Jonas Garstell

Right. You mentioned for Value City you hope by back-to-school the average unit retail price will be up, the systems will kick in. What about the assortment? Is Stu pleased with the assortment he has on floor? Will there be changes, whether space to men's, or furniture or whatever?

Male Voice

As we turn the corner into April, I think that Stu is pleased where we are in the progress of content. We're not satisfied for the spring season that we're up to speed, but we're satisfied that we're making good progress and we're satisfied that more progress will be made it looks like for the back-to-school and fall season.

Jonas Garstell

Okay. Are you closing any Value City stores this year?

Male Voice

We don't have any plans to do so at this time, Jonas.

Jonas Garstell

Okay. And your capital expenditures I see is going to be roughly, you know, about 10 to 12 million below a year ago, and your opening more stores, so imagine your store opening costs are up, and I know you're spending a lot of money on systems. Is the difference that less on systems than last year?

<u>Male Voice</u>

Actually, one of the major pieces of it is existing stores, what we have to do there to get renovations and improvements in those is one thing, and we are spending less at the corporate level this year.

<u>Jonas Garstell</u>

I see. By the end of this year, will basically the implementation of systems be complete?

<u>Male Voice</u>

I don't think that it will at the end of this year. I think that a real good piece of it will be done, but I don't think that it's going to be totally complete at the end of fiscal 2004.

<u>Male Voice</u>

2005 will be the implementation year for some key distribution systems for Value City.

Jonas Garstell

Okay. Do you have a date when the DSW-Filene's will open on 14th Street?

Male Voice

It will be mid- to late-September, Jonas.

Jonas Garstell

Okay. Could you – do you want to discuss that a little bit, because I imagine that's a very important and a key location. How many square feet that will be and just in general?

Male Voice

Well, it is a key location and, you know, some people refer to it as "flagship," but, to us, it's not a flagship for the purpose of brand visibility, although it will be to an extreme – for us it's for the purpose of being profitable like we open other stores. What it will be in Union Square is DSW will have a 30,000 square foot floor on the second, which is the size that's pretty close to its prototype size. Filene's Basement has 90,000 square feet on Floors 3, 4 and 5. Some of that space we're going to use for office and storage, so it will be the equivalent of probably a 70,000 square foot store. We're very excited about it. We know it's going to come on strong. We're experienced with second-floor, multiple-floor stores. So, yes, it should be good. It should be very good.

Jonas Garstell

Yeah. That size of Filene's, what does that compare to the normal Filene's store?

Male Voice

There's quite a range in Filene's, but, you know, typically the right size for Filene's Basement would be 40,000 to 60,000 square feet in most instances. We'll be opening a store at the end of April in White Plains that's closer; it's in the neighborhood of 70,000 square feet, Filene's Basement.

Jonas Garstell

In the larger stores, are you adding any more categories or anything, or just a wider assortment of the regular size store?

Male Voice

Much larger home goods assortment and a few departments will expand.

Male Voice

Our recent opening in Atlanta was right around 50,000, and that has exceeded our expectations.

Jonas Garstell

Okay. Thank you.

Operator

And, again, to ask a question, please press a "1" followed by a "4" on your touchtone phone. And our next question or comment comes from Mr. Arnold Brief.

Arnold Brief

I got back in line. Could you give us some comments on how the DSW store licensed departments are performing in SteinMart?

Male Voice

We're very pleased with our progress. We're not satisfied with how we're doing today. We're still relatively a new relationship. But we and SteinMart are both very pleased with our progress. It continues to improve with each passing day.

Arnold Brief

Do you report sales through SteinMart, or you just report license income?

Male Voice

We report sales, and they're included in the DSW segment.

Arnold Brief

Oh, okay. And it would be the same for your DSW sales in Value City? Those sales are in DSW?

Male Voice

No, those sales are in the Department Stores.

Arnold Brief

They're in the Department Stores. Then you just sort of license income in DSW?

Male Voice

Say again, Arnold.

Arnold Brief

Then the sales are in Value City, the license income is in DSW?

Male Voice

Right, but it gets eliminated in consolidation.

Male Voice

So the profitability shows up in Value City.

Arnold Brief

Right. Okay. You know, looking for comparable companies, with DSW it's sort of easy, I mean, Famous Footwear and Shoe Carnival are out there. And you guys, your comps are outperforming them substantially. With Value City it's a little harder. I looked at Big Lots and they don't have nearly the same merchandise mix. It's a comparable concept; but the merchandise mix is completely different. But Cost Plus looks fairly comparable, and, if so, their operating margins – I don't think they're there yet, but I think they're talking about going to eight percent. What's the difference in their business and your business that would prevent you from showing substantially higher margins than three percent or margins more comparable to them? Is there some difference in mix of operations or whatever?

