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Caleres, Inc. (CAL)

Q3 2021 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good afternoon, and welcome to the Caleres Third Quarter Earnings Conference Call. My name is Erica and I will be your conference coordinator. At this time, all participants are in a listen-only mode. After the speakers' presentation, there will be a question-and-answer session. [Operator Instructions] Please be advised that today's conference is being recorded. [Operator Instructions]

At this time, I would like to turn the call over to Logan Bonacorsi, Vice President of Investor Relations. Please go ahead.

Logan Bonacorsi

Vice President-Investor Relations, Caleres, Inc.

Good afternoon. I'd like to thank you for joining our third quarter 2021 earnings call and webcast. A press release with detailed financial tables, as well as our quarterly slide presentation are available at caleres.com.

Please be aware, today's discussion contains forward-looking statements, which are subject to a number of risks and uncertainties. Actual results may differ materially due to various risk factors, including but not limited to, the factors disclosed in the company's Form 10-K and other filings with the US Securities and Exchange Commission.

Please refer to today's press release and our SEC filings for more information on risk factors and other factors, which could impact forward-looking statements. Copies of these reports are available online. The company undertakes no obligation to update any information discussed on this call at any time.

During today's discussion, and unless otherwise noted, our comparisons will be primarily in relation to the third quarter of 2019. We believe this to be a more comparable time period for most of our key metrics due to the pandemic-related pressures that impacted the third quarter of 2020.

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Joining me on the call today is Diane Sullivan, Chairman and CEO; Ken Hannah, Senior Vice President and CFO; and Jay Schmidt, our President. We will begin the call with brief prepared remarks, and thereafter, we'll be happy to take your questions.

I would now like to turn the call over to Diane. Diane?

Diane M. Sullivan

Chairman & Chief Executive Officer, Caleres, Inc.

Thanks, Logan. And good afternoon, everyone, and thank you for joining us on today's call. I'm thrilled to report that the positive consumer demand dynamics that re-emerged earlier this year continued during the third quarter. These trends were powered by a return to a more normal back-to-school buying activity, accelerated holiday shopping and the ongoing momentum from the great economic reopening. In short, the footwear consumer is strong, healthy and motivated.

Caleres capitalized on this robust consumer demand, achieving another exceptional operating performance during the quarter, while navigating the persistent challenges we are all facing in the global supply chain. I'm extremely proud of how our team has continued to deliver through the ongoing volatility, never losing focus on the variables within our control and driving forward with our strategic priorities.

As a result of our strong performance during the first nine months of the year and our expectations for ongoing momentum for the remainder of 2021, we are raising our full-year earnings outlook. We now expect record adjusted earnings per share of between $3.80 and $3.90 for fiscal year 2021, up from the initial guidance range of $3.25 to $3.50.

Among the many highlights for the third quarter, we achieved another record quarterly operating earnings of $81 million and adjusted earnings per share of $1.59. We generated $784 million in revenue, nearly matching our third quarter 2019 performance. We captured a strong consolidated gross margin of approximately 43%, a 241-basis-point improvement over the same period two years ago, and we drove forward with our digital-first initiative to attract new, maintain current, and reactivate previous consumers across our entire portfolio of brands.

In addition to our strong execution, we continue to further our strategic priorities, invest in our diversified portfolio to support our long-term growth and, of course, made progress toward our balance sheet objectives. We continue to reduce our debt levels and given our strong outlook for the remainder of 2021 and 2022, we fully expect to approach our goal of zero net debt over the course of the next five quarters. We view this as hugely value creating for our shareholders as we effectively convert debt to equity value via these efforts.

Furthermore, we took action to bolster our financial foundations still further, finalizing more advantageous terms on a revolving credit facility. This new agreement, coupled with our proactive debt reduction initiatives earlier this year, will lower our 2022 annual interest expense by approximately $12 million. Ken will discuss the specifics of these activities and great accomplishments in more detail in just a few moments.

Before we take a closer look at our segment-level results, I want to briefly touch on the impact from the highly discussed supply chain and global logistics challenges that have significantly intensified in recent months. During the quarter, factory closures, increased delivery lead times and port delays hindered our ability to capitalize fully on the significant uptick in consumer demand. Our teams have worked hard to mitigate the impacts of these ongoing disruptions, and while we're encouraged by factory reopenings, we do expect increased lead times and port delays to continue and will likely affect our ability to capture incremental demand opportunities in the near term.

