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SBH.N - Q4 2022 Sally Beauty Holdings Inc Earnings Call

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PRESENTATION

Operator

Good morning, ladies and gentlemen, and welcome to the Sally Beauty Holdings conference call to discuss the company's fiscal 2022 fourth quarter results. (Operator Instructions) As a reminder, this conference is being recorded for replay.

Now I would like to turn the call over to Jeff Harkins, Vice President of Investor Relations and Treasurer for Sally Beauty Holdings. Please go ahead, sir.

Jeff Harkins - *Sally Beauty Holdings, Inc. - VP of IR & Strategic Planning*

Thank you. Good morning, everyone, and thanks for joining us. With me on the call today are Denise Paulonis, President and Chief Executive Officer; and Marlo Cormier, Chief Financial Officer.

Before we begin, I want to remind everyone that we have made a presentation available for today's call that can be viewed from the link provided on our investor site at sallybeautyholdings.com.

I would also like to remind you that management's remarks on this call may contain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Actual results may differ materially from those indicated by these forward-looking statements as a result of various important factors, including those discussed in the Risk Factors section of our most recent annual report on Form 10-K and other filings with the SEC. Any forward-looking statements made on this call represent our views only as of today, and we undertake no obligations to update them.

The company has provided a detailed explanation and reconciliations of its adjusting items and non-GAAP financial measures in its earnings press release and on its website.

Now I'd like to turn the call over to Denise to begin the formal remarks.

Denise A. Paulonis - *Sally Beauty Holdings, Inc. - President, CEO & Director*

Thank you, Jeff, and good morning, everyone.

In fiscal 2022, we delivered full year net sales of $3.8 billion, gross margins over 50% and adjusted EBITDA of more than $500 million. We did this by leveraging our people, platforms and scales to delight our core Sally Beauty customers and BSG stylists amid persistent inflationary pressures and supply chain disruptions. I'm particularly proud of our team's ability to navigate the numerous macro challenges over the past few years, becoming more agile and focused organization overall.

Importantly, during our transformational period from 2017 to 2021, we built the infrastructure and key foundational elements to take our business well into the future, including our CRM platform, our advanced digital commerce capabilities and our enhanced supply chain.

On today's call, we'll be sharing our vision for the Sally Beauty Holdings of the future, including new strategic initiatives will be focused on over the long-term and will provide our long-term growth algorithms that we'll be executing towards over the coming years. Ahead of that, let me take a moment to comment briefly on the current operating environment as well as share a few highlights from fiscal 2022.

First, the operating environment. As we ended fiscal 2022, inflationary pressures continue to influence customer and Sally's behavior. In Sally U.S. and Canada, the inflationary environment continues to cause some of our customers to color less frequently and reduce the size of their basket when they shop with us. While the situation has not improved, of note, we believe our focus on customer service and our Pro quality for less marketing is resonating, limiting additional pressure on sales.

In BSG, our sales are focused on saving time and maximizing profitability. We continue to see them purchasing closer to need, while responding favorably to promotional bundles and education for express services. We believe salon had a healthy back-to-school season, followed by a sole softening of demand once customers transition into their fall routine.

On the supply chain front, while improving some of our vendors are still experiencing raw material shortages, which is impacting stock levels in a few of our top-performing SKUs. As we look to fiscal 2023, we're expecting a similar operating environment to what we saw at the end of fiscal 2022.

Turning to wins in fiscal '22. I am pleased to share several highlights. Throughout the year, we remained at the forefront of product innovation across both the Sally and BSG segments. This includes our strong partnerships with premier brands like Wella, Matrix, Joico, Olaplex and (inaudible) as well as owned brands like Ion and Strawberry Leopard.

We also grew our loyalty program. As you know, our loyalty program drives the majority of our sales at Sally U.S. and Canada and is an important indicator of customer retention. As of year-end, the number of Sally U.S. and Canada active loyalty members was 17 million and represented 77% of sales for the fiscal year. At BSG, our rewards credit card continues to benefit our Pro customers in helping them manage their working capital needs for their business. The rewards credit card comprised 9% of BSG's sales for the fiscal year.

New conveniences and increased personalization enable us to better serve our loyal customers. Initiatives ranging from Sally's virtual color experts and 2-hour deliveries, to personalized shopping journeys were met with tremendous customer response and continued to gain traction.

Another important means for better serving our customers is the advancement of our supply chain. As a top destination to shop for professional color and care, our goal is to be in-stock in these core categories every time for our customers. And we made great strides last year towards increasing speed to market and improving our in-stock levels, notwithstanding macro-related supply chain disruption.

