Retail Ventures, Inc.

3rd Quarter Operating Results

December 8, 2003

Operator

Thank you for holding, ladies and gentlemen, and welcome to the Retail Ventures, Inc. 3rd Quarter's Conference Call. At this time, all lines are in a listen-only mode. There will be an opportunity to ask questions at the end of today's conference. Instructions will be given at a later time. I thank you for your attention, and I now turn the time over to your host, Mr. John Rossler.

John Rossler, President and CEO

Thank you, {Miquelle}. Good afternoon everyone, and welcome to Retail Ventures' 3rd Quarter Fiscal Year 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'd 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 of the future, are forward-looking statements. Actual results could materially differ from the forward-looking statements. 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 the 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 obligations to update any such forward-looking statements.

Recalling our second quarter conference call, we positioned ourselves as a business on the upswing and building momentum. We also stated that we were halfway through what we feel was a three-year turnaround. While many system and business process improvements need to be made during the remainder of our turnaround period, we are aware of what they are, and we know they are not insurmountable. Today, momentum remains on our side. And while an improving economy is playing a role, I believe that the key was investing in what was needed to fix this company and our three brands: new talent, new systems, and new marketing.

Secondly, why do I say our business is on the upswing? Sales are meeting our expectations. This is in the face of some unpredictable weather changes which influenced our Department Stores' seasonal apparel sales. Comparable sales increased 5.4 percent for the quarter, and each brand had a positive comp sales during that 13-week period. As encouraging, we are pleased with our customer counts in each division. While our margin rate declined during the quarter as a result of aggressive seasonal markdowns taken in our Department Stores early in the period, this allowed us to be prepared early for the holiday shopping season with a fresh and exciting new presentation of goods.

Our third quarter net income of $901,000, which includes a disproportionate tax rate that Jim will discuss later, was in line with our expectations. During this quarter, as throughout the first nine months of the year, we have invested heavily in our marketing efforts, particularly in the DSW and Value City operations. We expect our investment to continue into the fourth quarter. For the third quarter and year-to-date periods, advertising expenditures to create heightened brand awareness and promote our value pricing were about $2.9 million and $17.3 million above last year's respective amounts.

We are starting to see the positive impact of our investment in these programs. You may have seen or heard many of these campaigns, like DSW's "thrill of the hunt" or one of Value City's brands in an extreme value promotions, such as "bargain blitz," "best bargains in the city," "10 under 10," "once in a blue moon," or "mall-busters." Additionally, Filene's Basement continues to focus its merchandising and its event-based marketing on "best brands for less." Unquestionably, creating and maintaining momentum and improving systems and processes are an ongoing process. We believe our results are starting to be reflective of the investments we are making. I will now ask our CFO, Jim McGrady, to proceed with the financial review.

Jim McGrady, Chief Financial Officer

Thanks, John. Good afternoon everybody. Today, this afternoon, we announced a net profit for the quarter of $901,000, or three cents a share, compared to a loss last year of $3.5 million or 10 cents a share. Our loss for the first nine months of the year is $15.9 million, or about 47 cents a share, compared to the prior year's loss, which included a change in accounting principles, and that totaled $9 million or about 27 cents a share. Total third-quarter sales increased $63.6 million or about 10.3 percent. Comparable store sales for the quarter increased 5.4 percent, as John mentioned. Our comparable stores by business unit were Value City improved 2.3 percent, DSW 11.7 percent, and Filene's Basement 8.5 percent.

At our Value City operating unit, we saw sales were about $375.4 million, which is an increase of about $8.4 million from the prior year's quarter. Apparel sales in the quarter improved 1.4 percent. Now, apparel categories of ladies', men's and children's represent approximately 60.4 percent of the total retail business at the Department Stores. And they had comparable sales of 0.9 percent and negative 1.3 percent and 6.7 percent, respectively. Our non-apparel sales improved 5.1 percent in the quarter, and this is primarily the result of the strong performance in our domestics and houseware categories, which were up 7.2 percent and 13.3, respectively. Shoes in the Value City operations also had a positive quarter at 1.6 percent.