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Now, let's move to our third quarter segment results, starting with the outsized performance of Famous Footwear. We raised the bar again during this period, leaning into our competitive advantages, taking advantage of the strong consumer demand and achieving a second straight record-setting quarterly performance.

Notably, Famous generated quarterly sales of approximately $495 million, a nearly 11% improvement over the third quarter of 2019 and the highest level of quarterly sales in the history of the brand. This outstanding revenue performance was driven by an extremely successful back-to-school period where sales and margins were up from the comparable timeframe in 2019 and marked the most profitable back-to-school period in our history.

Even more positively, sales momentum continued even after the conclusion of the back-to-school season, despite limited promotional activity. While the robust demand clearly played a role, we also believe this resilient sales activity in the second half of the quarter reflects our inclusion of TV into our marketing mix, the power of our product allocation system, as well as the depth of our inventory as it relates to in-demand brands and styles.

It's really worth highlighting, as you would expect, that the third quarter was another period of minimal promotional activity and significantly less promotional days resulting in near-record margin levels for the segment. Margins reached nearly 48% and were 657 basis points higher than 2019. Also helping to support these strong margins was much tighter inventory position at Famous. Inventory levels were down 24% from two years ago.

What was really powerful driver was having the right level of inventory behind the key brands and styles. Specifically, our inventory in our top 10 brands was down only 9% from the third quarter of 2019. At the same time, we experienced meaningful improvement in sales, margin and AURs over the comparable time period from these brands. We've leveraged our allocation expertise to ensure that we are maximizing our inventory with the right product and the right places to meet demand at the local level. Through the work of our merchandising, planning and allocation teams, we really believe we're reasonably positioned from both a product and inventory standpoint as we enter the heart of the holiday season.

Looking ahead, we will maintain our sharp focus on managing the supply chain issues, working closely with our partners to properly align our inventory with consumer demand. Additionally, expenses were well-managed in the quarter with a 490-basis-point improvement from third quarter of 2019. And as a result, we delivered operating earnings of $87.4 million, which was $59.7 million higher than the same period two years ago. Finally, our return on sales reached approximately 18%, which is more than 11 full percentage points higher than a comparable 2019 period and a third quarter record for Famous.

Now, looking at the performance in more detail, we experienced broad-based strength as we saw sales growth and gross margin rate expansion across women's, men's, kids and accessories. Not surprisingly, our kids business was particularly strong in the period increasing 26% over 2019, highlighting the widespread return to in-classroom learning, a strong inventory position and demonstrating the work we've done to amplify our kids offerings to the consumer.

Shifting to style categories, athletics, casual and sandals all recorded increases over the same period in 2019 while boot styles were down modestly. In addition, we saw strong improvement across the omni-channel. From an e-commerce perspective, we achieved our two-year growth plan put in place prior to the pandemic during the period.

Our online sales were up approximately 44%, contributing an incremental $20 million of sales when compared to the third quarter of 2019. However, what wasn't envisioned at the time two years ago was the growth we

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experienced in our brick-and-mortar business during the period. Brick-and-mortar sales increased 7% over the third quarter of 2019, even with 55 fewer stores. Notably, we saw an increased conversion despite much lower inventory levels and improved AURs across both channels.

On an exciting note, early next week, Famous is testing its first-ever catalog. We've experienced great traction from recent catalogs with Sam and Allen Edmonds and Vionic, and we're using these learnings to support our customer acquisition objectives for our largest brand. Famous is a convenient stop for holiday style, and this is the perfect time to connect consumers with the great brand offerings and gift opportunities, including shoes, accessories, and gift cards as we head into the holidays. There's just a lot to be proud of at Famous, and while this is record performance is notable, our focus is on how we can maintain and build on this momentum to drive profitable growth going forward.

Now, let's talk a little bit about the Brand Portfolio segment. During the third quarter, sales volumes in the Brand Portfolio expanded approximately 26% sequentially, supported by strong consumer demand fundamentals and underscoring the ongoing rebound for certain brands and trending styles. While the sequential sales improvement was encouraging, supply chain disruptions, including the factory closures and the port delays tempered our ability to utilize our speed programs, deliver goods on time, and to capitalize on incremental demand.