The underlying strength of our supply chain also allowed us to significantly expand our partnership with Regis salons during the latter part of 2022. After a multi-quarter rollout, we now have full distribution for all 5,000-plus Regis locations.

Finally, we further strengthened the balance sheet in fiscal 2022 with the full repayment of $300 million outstanding under our senior secured notes while returning $130 million to shareholders through the repurchase of almost 7 million shares. Our historically strong cash flow generation and our healthy balance sheet leave us well positioned to invest in new business models and services to drive growth and return value to shareholders.

As I shift my comments to our longer-term vision and strategic initiatives, I think it's important to reiterate that underpinning our advancements in fiscal 2022 is our operating model centered on owning professional hair color and care for both the DIY enthusiasts and professional salons. At Sally Beauty, we are distinguished by our differentiated core in color and care for home use and this is supported by the unparalleled expertise, education and content we provide to our customers.

At BSG, we're the largest North American distributor of professional color and care, and we offer stylists and salons the most extensive portfolio of third-party brands in the market, most of which are under exclusive distribution rates. Beginning in fiscal 2023, we will be leveraging and building upon these core competencies and competitive advantages as we embark on our new strategic initiatives to drive growth and profitability.

Our 3 strategic initiatives are as follows: enhancing our customer centricity, growing high-margin owned brands at Sally Beauty and amplifying innovation, and increasing the efficiency of our operations and optimizing our capabilities. Moreover, we'll also be focused on advancing our ESG and our diversity inclusion and belonging commitments.

Let's dive into our strategic initiatives. Our first initiative is enhancing our customer centricity. I'll start with how this comes to life at BSG. Designed to drive continued growth at BSG, we are building a services ecosystem for our stylist community, designed to empower them to operate more value-added and profitable businesses. This fall, our first step in these efforts was the launch of a new strategic partnership with SalonHQ, which enables our stylists to increase retail sales through strategic customer engagement while carrying less inventory. SalonHQ's customizable digital storefront platform gives our stylists the ability to curate a product selection from thousands of choices and enable clients to purchase directly from their shops without having to hold inventory.

By providing our stylists with a digital storefront, a seamless funnel and powerful support tools, they'll have the ability to sell the full line of BSG products and increase the profitability of their business.

In addition, stylists and salons will be able to engage with their customers using advanced marketing tools to present product recommendations and follow up on previous orders. Initial response from the sales community has been tremendous, and the concept is gaining traction.

As we look beyond fiscal 2023 for BSG, in addition to our stylists platform with SalonHQ, we are exploring additional value-creating services while continuing to amplify innovation and leverage our exclusive distribution rights to help our stylists grow their businesses.

On the retail side of our business, we know how much our customers value the inspiration, education and advice they get from Sally. We're leveraging this core competency to create an unrivaled platform for the future. We already have certified color consultants who provide in-store education and advice. And for more complex needs, Sally customers can access next-level expertise by connecting with our virtual color experts through a live video call conducted on-site in our stores.

We began piloting this convenience in the first quarter of last year and have found that our Sally customer loves this incrementally higher level of touch and counseling. We currently have 45 stores offering virtual color experts and plan to expand this to approximately 30 additional stores as well as our Sally website in fiscal 2023.

Building upon this high-touch service offering, we've created Studio by Sally, a new concept store that includes a DIY-centric salon. Studio by Sally allows for personalized appointments with a licensed stylist who will train and educate the consumer on how to color their own hair and achieve their desired results. This is a new and inventive way to engage, educate and empower consumers using interactive experiences to showcase our on-trend, color and care expertise and to drive product sales.

We think that this extensive market research to bet this concept, and the results tell us that there is a great deal of excitement among not only our core customers, but also lapse customers and non-Sally customers alike. Studio by Sally will have a digital-first focus from virtual check-in and digital education throughout the store to DIY demos streaming at the storefront and take-home videos from individual salon teaching sessions. We plan to pilot an initial 6 stores in fiscal 2023 and believe there's an opportunity to grow this concept to 100 locations throughout the U.S. over the next 3 to 4 years.

Turning to our second initiative, growing our high-margin owned brands penetration and amplifying product innovation. While you note that delivering product innovation has been a core tenet of our operating and growth model for years, this remains of crucial importance for our company, and you can expect to see us build upon our already strong track record in the quarters and years ahead. Indeed, innovation has been a key differentiator for both Sally and BSG and is expected to be an important driver of growth going forward.