Our DSW sales were $215.8 million, which is about a 26.8 percent increase in the quarter, and this includes 13 new DSW stores and an additional 98 lease locations over last year. Comparable sales, as I said earlier, were up 11.7 percent, and during the nine-month period, the comp store sales increased 4.2 percent. Our DSW sales rose to $591.1 million in the nine-month period, an increase of about $106.1 million, or 21.9 percent. Our lease department operations account for about 6.9 percent and 1.1 percent of the total DSW sales in the quarter and year-to-date periods.

Filene sales were $89.5 million, a 12.2 percent increase in the quarter, which includes one new store. As comparable stores' sales increased 8.5 percent, the improvement was influenced by a broader assortment of brand name merchandise available in the period. For the nine-month period, Filene's sales increase was about 0.6 percent as sales rose to $227.8 million. This actually reflects the repositioning of our merchandising plan to improve brand mix and merchandise presentation.

In the third quarter, gross profit as a percent of sales increased about 60 basis points to 38.4 percent. Total gross profit increased around $28.3 million, which is a 12.1 percent improvement. And for the year-to-date period, gross profit improved by about $35 million, around 5.1 percent. Our gross profit did decrease as a percent of sales to 38.1 percent from 38.4 percent in the year-to-date periods. For the three-month period, gross profit was positively impacted by margin improvements in DSW and Filene's Basement, as improved initial mark-ups and lower markdowns occurred for us in these business units. For our year-to-date period, our Department Store gross profit decease is attributable to a lower IMU during the nine-month period and some higher markdowns, as John mentioned earlier. The DSW increase is a result of those improved IMUs purchased during the first nine months, and our Filene's Basement, which really had a negative impact by some markdowns required to transition to our merchandising plan that we have in place right now. By operating unit, our gross profit was at the Department Stores 38 percent. DSW saw a 40.8 percent, and Filene's Basement was at 34.2.

Total selling, general and administrative expenses in the quarter increased by $19.3 million to about $250.6 million, and decreased as a percentage of sales from 37.5 percent to 36.8 percent. Included in the dollar increase is about $8.6 million, which is attributable to 14 new stores that are in operation and the 98 leased shoe departments that I had mentioned earlier. Year-to-date, our SG&A increased $43.6 million to $717.5 million, and we did see an increase as a percent of sales there to 38.3 percent from 38 percent. The dollar increase has about $28.9 million attributable to the new stores we have in operation and the 98 new leased shoe departments, compared to the prior year's quarter.

Our current quarter and year-to-date SG&A includes the additional advertising expenses that John mentioned earlier, and this is particularly in the DSW and Value City segments. As John also said, we do expect to see these promotional efforts continue, especially for Value City into the fourth quarter. Remember also that our prior year SG&A includes a $3.3 million debt extinguishing expense that last year was reported as an extraordinary item.

Operating profits for the quarter improved $9.2 million to a profit of $12.3 million, and that's in contrast to the $3.1 million we saw in last year's third quarter. Year-to-date, our operating profit for the current year is $1.2 million versus a profit of $11.8 million for the same period last year. Our interest expense for the quarter decreased $200,000 to about $8.6 million. This decrease includes a $46.5 million increase in our weighted average borrowings for the period, which was offset by about a 122-basis-point drop in the weighted average borrowing rate we had. Year-to-date, we saw a little bit of the opposite. We have a $3.3 million increase, to $26.2 million, and that results from a $14.9 million increase in the weighted average borrowings. And year to date, we've got about a 147-basis-point improvement in the weighted average borrowing rate.

As John also mentioned earlier, we've got a little disproportionate tax rate that has occurred to us in this quarter. The effective tax rate for the three months is 75.5 percent versus 38.5 percent last year. Also remember that we did not change the valuation allowance for our deferred taxes during the quarter. For the nine month period, our effective tax rate is 36.4 versus 37.8 last year. We do have a valuation allowance that we established earlier on in the year of about $9.8 million. And prior to this allowance, our tax rate is 75.5 percent. This reflects the impact of some nondeductible expenses that we have in our books that we can't deduct for tax purposes.