Male Voice

I have to say that I'm not 100 percent familiar with their operations. I'm familiar with the company. I would say that probably some of their costs of distribution are different than ours, and some of their store operating costs are definitively different than ours. I would say that those are probably the two major components that are in there, Arnold. That's generally what we find.

Arnold Brief

So, Value City doesn't have the potential to have a five, six, seven percent operating margin?

Male Voice

Well, again, that's going to be dependent upon the sales growth that we are able to put into the division, yes.

Male Voice

Arnold, I think the other thing is that once Value City gets its systems completed, and I won't say "completed," but once we get to the next step in 2005, we are then within the potential to begin reducing the distribution costs. When we got involved with the company two years ago, the distribution side of Value City was a very labor intensive, non-system, non-mechanized operation. We've improved it, but without further capital investment and without these systems, we're not going to be able to take it to the next step. So we made substantial improvement in the two years.

This year we're going to mark time to a degree until we get to that systems install in 2005. Once we get that systems install, with capital expenditure we can then make the step move in reducing those distribution costs down to levels that are seen by, say, a TJX or a Ross, or some other folks who are in the off-price business. The off-price business, depending on the amount of rework, you're always going to have higher costs than you might like to have because of just the amount of labor you have to put into the product. But within a couple of years we can get to where we are within the peer group in which we operate. But that's still a couple years away to achieve those kinds of levels.

So I think your big question is in the long run can Value City achieve an improved operating margin. And Jim's right, with comps we can definitely start to leverage the store operating structure, but then the distribution structure is really two steps away. The systems install and then the capital install to then leveraging those costs one more time.

Arnold Brief

So if you do the MIS by the first quarter of 2005, would the capital expenditures then follow in 2005, and we'd see better results in 2006? Or is that –

Male Voice

Well, we're in the process of evaluating exactly when those systems will be complete, and then what the second step is.

Male Voice

But, yes, you're right. It could come that fast, but it could take a little bit longer, as well. So we have not yet reached the decision point on exactly how long that will take.

Arnold Brief

Okay. This is a difficult question to ask. I'm hesitant to get off the phone now, because I re-hooked-up, and I guess if there was nobody else there, I don't want to lose the call, frankly. How do I phrase this? I know you can't tell us at this point what you're going to do in terms of restructuring your financial situation at this point. But I wonder if you could discuss what you see the alternatives are, without indicating at this point which way you're going to go on the assumption that you don't know which way you're going to go? But there must be two or three different things that you're looking at. Maybe you could just sort of rationalize us through those to have some understanding of what we might be looking at.

Male Voice

Arnold, at this time, we're really not going to say anything about what our expectations are for a refinancing. At this point in time, I would say that we are definitely pleased with what we expect we can do. But until we get the full opportunity to evaluate everything, I think it's just far too preliminary to really say anything.

Arnold Brief

I'm going to ask you another question I don't think you can answer. But, the convertible debt is not due I think until 2009. Is there any indication at all that the holders of that debt would consider converting prior to 2009?

Male Voice

I can't answer that question.

Arnold Brief

I tried. Just as an analyst who understands, the DSW has a footprint of about 25,000 square feet, which is some two, two-and-a-half times the size of a couple of the leading competitors. With a similar number of SKUs, could you give us the rationale of why the bigger store, the bigger capital investment? I'm not criticizing; I'm just trying to understand, because obviously your comps are doing much better than theirs.

Male Voice

Well, I'm not sure that we have a bigger capital investment, as perhaps maybe paying rent. Obviously, if you have more square footage, you have more rent. But the success formula for DSW is selection, convenience, and value. And we need a fairly big box to get the selection out and display it in an impactful manner. And we're a market research-based retailer, and we know from research that the customer finds it convenient to be able to walk in the store and look across the tops of the display shelves and be able to see the entire offering. That's not the case in our competitors, where they have smaller boxes and pile the goods high, where you walk in and you can't see – you know, over fixtures, you can't really see the offering. We spend substantial money every year for probably the past 10, 12, 13 years on DSW, and we know how the customer feels about the environment and the convenience of it. And that's all I can tell you. It's part of the success formula.

Arnold Brief

It works. Could you give us some idea of the merchandise mix at DSW? Male? Female? Athletic? Casual? Dress? Some understanding of how the mix is?

Male Voice

It's mostly a female, ladies type of a merchandise mix that we do have. We do blend it in. Men's would be second in that line, and then athletic would probably follow after that. So, that's really the concept, and the driver behind it is ladies area is still the big driver for the DSW operation.

<u>Arnold Brief</u>

All right. One other question and hopefully somebody else is on, but could you give us some feel – you gave us a lot of guidance, could you give us some feel on the inventory turn outlook this year versus last year, and the implications that would be for increased need or less need for working capital?