We will continue to cultivate differentiated products through strong relationships with the best innovators and beauty companies in the world. We see our customers and stylist reach as an exceptional asset in driving joint growth with our vendor partners. As part of this effort, we'll also be prioritizing secondary categories, notably nails to ensure that we're on trend and in stock with focused assortments beyond our core.

Additionally, we see great opportunity to grow our high-margin owned brands. This includes powerful brands that we have built from the ground up like Ion, which today is a $280 million brand. Strawberry Leopard is another great example of our innovation engine. We're pleased with the traction we gained with it in just 1 year.

We will continue to be highly selective in our approach to developing proprietary brands, focusing on areas where we can leverage our expertise to fill a void in the marketplace and garner meaningful share.

Our latest innovation, bondbar, showcases this strategy. As we announced back in October, bondbar is a new line of pro-quality bonding products that we are bringing to market at a tremendous value to customers. We're incredibly proud of this innovation, which leverages our vast knowledge of hair care, addresses the growing consumer demand for powerful hair repair solutions and fills a void in the market for bonding products at accessible price points.

As we look ahead, we believe owned brand penetration at Sally can increase from 33% of sales in fiscal 2022 to over 50% in the next 4 to 5 years.

Now I'll turn to our final strategic initiative, increasing the efficiency of our operations and optimizing our capabilities. We'll focus on 3 opportunities in this area, including optimizing our store base, consolidating and leveraging our enhanced supply chain and capturing efficiencies by rethinking the way we work.

First, store optimization. Our investments in recent years allowed us to build a robust omnichannel platform that will serve us well into the future. As we focus on delivering a seamless omnichannel experience, we've enhanced our digital offerings to meet customers where and when they want.

In turn, our channel mix has shifted, and we expect it to continue to evolve. In response to this shift, and continued expense inflation, during the past year, we conducted a 90-store optimization pilot, which yielded positive results with sales transfer exceeding our targets. After extensive analysis of those sample stores, we've made the decision to accelerate our store optimization program and close approximately 350 additional locations with the majority closings in December of 2022. Most of the closing stores are Sally stores based in the U.S. This optimization program allows us to improve productivity and profitability while delivering a convenient omnichannel experience that benefits our customers.

Moving on to our supply chain. The progress we've made in modernizing our supply chain enables us to increase efficiency while supporting growth. On the efficiency side, we'll be closing 2 small distribution centers in Oregon and Pennsylvania and transferring the volumes to larger distribution centers. While continuing to delight our customers, these actions will enable us to realize cost savings and serve as an important offset to inflationary headwinds.

Further, the muscle we have built within our supply chain in recent years has become a source of growth. Notably, it has enabled us to significantly grow our Regis partnership with sales volume expected to double from fiscal 2022 to fiscal 2023. The visibility and strategic importance of this expanded relationship raises our profile among other brand partners and establishes a solid foundation for future chain growth.

Last, but certainly not least, we have launched a Fuel for Growth initiative that is focused on rethinking the way we operate our business over the longer-term, supporting our longer-term operating profit margin objective. Our teams are energized for our new strategic initiatives and remain committed to delivering innovation to both our Sally and BSG customers across products, services and education. Over the long-term, we believe these initiatives will enable the business to generate low- to mid-single-digit net sales growth, gross margins over 50% and low double-digit operating margin.

I'm confident in our strategies and impressed by our team, whose passion, perseverance and creativity are allowing us to build upon our core strengths and create new pathways for growth in the face of a highly dynamic external environment. Looking ahead, I have tremendous conviction that our ability to leverage our infrastructure and capabilities while introducing exciting new initiatives, will set us up to deliver improved top line growth and profitability.

We appreciate the support of our shareholders as we embark on a new set of initiatives to drive growth and create long-term shareholder value.

Now I'll turn the call over to Marlo to cover the financials.

Marlo Cormier - *Sally Beauty Holdings, Inc. - Senior VP & CFO*

Thank you, Denise, and good morning, everyone.

Our fourth quarter results saw trends to remain steady with sales landing around our expectations. We concluded the year with fourth quarter net sales of $962 million, down 2.8% and comparable sales approximately flat to last year. The results reflect a few key factors. First, the transitory pressures that Denise outlined, the ongoing effects of inflation impacting consumer behavior in both our retail and professional divisions, as well as the continued supply chain disruptions at BSG, although improving as we anticipated. Additionally, we are operating 117 fewer stores at the end of the period compared to a year ago.

Foreign currency translation had an unfavorable impact of 170 basis points on consolidated net sales for the quarter. And comparable sales held flat on growth of our e-commerce business, our expanded Regis partnership at BSG and positive comp growth in our Sally International business.