As we turn to our balance sheet, inventory was $547.7 million, which is about a 12.2 percent increase over the prior year. Our net working capital was $285.3 million versus 247.1 in a prior year. Our current ratio was 1.79 and 1.67 at those respective dates. We used cash and operating activities this year of about $80.3 million compared to having cash provided last year of about $13.9 million. The decrease in our operating cash flow is really primarily the result of the loss, which principally came to us in the first quarter of this year in the increased inventory levels that we have right now to support the new DSW stores and the leased operations, plus some early buying that we did in the Value City and Filene's Basement operations to make sure we got an early start on our merchandise for the holiday season. Depreciation and amortization in the third quarter was $13.9 million, and that compares to about $13.7 million in the prior year.

Turning to capital expenditures, we had about $43.5 million we spent in the nine-month period this year, and that compares to $30 million last year. During this period of time, we've spent about $11 million for new stores, $20.2 million for improvements in existing stores, and about $12.3 million for corporate and IT equipment and systems upgrades. Our EBITDA in the third quarter and year-to-date were $26.1 and $42.9 million respectively. At this time, we are in compliance with all of the terms of our lending agreements, and availability under our revolving credit agreement was over $120 million, and we have a cash balance, as you see, of about $8.5 million. That concludes the review of the third quarter.

Looking forward with respect to the remainder of this year, we anticipate that our comp stores will be in the low single-digits area for the fourth quarter. And, again, as we experienced in the first nine months and have said we will continue to advertise to promote our brands, and we believe that these costs will continue to be balanced somewhat by the savings that we can generate and have generated in our store operations, warehouse and support areas. We do anticipate a breakeven year for fiscal 2003.

At this time, we are not prepared and ready to provide guidance for fiscal 2004. We will do that at our fourth quarter call. And that concludes our review. I would now like to ask Miquelle to open the lines for questions, and thank you everybody.

Operator

Thank you. If you would like to ask a question, please press "1" followed by "4" on your touchtone phone. If you need to retract your question, please press "1" followed by "3". All questions will be taken in the order they are received. Once again, to ask a question, please press "1" followed by a "4" on your touchtone phone. And our first question comes from Mr. {Jeff Fineberg}.

Jeff Fineberg

Thank you. Congratulations, guys, nicely done.

Jim McGrady, Chief Financial Officer

Thank you, Jeff.

Jeff Fineberg

Just a question for John. As you're looking at the improvements, and you mentioned you feel like you're maybe a little bit more than halfway through now, would you be kind enough just to, as you look out at the end of the rainbow, just to give a little perspective when you benchmark yourself versus others, where you would hope to get the operating margins for the company and what the keys to getting there would be.

Jim McGrady, Chief Financial Officer

Yeah, Jeff, this is Jim. I think, as we said, we're going to wait until we give guidance for the fourth quarter before we really go into any of the details of what our true expectations are as we look out here over the next 12 months.

Operator

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

Lee Baccus

Yeah, Lee Backus. A couple of questions. First, could you give us a sense what the balance sheet will look like at year-end?

Jim McGrady, Chief Financial Officer

Well, I think, actually, you know, obviously, we're going to see a pretty good size reduction in the inventory levels, Lee. But, you know, we always build, as we get into January, we start to build our inventory levels for our DSW operations, for the shoe operations as they get ready for the spring season. So I think, really, we're going to see, because we have a number of new stores that are out there with us this year, we're going to see an increment over what we saw last year. But I don't think it's going to be anything out of proportion to the store growth that we do have. We have and continue to do some forward investments in the Value City operations, trying to be prepared for the seasons rather than buy right on top of the need. We're trying to temper that right now as we take a look at our operations, make sure that we really don't get too far out in front of ourselves. So any increase that we see there is really going to be something that we have managed well as we go into the seasons.

Lee Baccus

Okay. Could you just give us a sense on your inventories, maybe by concept, your level of comfort with your current inventory levels and especially your Value City Department Stores. I mean, you indicated that you had some early buying in that area. Could you compare and contrast your feeling of the inventory this year versus the same time last year?

Ed Kozlowski, Chief Operating Operator

This is Ed Kozlowski. If you really look at the three businesses, first of all, in Value City, one of the things we've returned to is doing packaways. So we are going to have a little more inventory at year-end as we get ready for spring, because we bought packaways, and they're in the process of either here or coming in. In addition to that, from a quality of inventory, I would say the quality of inventory is as good as it was a year ago, we are clean from the standpoint that we did not pack away anything from last spring to next spring. That's all gone out of the system. We have plenty of current goods to sell through the Christmas selling season and, you know, we expect to enter into January/February in a similar position as we were a year ago, probably with a few more dollars in that inventory, but the quality of that is the type of goods that we need.