Most significantly, though, exceptionally high ocean freight cost compressed margin rates by approximately 400 basis points from the third quarter of 2019 as the timing of product price increases on ship goods lagged the current higher cost to ship. The Brand Portfolio experienced an incremental $11.5 million of ocean freight cost during the quarter. We believe that focusing on the items within our control will pay off as we navigate these ongoing disruptions.

While there just isn't a one-size-fits-all solution, our teams are working to pull every lever and this includes taking price increases, working with our factories to manage input costs. Obviously, placing future buys earlier, renegotiating container contracts, evaluating freight options, and looking at everything we can do to fix the ocean and help the ocean transit times, and minimizing our country exposure risk through dual sourcing wherever we can. So it's really a basketful of a lot of different things that we're going to be doing to ensure that we continue to improve our position.

Looking ahead, while ocean freight will likely remain elevated above historical rates, through the combination of efforts that I talked about, we would expect to be able to somewhat offset the higher cost of ocean shipping in future quarters, with the larger offsets to occur as spring 2022 goods are sold through.

All of that withstanding, we continue to make really great progress on a number of our key brands as they continue their upward progress, registering sales and/or margin and earnings improvements, along with increases on key strategic objectives, including our direct-to-consumer presence, where we saw a 20% increase in sales from our old e-commerce sites. In fact, we're seeing favorable consumer response to and strong sell-throughs from many of our brand product offerings.

So let me share a couple of those standout performances in our Brand Portfolio in this period. It was again Vionic, Sam Edelman, and Allen Edmonds. These leadership brands had a more advantaged inventory position during the quarter and overall have a high degree of brand equity and authority in the segments they compete in.

Starting with Vionic, which continued on its strong growth track and strengthened its place as one of the leading brands in our portfolio. During the quarter, Vionic grew its sales 12% over the third quarter of 2019 and experienced significant improvement in e-commerce sales, which were up nearly 90% over the same time period.

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Furthermore, continued full-price selling during the quarter led to stronger gross margins and an improved levels of earnings. I'll also mention that Vionic Beach, which we launched in the fall of 2020, has quickly become one of our best-selling styles.

Now, turning to Sam Edelman, a central part of our – and important part of our portfolio. The brand built on its first half performance, delivering positive operating earnings growth over 2019. During the period, SamEdelman.com delivered significant improvement in demand, with online sales up 77% over the two-year period.

In addition, I have to say I just continue to be encouraged by the progress that we're making at Allen Edmonds. Sport and casual continues to be a growing part of our assortment. Dress has returned as more and more people return to work, and boots are performing well. While sales have yet to reach pre-pandemic levels, we're pleased with the operating earnings that came in ahead of our third quarter of 2019, as we have seen positive consumer reaction to new products and loyalty to our heritage styles continue to accelerate.

Given the strong demand in the marketplace and our difficulty and our inability to circumvent the global supply chain issues with our domestic and near-shore production facilities, we expect the recovery of this brand to continue into 2022.

I'd also like to highlight Rykä, which continues to deliver a strong sales performance as its casual and sport styles and its focus on health and wellness resonates with the active consumer. More recently, the brand's expansion into outdoor and trail has opened up another category for the Brand Portfolio, with these products already showing positive trends in the marketplace and is expected to grow into next year.

Finally, we're happy to officially welcome Blowfish Malibu to the Caleres portfolio of brands. As you will remember, we purchased a majority stake in the company back in 2018, and after the third quarter, we completed the acquisition and now have 100% ownership of the brand. I want to thank all the associates who work so closely together to bring this transaction to completion.

Going forward, we expect the challenges in the macro supply chain to be part of the operating environment for the foreseeable future. However, we're highly confident that as supply chain issues moderate and inventory positions improved that we will continue to see tremendous upside in this business over the long term. Our unique balance of brands and styles in the trending casual and sport categories and our strong long-standing presence in the improving dress and event categories positions Caleres well to capitalize on the robust consumer demand trends playing out in the marketplace.

Before I hand it over to Ken, I want to recognize our global workforce in their outstanding performance. No one would have predicted this level of recovery, and it's through their outstanding efforts that we expect to deliver a record year for our company in 2021 and what also makes us highly optimistic for our prospects for another terrific year in 2022.