At constant currency, global e-commerce sales increased 30% to $90 million, representing 9.3% of total net sales. E-commerce is beginning to comprise a larger percentage of the business, as we scale our digital capabilities and utilize our new tools and resources to drive customer engagement.

Looking at gross profit. We maintained adjusted gross margins north of 50%. Compared to a year ago, fourth quarter adjusted gross margin decreased 60 basis points as higher product margin from pricing leverage at Sally Beauty was more than offset by a sales mix shift between Sally Beauty and BSG and we incurred higher distribution and freight costs in both segments.

Moving to operating expense. SG&A totaled $398 million. That's up about $11 million versus a year ago and can primarily be traced to increased labor costs, partially offset by lower bonus expense. In fiscal 2023, we expect our distribution center consolidation and store optimization program to serve as a partial offset to wage inflation.

As we announced today, we expect our distribution center consolidation and store optimization acceleration plan to generate expense savings of approximately $50 million in fiscal 2023. The sales recapture rate is expected to be strong and similar to our pilots. However, the store closures will result in some reduction in overall sales. The net result is we expect a positive impact to adjusted operating income of approximately $10 million. In the first quarter of fiscal 2023, we expect to incur an additional charge of approximately $20 million to close out these optimization efforts.

Turning now to earnings. We maintained our healthy gross margin profile and continue to deliver good cost control with prudent spending focused on investments for strategic priorities. Fourth quarter adjusted operating margin was 8.7%. Adjusted EBITDA came in at $112 million, and adjusted diluted EPS was $0.50. For the full year, on an adjusted basis, we delivered operating margin of 10.3%, EBITDA of more than $500 million and diluted EPS of $2.16.

Looking at segment results. Sally Beauty's net sales declined 5.4%, primarily reflecting inflationary pressures that impacted our lower-income Sally customer. Additionally, foreign currency headwinds had an unfavorable impact of 270 basis points, and we had 110 fewer stores in operations versus a year ago.

Comparable sales were down 1% and with the sales decline concentrated in the U.S. and Canada, which had a negative comp of 2% and accounted for 80% of segment net sales in Q4. At constant currency, segment e-commerce sales increased 20% to $33 million or 6% of segment net sales for the quarter.

For the global Sally segment, color was up 2% and care declined 7%. At Sally U.S. and Canada, color increased by 6%, with great coverage of 9%, while (inaudible) were up 1% and comprised 27% of the total color categories. While total transactions and units per transaction were down at Sally U.S. and Canada, average unit retail and average ticket increased. These dynamics have been fairly consistent for the past 3 quarters as our Sally customers stretch their visits and minimize basket adds in response to the inflationary environment.

Adjusted gross margin at Sally expanded 60 basis points to 58.3%, reflecting solid product margins, driven primarily by pricing leverage, partially offset by higher distribution and freight cost. Segment operating margin came in at 14.5%.

We delivered growth in the BSG segment with net sales up 1% and comparable sales increasing 1.5%. While we continue to be impacted by supply chain disruptions, we did see some improvement in Q4 and expect the situation to normalize as we move through fiscal 2023. We estimate that the sales loss from raw material shortages was approximately $5 million or 120 basis points of impact on net sales growth.

Additionally, at constant currency, segment e-commerce sales increased 37% to $57 million or 13.9% of segment net sales for the quarter. The color category was down 5% in the quarter, driven mainly by stylists reducing their back-stock inventory as some of their customers are stretching time between coloring services and by raw material shortages. While hair care increased 9% versus a year ago due to our expanded Regis partnership and better in-stock levels of key brands.

Adjusted gross margin at BSG decreased 180 basis points to 38.9%, primarily driven by lower product margin from a sales mix shift between stores and full service and higher distribution and freight costs. Segment operating margins came in at 8%.

Moving to the balance sheet and cash flow. We ended the year with $71 million of cash and cash equivalents and $69 million outstanding under our asset-based revolving line of credit. Our net debt leverage ratio stood at 2.2x. We brought down inventories to $936 million at year-end after peaking just north of $1 billion in Q3. Excluding the Q4 noncash write-down of $19 million of goods related to the distribution center consolidation and acceleration of our store optimization program, year-end inventories would have been about $955 million.

As supply chain disruptions began to ease, we're pleased to return to more normalized levels entering the new fiscal year. We generated free cash flow of $75 million in the fourth quarter and $57 million for the full year. We anticipate that our working capital requirements will revert to historical patterns as we progress through fiscal 2023 and expect to return to free cash flow generation in the range of $175 million to $200 million, with the majority of that coming in the back half of the fiscal year.