In DSW, we are heading into, as Jim said, the spring selling season, plus we have a few more openings planned for the first part of next year than we had in the first part of 2003, so that would give us an attributable increase in the amount of inventory that will be on hand at year-end in the DSW.

In addition to that, Filene's Basement, we had one opening this year. We're looking to have one or two in the first part of next year so, again, their inventory levels will be up a little bit. But again, these numbers will be in relationship to what we're planning to do for the spring season.

Lee Baccus

Okay, and if this performance continues and you have a good Q4 and it continues into next year, could you talk a little bit about possibility of refinancing some of your high-interest debt.

Jim McGrady, Chief Financial Officer

Sure, I mean, obviously, what we're focusing on right now and we have to get through the fourth quarter here and see what our first quarter looks like it's going to bring to us. But, you know, we're definitely taking a look at that right now, Lee. We don't have anything at this point in time to report, but it is definitely a very top priority for us.

<u>Lee Baccus</u>

Okay. And just to get back to Jeff's question, I believe in the last conference call, you indicated that over the next, I don't know, year and a half, two years, you're going to get back to, you know, 1999 operating profit margin levels and so –

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

Yes, and that's correct. And I'm sorry, I didn't mean to cut Jeff off probably as quickly as I did there, but that is definitely still our expectations.

<u>Lee Baccus</u>

Okay. Thank you.

<u>Operator</u>

Thank you. Once again, ladies and gentlemen, to ask a question, please press "1" followed by "4" on your touchtone phone. Okay, we do have our next question from Mr. Jonas {Garstell).

Jonas Garstell

Hi, couple of questions. At the beginning, you said that you still have systems to implement. Could you just share with us what those systems are, what they timetables for each would be?

Male Voice

Jonas, hi. Yes, we implemented in the third quarter of this year planning and allocation, Arthur planning and allocation at DSW, and they came on and other than a few minor system plagues that you always get with an implementation, that has been relatively smooth and we've seen no effect on performance. We're beginning to and we anticipate the benefits of that as we head into the spring and summer season of next year. And right after inventories this year, we're planning to implement point of sale system and new in-store systems at Value City Department Stores. That'll take place very late in the fourth quarter and very early in the first quarter. In the warehouse and merchandising systems, we will begin a phased-in implementation in the beginning of the year. This will be a three-pronged phase, one very early in the first quarter, one around late after the spring selling season but before the back-to-school build-up, and then the third one after the Christmas buy and ship of next year. So during the course of 2004, we will see a heavy systems implementation in Value City, but that will be phased to not affect the primary selling season. And it will be done in three phases.

Jonas Garstell

Well, going forward, what tax rates shall we use for modeling purposes?

Male Voice

I would say going forward, once we get beyond 2003 here, that I would be comfortable with something about 40.5 percent.

Jonas Garstell

Okay. And could you give us an early indication, as we're early into the holiday season so far, what's working better than you figured, what's a little tougher across all three areas?

John Rossler, President and CEO

Jonas, it's John. I guess, you know, with the DSW business, knock on wood, pretty much everything's been selling. With the Filene's Basement and the Value City brands, we've been very successful with our home goods and hard goods. In the case of soft goods, it's been unfortunately, on a daily basis, a rollercoaster ride. As you could imagine, for instance, in the city of Boston, we did not fare too well the past couple of days. And on one day, we seem to have summer weather trying to sell outer gear and then, another day, we'll have three feet of snow. But on the normal seasonal base, our outerwear's been doing very well.

Jonas Garstell

Okay, and last question. You mentioned that in early next year, you anticipate opening one or two Filene's stores. Do you have a number what you might open in the second half, how many?

John Rossler, President and CEO

We're looking to open two Filene's Basements in the first half and two in the second.

Jonas Garstell

Okay, thank you.

Operator

Thank you, and our next question comes from Mr. Jeff Fineberg.