With that, I will now hand it over to Ken for a review of our financials. Ken?

Kenneth H. Hannah

Chief Financial Officer & Senior Vice President, Caleres, Inc.

Thanks, Diane. The progress we have made during 2021 both from an operational and a financial perspective is significant. Based on the strong progress, we believe we're well-positioned to close the year in record fashion and head into 2022 with excellent momentum. I'm particularly pleased with the fact that we've continued to drive forward with our efforts to strengthen the balance sheet. As you will recall, early in the pandemic, our total debt

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peaked at $640 million. However, since that time, we've systematically reduced it by $365 million in just six quarters, and the remaining $275 million of debt on our balance sheet is all classified as short-term. Even in the third quarter when we were building cash in advance of making the final payment on the Blowfish Malibu acquisition, we were able to reduce debt by another $25 million.

In addition to our debt reduction, we've also renegotiated the terms of our revolving credit facility during the quarter. The terms which now more accurately reflect our significantly improved capital structure, positive business trends and rapid recovery in the footwear market have been restored to pre-COVID terms, including a five-year extension of the facility's maturity date and a reduction in the borrowing rate.

As highlighted on our last call, we elected to call $100 million of our outstanding senior notes in August of 2021. In addition, we've since notified our bondholders that we will be calling the remaining $100 million of senior notes in January of 2022. We expect these collective actions to reduce our interest expense by approximately $12 million annually going forward.

Now, let's talk about a few of our financial metrics in a bit more detail. As Diane highlighted for the third quarter, we delivered $784.2 million in sales, which was only 1% below 2019 levels and driven by another quarter of record sales performance at Famous Footwear and a sequentially quarterly sales improvement in the Brand Portfolio.

Our consolidated gross margin was 42.8%, up 241 basis points for the third quarter of 2019 and reflecting another strong margin performance in Famous. In fact, Famous Footwear delivered gross profit margin of approximately 47.6% in the third quarter. This 657-basis-point improvement from 2019 was driven primarily by the continuation of more full-price selling and another quarter of minimal promotional activity due to the increasingly tight supply fundamentals industry-wide.

Brand Portfolio recorded third quarter gross margin of 32.9%, which was 426 basis points lower than the third quarter of 2019, reflecting an incremental $11.5 million in ocean freight costs. Our third quarter SG&A expense was $254 million during the period or 32.4% of sales, the $21.3 million and 235-basis point decline from the same period two years ago.

The company generated approximately $54.2 million of cash from operations in the third quarter. And as we discussed, we used that cash to further reduce our debt levels, fund our dividend, and continue to invest in our business. As I mentioned previously, we built cash in the quarter in advance of our final payment on the Blowfish acquisition, which we subsequently made on November 4. We continue to be highly pleased with this acquisition, which has proven to be accretive, fits exceptionally well into our broader portfolio, and offers still additional growth potential.

Our inventory at quarter end was down approximately 15.7% compared to the third quarter of 2019 and included an approximate 24% decline at Famous Footwear and a 6.7% decline for the Brand Portfolio. The inventory levels of the Brand Portfolio included more than $100 million of inventory in transit, reflecting the increased shipping times which was not yet available to sell. For comparison, our in-transit inventory for the segment is 3 times higher than historical levels.

Given the current operating environment, it's imperative that we judiciously manage our inventory, making quick decisions, focusing on styles and brands with strong consumer momentum and striving to align our inventory levels with our consumer demand. While challenging, we're hyper-focused on counterbalancing the inventory headwinds caused by ongoing tightness in the supply chain.

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Looking ahead, as Diane mentioned, we're currently guiding to record adjusted earnings per share between $3.80 and $3.90 per share for the full year 2021. Implicit in that guidance, of course, is the fact that the fourth quarter is typically the weakest of the year, reflecting the typical seasonal sales declines for Famous, as well as supply chain and logistical cost pressures that could limit our ability to capture strong consumer demand across the portfolio. We do expect Famous Footwear sales in the fourth quarter to be slightly above our 2019 levels with another quarter of record earnings and Brand Portfolio sales are expected to be in line with the third quarter.