<u>Male Voice</u>

Well, I actually think that this year that we are, as we improve our AURs, we take a look at it, that we're actually going to see some improvement in the turn. I don't think that it's going to be a real large number, but we will see an improvement there. At the same point in time, you know, we have somewhat changed how we're doing in some of our buying, and we're buying out in front of the seasons now where we hadn't done that in the past. So that may slow us down a little bit. But, overall, our expectation is that on a per-store basis that our turn will improve, especially in the Department Stores. And we are going to try to operate these stores with a little bit less inventory in number of units at each location, but, as I said, with a higher average unit retail.

<u>Arnold Brief</u>

Okay, thank you.

Male Voice

Thanks, Arnold.

Operator

And our next question or comment comes from Mr. David Mann.

Male Voice

Hi, David.

David Mann

Hello. Just a couple of follow-ups. In terms of your advertising expense in 2003, can you give us a sense on what that total number was versus 2002, and how you would expect that to ramp or change in 2004?

Male Voice

Yeah. We actually spent about, in actual store advertising chain-wide, we've spent about $110 million, and I think that our expectation is that we'll spend that same amount in 2004. And the amount that we did spend in 2003, I believe it's actually about $10 million higher – 10 to $11 million higher than it was in the previous year.

David Mann

Okay. And then in terms of Filene's Basement, now that you're going to embark on a growth pattern, can you give us a sense on what your market analysis is showing you in terms of the number of stores that that could handle?

Male Voice

Well,. David, right now we feel confident there could be 100 stores, but we're in the infant stage of that, you know. I remember back many years ago we thought DSW could be 50 to 100 stores, and then we got to a point we thought it could be 200, then 300. Today we think it could be as many as 500. So, you know, as the concept evolves, that might increase, but we feel confident about saying there could be 100 stores.

David Mann

And in terms of the number of sites that you've identified for Basement, do you already have a pipeline for the next couple of years?

Male Voice

Yes. We definitely have the four taken care of for 2004, and we feel real comfortable with our 2005 pipeline if we want to do four of them for 2005, also.

David Mann

Okay, great, thank you.

Operator

And our next question or comment comes from Mr. Arnold Breis.

Arnold Brief

I got back in line quickly. Most retailers basically try to buy what is selling to the consumer. And as I understand the closeouts, you buy what you can and then try to sell it to the consumer, and it's a more difficult procedure. I guess there's two questions coming out of that assumption, which you could comment on also. One, as you get bigger, does the nature of this business become more and more difficult? And two, is the reason the IT investment becomes so important is that it's critical to running a closeout type of business, where to allocate merchandise and to know what's selling in each store becomes extremely important?

John Rossler, President and CEO

Arnold, it's John. I think as retail concepts evolve, and it's very important to do what you say, to buy what the customer wants. Now, you also are right that in the closeout business you sort of buy what's available. It's a matter of refining that formula and, as we learn these brands more and more – I know in the case of DSW, when we first started, all we bought was what was available closeouts without regard to what the customer wanted, then we tried to sell it to them. And every year over the years, we've evolved more towards buying a lot more what the customer wants and a lot less just what happens to be available. And it's an evolution. And we started last year to make that evolution successfully in Filene's Basement. And over the next couple few years, I think it will continue.

In the case of Value City, it's more complicated because there's so many categories under one roof. But it's the same thing. It will help our business to maybe shy away a little bit from some of the situations that are available. I they're not really opportunistic in relation to what the customer wants, we have to walk from those situations and work harder on programs with vendors and vendor partnerships. And that plays into the hand to allowing you to grow, also, because, you're right, there comes a day when there's only so much closeouts to go around to all the closeout players. And you get to a point where now you do have to do brand and makeup programs, and cutting deals, and things like that. But it's an evolution that's necessary to better serve the customer, and it's an evolution that plays into the hand of allowing us to grow and have a never-ending source of supply.

Arnold Breis

And as you get bigger and your financial position becomes "cleaner," so to speak, the vendors see that and it becomes easier to make deals with them?

Male Voice

Yes, that's exactly right.

Arnold Brief

Okay. Thank you. I asked a lot of questions, so I'll back off now.

Operator

And, again, to ask a question, please press a "1" followed by a "4" on your touchtone phone.

Male Voice

No more in line, Joe?

Operator

It looks like we have no further questions.

John Rossler, President and CEO

Okay. I would like to at this point in time thank you everybody for joining us this morning for our conference call and wish everybody a good day. Thank you.

Operator

Thank you. This now concludes today's Retail Ventures, Inc. 2003 4th Quarter Earnings Conference Call. Thank you for your participation.

(End of Conference Call)