Jeff Fineberg

Yes, two follow-up questions, please, one for Jim, one for John, please, I guess just with regard to the financials. To understand, I thought you said in the conference call that for this year, the guidance was still breakeven. I just wanted to know what type of comp that was predicated upon in December and January, please. And with regard to, John, I'd just like to understand a little bit, which areas of the company still allow for the most improvement from an operational perspective that will allow us, you know hopefully, to get to the longer term goals that you've elaborated.

Jim McGrady, Chief Financial Officer

Jeff, it's Jim. I think for the quarter, I can address your comp question a little bit easier. If we can have a mid single-digit, low-mid single-digit, we should be able to achieve our goals as we've said. That's our expectation right now. Does that answer your question?

Jeff Fineberg

So low to mid single-digit comp from the quarter?

Jim McGrady, Chief Financial Officer

Low mid single-digit comp, somewhere probably in the area of three to four percent.

Jeff Fineberg

Okay. Thank you.

John Rossler, President and CEO

Okay, Jeff, it's John. I have to answer the question about areas of improvement by brands and then our fourth brand is our service division. First on our service corporate overhead, we're very pleased with how we've been able to reduce corporate overhead and, you know, to manage it. It's a long-term process. We know that our corporate overhead's still high, but it continues to head in the right direction, and we're certain we can become more effective and cost efficient in our service business. In the case of DSW, it's we believe for the most part simply a case of continuing to leverage the brand. You know, there's always tweaking to be done with any brand, but it's in real good shape, and I think it's incumbent upon us to accelerate the number of openings. This year, we'll have open in the neighborhood of about 18 stores and, really, we should get back to a point of opening 30 stores, continuing to leverage that brand.

In the case of Filene's Basement, I believe we have a situation where we've taken an extremely strong merchant and business manager in the case of Filene's Basement, Heywood has been with the brand now for 10 months and has obtained a lot of market research, consumer research and has worked in market hand in hand with our buyers. He has worked hand in hand with each of our store managers. And we're at a point that the business was small enough and few enough stores, he's been able to get his hands around the vision of getting it back to best brands for less and marketing the business as event-based marketing, so it's just a wedding gown operation instead of a POS business like we had been running it. I think there, in Filene's Basement, we're just talking about passage of time. I feel certain that within – you know, at least by the second half of next year, the Basement will be firing on a lot more cylinders than it is currently.

In the case of Value City Department Stores, you know, there are a number of issues. I think for the mid-term, I think that the biggest issues are the systems that we keep talking about. We're about a year, year and a half now into totally renovating the systems, and it is for a real; that works way down the road. And as it gets implemented and put – I think that will help our business for the long term. More currently, as we look in the 2004, we've been around long enough now that a couple of years ago, we really had no consumer research to operate off of, and we did not really know clearly who our customer was and what they wanted to buy by category. We've come to learn the brand and our customers a lot better now.

You know, the store itself was a big box. And since it's a turnaround, it's like trying to tame a jungle. But we've identified all of the animals, we have half of them domesticated. And I would say that, again, it's just passage of time. You know, the retail formula, being as complicated as it is to keep in balance, that being stock-to-sales ratio and average unit retail and initial markup, we actually don't just have one business in that big box, but it's a grouping of several businesses, and each needs its own, you know, precise combination of those retail factors. So, I think that's probably the thing that we've struggled the most with is the fact that there are so many businesses within one roof. But that's the thing that I believe that we'll make the most progress with and will most greatly impact our business in the year 2004, is just continuing to refine that retail formula within each of our categories, Jeff.

Jeff Fineberg

Thank you very much for that thorough description. I appreciate it.

Operator

Thank you. And our next question comes from Miss Julie {Lerner}.

Julie Lerner

Hi, good day. A few questions for you guys. First, could you spend a little more depth on the nondeductible tax expenses and just give me an idea of what I should model for the end of this year for a tax rate?

Jim McGrady, Chief Financial Officer

Julie, it's Jim. Actually, there's two things that influence that, and the biggest and obviously the most impactful thing is the OID on the warrants that we have. And that really comes into play. I would suggest that, for the balance of the year, that probably, you know, if we do break even, I would say that it's going to be a very high rate. It'll probably come in at about the 75 percent rate that we're seeing right now, and that would be my expectation.

Julie Lerner

Seventy-five percent for the quarter or for the year?