Despite supply and demand uncertainties and volatility in the macro environment, we believe we are well-positioned for another strong year in 2022. While it's premature to provide specific 2022 guidance, the work we have done on our balance sheet and the progress on our expense structure alone should drive incremental 2022 earnings well above our full year fiscal 2019 levels. All told, we believe we made excellent progress across a wide range of operating and financial metrics since the start of the year, and in doing so have set the stage for ongoing value creation for shareholders throughout the balance of 2021 and into 2022.

With that, I'd like to turn the call over to the operator for questions. Operator?

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] Your first question comes from the line of Laura Champine with Loop Capital.

Laura Champine
Analyst, Loop Capital Markets LLC

Q

Congratulations on a great quarter and record guidance – it's particularly the gross margin levels of Famous are really exciting. I'm guessing they're not sustainable, though, because at some point, I would guess that inventory flows normalize. What do you think is a normalized gross margin level for Famous?

Kenneth H. Hannah
Chief Financial Officer & Senior Vice President, Caleres, Inc.

A

Laura, I think if we, you know, if we go forward and we look at Q3, we typically would be in a BOGO situation. We chose not to run more in BOGO this year. As we get into holiday, given the current supply situation, I mean, it will likely not have a lot of holiday promotions going on. I mean I think that we're buying as though, we're going to continue full price selling. And certainly, I think we're all enjoying the benefits of that. Certainly has had a really nice impact on our P&L. So, it's really going to come down to – as we move forward and the supply chain starts to work out, kind of what are the levels of promotion that are going to be baked into the calendar?

As we sit here today, we don't have a lot baked in in the foreseeable future. And I think we'll look to put some very specific guidance around kind of how we see 2022 specifically from a margin standpoint when we're back together in March.

Laura Champine
Analyst, Loop Capital Markets LLC

Q

Understood. Would you contemplate not running BOGO next year or two? And do you think the industry will be disciplined enough to let you do that?

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Diane M. Sullivan
Chairman & Chief Executive Officer, Caleres, Inc.

A

Hi, Laura, it's Diane. I think that we're going to be in this environment of tighter supply for quite some time. And I think we're really focused as you could hear about making sure we have that inventory against those really important brands and styles, so that top 10 that I spoke to. So, we're really going to make sure that we're focusing that inventory against the brands and the styles that we think are the most important. So that is something that we're making sure that we do.

We had always thought that there was an opportunity for us to improve our productivity and our turn. And while we're sure, would we have wanted a few more shoes, maybe this year, we've learned, I think through this pandemic a lot about what the possibility is. And we don't really see any reason why we would want to go back. If we can live in a full-priced selling world, we're going to certainly do that. So, we feel pretty strongly about that because we think that's healthy all the way around.

Laura Champine
Analyst, Loop Capital Markets LLC

Q

Makes sense to me. Thanks so much.

Diane M. Sullivan
Chairman & Chief Executive Officer, Caleres, Inc.

A

All right. Thanks, Laura.

Operator: [Operator Instructions] Your next question comes from the line of Steve Marotta with CL King & Associates.

Steven L. Marotta
Analyst, C.L. King & Associates, Inc.

Q

Good evening, Diane, Ken, Jay, and Logan. Thank you for taking my question. Diane, I know that you don't specifically provide order book guidance, but can you talk a little bit about what you were seeing on the Brand Portfolio side from an order book? How far out are wholesale customers taking orders? And maybe talk a little bit about the cadence of next year and how confident you are in the order book and the delivery schedule. Thanks.

Diane M. Sullivan
Chairman & Chief Executive Officer, Caleres, Inc.

A

Yeah. Okay, thanks. Thanks, Steve. Yeah, we are – if the order book continues to get better and better, not only I think because of the, obviously, the strength of many of the brands in the portfolio, but as people are placing orders a little bit earlier. So we have pretty good visibility right now and our order position looks great. I would say through most of spring we have right now and we're now taking orders for really summer. So all of that seems to be good and it feels like we're exactly where we need to be.

And as you could see with what we talked about with respect to even our inventories and in-transit, those in-transit inventories also speak to the strength of the on-order that we see as we turn the corner into spring of 2022 as well. So I think we're in very good shape. Jay, I don't know if you have anything else that you would want to add on that.

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John W. Schmidt
President, Caleres, Inc.
A

No, I think that says that we're up significantly from 2020 and we're moving back toward levels where we want to be in the lead asset brands.