Jim McGrady, Chief Financial Officer

For the year. The smaller the pre-tax profit, the more impactful that nondeductibility becomes, and it forces that rate higher and higher, is really what happens.

Julie Lerner

Great. Second question: Could you speak a little bit about I guess the free cash flow generation ability, if there is any, what your expectations would be for this year but also, going forward, how you look at the free cash flow. And especially I'm also very interested in how you look at DSW, financing that and pre-cash flow ability of that segment.

Jim McGrady, Chief Financial Officer

Well, we really look at these things in total and try to evaluate the businesses, you know, one by one where we can, but it's really a total. We really haven't done any type of discussions or disclosures yet on what we think the free cash flow expectations are out into the future. But I would say that, you know, if you were take a look at our capital expenditures for this year and the EBITDA calculation, that something in those areas as far as depreciation, amortization, capital expenditures, I would think would probably be in line with what we would expect to see next year.

Julie Lerner

And I guess just wrapping up, on DSW, could you give me a sense – I know you had said last conference call that you might be better prepared to talk about this one, on how big you guys view it can get, not only in number of stores over the next year or two, but as well as the EBITDA that can generate.

John Rossler, President and CEO

Julie, hi, it's John. You broke out, and I wasn't sure that I –

Julie Lerner

I'm sorry. I'm asking about DSW in the next year or two, how big it can both be on the store number, as well s the EBITDA potential, if you guys think about that.

John Rossler, President and CEO

On the number of stores, we continually, through market research, update our national market screening survey, and we are currently confident that DSW, in its present form, can be a 450-store chain.

Jim McGrady, Chief Financial Officer

Yeah, as far as EBITDA, again, really we haven't talked much about that, what our expectations are for that or anything. But I would say that it's a very, very good cash generator business. It takes generally about three years for the stores to reach a full maturity base for us. So as we invest in new stores, we see them come online, you know, it's really you are investing for the future. You know, I would expect that the EBITDA in the future is probably going to be somewhere a little bit stronger than what we've seen here in the past, but at this point in time, I don't think we're ready to discuss that.

Julie Lerner

Okay, and then one last question, Value City, I was in a bunch of your stores recently. The box seems enormous. Have you given any thought to decreasing the box size, or how do you guys think about that?

John Rossler, President and CEO

Julie, it's John. Sad to say but, you know, one of the reasons why it's not such a quick turnaround as we would all like to see is that standpoint from its information availability, that our systems really are 1960s legacy systems. And it's, believe it or not, been very difficult for us to get, and get on a rolling basis, information about gross margin per square foot, which is a sort of a foundation not only to see if we can use the whole box, but within what box size we are going to use, how we should reduce the size of some categories and increase the size of other categories. So we're not totally concluded yet on the subject of how we're going to move the space around, let alone if we're going to use all of the space. I'm optimistic that we can continue to use all the space, if not for our own departments, at least to be able to farm some of the excess space out for certain licensing activities.

Julie Lerner

Great. Well, good luck to you guys. Thanks.

John Rossler, President and CEO

Thank you, Julie.

Operator

Thank you. And our next question comes from Mr. David Mann.

David Mann

Yes, good afternoon, just to follow up on that last question, can you give a little more detail on the cap-ex that you've spent on existing stores and then, you know, especially if you've done any reformats. And when you look at your base of stores, are you starting to see a few maybe that you'd like to close this year in the Value City format?

Jim McGrady, Chief Financial Officer

Hi, David, it's Jim. Yes, we did do a reformat and a pretty extensive renovation at two of our locations. One is in the Covington area, which we are continuing to evaluate on how that's going as it goes out throughout the entire year. We have another one that we've just recently completed that's still too early to tell on that and a couple of others that we did not quite do as extensive of a remodel as what we had on these other two.

And we're really in the process – we did these later in the summer season except for Covington so, you know, we really don't have a lot of information right now that I could share with you that I think is tangible. We do look at our stores annually – actually, it's more than annually – about, you know, what's upcoming for new lease renewals and the potential for relocations and, you know, those that are underperforming, which ones we might want to cull out of the herd here. We do critically evaluate that, and I think that there are definitely some that we do have as candidates for replacement that we would like to do. But again, you know, it's something that we have to evaluate financially to make sure that it really fits the needs of the total company. And, you know, we have marketing and advertising considerations. If we close a store in a certain area and don't have a replacement for it, we could damage, you know, frankly the ability to fund the marketing that we see in those areas.