Diane M. Sullivan
Chairman & Chief Executive Officer, Caleres, Inc.
A

Good. Okay. Thanks. Steve, is that good?

Steven L. Marotta
Analyst, C.L. King & Associates, Inc.
Q

Very helpful. And I know that you're not providing guidance for next year, but maybe you can talk a little bit about the inflationary pressures that you're seeing on a consolidated basis. I understand there's a lot of moving parts between ocean freight as well as raw materials, labor, the whole shebang. But maybe you can talk a little bit about what you're seeing. And, Diane, with the exception of price increases which you've mentioned, you mentioned a few other potential offsets. Maybe you can talk about those as well. Thanks.

Diane M. Sullivan
Chairman & Chief Executive Officer, Caleres, Inc.
A

Yeah. Okay. Yeah. Well, of course, everybody is looking at price increases, and I think we had mentioned even in our last call that we're taking price increases going into spring of 2022, and expected for them on average that those increases would be somewhere at retail in the range of 15%. So, those are in place and are part of the plan going forward.

I think the biggest impact as we discussed was the ocean freight costs really. We're seeing some input costs in product, too. And the teams are managing through that, doing whatever we need to do, taking price increases, reworking things. But, basically, we're very confident we can manage through those input cost issues.

The transportation ones and the ocean freight costs have been the biggest impact. We don't expect that they're going to stay at the current rates where they're at. They're going to moderate at some point in time during 2022. And it's hard to know, Steve, exactly when that's going to be. But as we work through our plans and our guidance for 2022, we'll take that into account, but don't really think that will remain at the current levels.

And I think the last thing I'd say is what I'm really hoping for is that the delay in the lead times within the supply chain somehow gets smoothed out, because right now, we're trying to get product to consumers today at almost every step of the way is taking a little longer than what everybody had expected. So, whether it's even coming out of our distribution centers and getting to our customers' warehouses, it's taking longer than ever.

So as much as the cost, it's really back to some kind of normalized speed and operating time to service the customer, I think is our biggest hope. And fortunately, in our DCs and even as we're getting our products to stores at Famous Footwear, we've been fortunate that we haven't had any delays at all. We're getting – once we get goods in, we're getting them out in a week to our stores at Famous. So, actually everything is operating very, very nicely within the network that we can control.

So, managing through it and like having to be agile, just like we had to be this year. You deal with the cards you're dealt with and you make the most of it. And we feel highly confident that we've got the plans in place and are doing the right sort of things to continue this momentum that the company has.

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Steven L. Marotta
Analyst, C.L. King & Associates, Inc.

Q

That's great. Very helpful. And one last question, Ken, of the $12 million that is expected to be saved in annualized basis from interest expense, how much is captured in 2021? And by extension, I'm asking what Delta would be expected for 2022? Thank you.

Kenneth H. Hannah
Chief Financial Officer & Senior Vice President, Caleres, Inc.

A

All right, Steve. Yeah, we would captured a little bit since we renegotiated the credit facility in the third quarter and then we call that first night. So, it's really, the $12 million is starting from August when we call the first $100 million kind of going forward. So, just on an annualized basis. So, we'll get a little bit of that in the fourth quarter.

Steven L. Marotta
Analyst, C.L. King & Associates, Inc.

Q

Very helpful. Thank you. Best of luck.

Kenneth H. Hannah
Chief Financial Officer & Senior Vice President, Caleres, Inc.

A

Yeah. Thank you.

Diane M. Sullivan
Chairman & Chief Executive Officer, Caleres, Inc.

A

Thank you.

Operator: [Operator Instructions] At this time, there are no further questions. I'll turn the call back over to Diane Sullivan for any closing remarks.

Diane M. Sullivan
Chairman & Chief Executive Officer, Caleres, Inc.

Thanks. Thank you, as always, for your interest and support of our company as we round out 2021 and as robust consumer demand dynamics continue to accelerate. We really fully expect the ongoing recovery in the Brand Portfolio to be an increasingly strong complement to the ongoing success at Famous Footwear in the quarters ahead. And I can just tell you that this team is all-in and doing everything to power and harness this momentum and capitalize on everything as we move into 2022. So thanks so much. Appreciate it. Have a nice holiday season.

Operator: This concludes today's conference call. Thank you for participating. You may now disconnect.

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