David Mann

In terms of advertising, can you just give a sense in terms of 2004, should we expect a similar spend as this year, or should that increase somewhat?

Jim McGrady, Chief Financial Officer

It will not increase. I think that it will be in the same general vicinity. I think that we're definitely taking a look at redeploying where we're investing our marketing money in as far as the type of media that we're going to promote and the branding and an awareness that we're trying to achieve. So, you know, right now, I do believe that we'll probably see it in about the same vicinity as what we are seeing this year.

David Mann

And in terms of the inventory, I think, Ed, you talked about an increase in packaway inventory. Can you give a sense, Ed or Jim, in terms of the magnitude of packaway now that you're doing versus what you perhaps did in the third quarter last year, and as a percentage of inventory, where you see that number going, maybe at year-end and into the future?

Male Voice

On all brands, I mean, frankly, last year, we did very little packaway at all through the season. Please be aware when we talk about "packaway," we're talking about goods that have not had a floor presentation. These are things that we got in early. They are not something that's been on the selling floor that we take off of the sales floor and put into the packaway program. So once it's on the floor, it's had a presentation.

I would say that, at the very most, we're probably going to see somewhere at 10 percent of the inventory level being packaway, and that would be the absolute maximum. We're not committed to do that. This is really something that we committed to do earlier on this year just to be prepared for the season, you know, in case we had the ability to bring up perhaps a system or two that we wanted to get implemented, that we wouldn't have a disruption. And we didn't bring the system up because, quite honestly, it wasn't the right time to do it. It would have got into the way of the early part of the holiday season.

So that's where we are with the packaways right now. And it is really something that we will continue to do, but it's going to be very specific programs. It's not an individual buyer program. This is something that each one of the business operating unit heads has to approve and is controlling.

David Mann

And in terms of the amount that you're carrying in the third quarter, what is it, a few percent this year?

Male Voice

David, we caught a lot of noise there. In the department stores, it's somewhere around $11 million that we're carrying.

David Mann

Okay. And then, I'm sorry, one last question just to clarify, I think, what Julie Lerner had asked. If we look at the fourth quarter guidance that you basically gave about having a breakeven year, that would capture in the higher tax rate?

Male Voice

Yes.

David Mann

Okay, great. Thank you, gentlemen.

Male Voice

Thank you, David.

Operator

Thank you. And our next question comes from Mr. Lee Baccus.

Lee Baccus

Hi, Lee Baccus again. John, you talked about Value City and a lot of businesses, you know, they seem to be in different stages of improvement. Maybe you could give us a sense of which ones you're starting to feel good about and maybe, you know, talk a little bit about the shoe business there and whether you think the merchandise mix is where it should be in relation to the customer you're going after.

John Rossler, President and CEO

The merchandise mix relative to each brand or –

Lee Baccus

Well, relative to footwear, I mean, women's apparel, men's apparel, kid's apparel, household, you know, just to get a sense of – you know, over the last few years, the merchandise mix has changed, I mean, when you went after a higher-end customer then a lower-end customer. You've sort of been all over the lot. I mean, do you think it is now positioned the way you want it positioned?

John Rossler, President and CEO

Lee, by brand, I would say that in the case of all of our shoe businesses, we are about as close to precision as we could expect to be now. And in the case of DSW, it's really come with extensive investment in market research and being close to our customer. Our Loyalty Club, over half of our sales in DSW come from Loyalty Club customers, and we know their demographic and psychographic profiles and things. So we've been able to merchandise to precision with that. And we've been around our other leased department operations long enough, I think, that we're in pretty good shape there. I think in the case of our Stein Mart leased departments, we're just within one year on that business, and it is a little different business, because the departments are very slow and small turn. That business requires us to allocate goods to it, footwear to it, with much more precision than we've ever been called upon before. So I believe that with the new Arthur planning and allocation system that we've just put into our shoe business, and with the strength of a half a dozen new very talented planning and allocation people, I think that we are up for that challenge. And we toured stores with the Stein Mart people the other day. They believe the same thing.

In the case of Filene's Basement, we feel that the merchandise, we had gotten too low-end and too POS promotional. And again, Heywood's vision for the business is “best brands for less,” and I think that if you visit the stores today, the merchandise does have Heywood’s fingerprints, beginning to have his fingerprints on it. And you are starting to see “best brands” rather than just brands and better brands. You’re seeing best brands at extreme value. So I think we’re getting a lot closer in focus with customer needs in Filene’s Basement.

In the case of Value City, as you know, Lee, you’ve followed us for a long time, the brand’s been footballed around where sometimes we think that we’re competing at a Wal-Mart price level, and sometimes we have Neiman-Marcus type goods in. We are getting closer, I believe, to the brands that we should be carrying, and I think we’re getting closer to the price points we should be carrying. It’s been complicated, because we pretty much two years ago had zero consumer research, but now we do have 18 months of consumer research, and we’re better able to focus on what the needs are there.

Also, it’s been very difficult because of the lack of systems that are needed to control the buying disciplines on a daily basis. You know, when the buyers are in the field making big buys, it’s not like they have a laptop that they can put the purchase order in and see how it’s run on their IMU or {AUR} up and down. So, you know, that’s why systems is really relevant to that business. But if for no other reason, just through trial and error, you know, where we’ve moved the AURs up and now we’ve brought them back down a little bit, even through trial and error, we’re getting closer to it. So I would say to you we understand better now the nature of the customer in Value City. They’re substantially budget customers, but we have a good tier of moderate customers in there. And we just have to be careful within each of the categories of that big box, that we allow and provide merchandise at both levels.

<u>Lee Baccus</u>

Great, thank you.

<u>Operator</u>

Thank you. And our next question comes from Mr. Jeff Fineberg.

<u>Jeff Fineberg</u>

Just one follow-up on that, and thank you for the perspective, John. Two-part question. One, when do you think the systems might be where you would like them to be? And the second part, just in terms of the brand of the store, what I've noticed in the stores is you've done a much better job on some of the brand names and some of the "better buys," if you will. So if you could just talk a little bit about that, how you're feeling with regard to the branded purchasing.

<u>John Rossler, President and CEO</u>

On the case of the branded purchasing, Jeff, which of the brands would you be referring to, Filene's Basement, DSW, or Value City?

Jeff Fineberg

I'm sorry. I was focusing on the Value City.

John Rossler, President and CEO

Okay. With the brands, we are getting better brands in Value City Department Stores and for a number of reasons. First of all, we have a focus and intent that the store needs better brands, so that's what we're chasing. The second thing is that we have got a group of merchants now that have very good vendor relationships, and I know some of you, Lee, for instance, visit with us at the MAGIC show, we have merchants that can walk in and out of pretty much any brand booth at the show, have very good relationships with top-level management and owner of brands. So I think having people like Stu Glasser, you know, that can walk in and have those friendly relationships has been very, very important to us to be able to start delivering the brands you're starting to see.

On the systems, I think that any of the three of us would probably answer that the best, but I think that our Chief Operating Officer should run back through that just a little bit. Ed, do you want to talk about the kind –

Ed Kozlowski, Chief Operating Operator

The systems, we'll start to see benefits from planning and allocation in DSW in 2004. I really think the shake-out will occur through the spring season, and then you'll start to see more benefit and more precision of allocation as you head into fall of 2004.

Value City, since we're putting those systems in over the course of the year, I really don't believe you'll see any substantive improvement until 2005. And I would argue you won't see it in the soft line side of the business until the second half of 2005, because that's going to be the last half of our implementation. So, you know, it's unfortunate that it pushes out so far, but the reality is these systems have to be put in at a time when they're best able to be implemented without disruption to the business. So we've had to push the soft lines to the back half of the year. We're going to push the hard lines onto the front half.

Jeff Fineberg

That makes sense. Thank you very much.

Operator

Thank you. Once again, ladies and gentlemen, to ask a question, please press "1" followed by a "4" on your touchtone phone. And I'm showing no further questions at this time.

John Rossler, President and CEO

All right. Thank you everybody for joining us, and we look forward to speaking with you again in the fourth quarter. Thank you, Miquelle.

Operator

That concludes today's conference call. Thank you for your participation.

(End of Conference Call)