From a capital allocation perspective, we will continue to prioritize investments for growth and returning value to shareholders.

Turning now to guidance. It is clear that the external environment will remain challenging for the foreseeable future, most notably inflationary pressure that is affecting consumer spending and also driving increased labor costs. We remain encouraged by our new strategic initiatives and the growth drivers we have just discussed, and they are reflected in our fiscal 2023 outlook.

For the full year, we expect the following: comparable sales, notwithstanding a notable change in consumer behavior, are expected to increase by low-single digits compared to the prior year, driven by growth in key categories, sales transfer from store closures, our expanded Regis distribution and new strategic initiatives.

Net sales are expected to decline by low-single digits compared to the prior year. This reflects approximately 150 to 200 basis points of net unfavorable impact of store closures and expected sales recapture rates from our optimization effort, as well as approximately 150 basis points of anticipated impact from FX headwinds.

At the end of fiscal 2023, store count is expected to be down in the range of 6% to 7% compared to the end of fiscal 2022, through our store optimization plan, net of a small number of new store openings.

Gross margin is expected to remain above 50% and adjusted operating margin is expected to be 9%, at the midpoint of our guidance range. This is inclusive of our investment in store labor as we lean into elevating the expertise of our associates to drive our growth in the coming years. In addition, we expect to partially offset this labor investment by the $10 million benefit to operating earnings from our distribution center consolidation and store optimization plan.

While the uncertain macro backdrop is impacting our outlook for fiscal 2023, our teams are energized by the opportunities ahead and the growth plans that is outlined in current remarks. We are focusing on our new strategic initiatives and laying the groundwork to drive solid top line growth, build scale and further optimize our operating model to return to double-digit operating margins in fiscal 2024 and beyond.

We appreciate your time this morning. Now I'll ask the operator to open the call for Q&A.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of Rupesh Parikh, Oppenheimer.

Rupesh Dhinoj Parikh - *Oppenheimer & Co. Inc., Research Division - MD & Senior Analyst*

So I just wanted to go back to your longer-term sales targets for low- to mid-single-digit growth. Just curious, what are the key drivers to get there? Your confidence in being able to get to that level, just given some of the challenges in recent years? How store closures impact that longer-term sales growth? And if there's any timing in terms of when you think you'll be able to start delivering those targets?

Denise A. Paulonis - *Sally Beauty Holdings, Inc. - President, CEO & Director*

Sure. Thanks for the question, Rupesh. I'll start, it's Denise and Marlo can jump in as we need to here. I think in the very near term, we really space out how we think about these growth initiatives, and let me walk you a little bit through year-by-year what we see coming online, which influences the numbers.

When we're looking to 2023 and our priority is to get that low single -- single-digit comp number, right, key sources of growth there, we'll be leaning in on owned brands. That's Ion, that's Strawberry Leopard, that's bondbar. Rebuilding our nail category. We have a new nail wall set in both Sally and BSG stores and seeing good response there, nearly doubling the Regis business that we have, which really leverages the e-commerce platform we've built.

And then when we think about the store optimization, DC consolidation pieces, there are a great help to operating performance for about $10 million this year. But we did talk about the fact that, that store optimization, it works, expecting about a 40% recapture rate. And so with that recapture rate, there will be some pressure on the top line that comes through. But of course, that recapture delivers comp sales.

As we work through 2024 into 2025, we see the new initiatives start to come online. So later in '23, our stylist platform of SalonHQ, we expect to be ramping up. It's only in a test-to-market right now. We really want to work out all (inaudible) to be sure it's just to rate before we fully roll that.

And then our virtual color expert experience will roll out online later in the year as well, and we think that, that will start to give that benefit and scale as we come through.

And then when we get into 2024 -- further into 2024, it's when those things really start to ramp up. So further owned brand growth, new innovation from our vendor partners, continued tailwinds from the virtual color expert and the e-commerce piece. And then when we talked about and of course, the stylist platform.

Then when we talk about Studio by Sally, it's a bit longer term. So we're going to pilot in fiscal '23 with a small number of stores. We're going to look to those results and with positive results, we'd add some stores in '24, but we really believe it's going to be beyond '24 where we can get to perhaps up to 100 locations in the U.S.

So when we think about the sales cadence. This year, we're on to run positive comp sales. As we turn into next year after we eliminate the drag that comes from the store consolidation work right now, net sales will turn positive and as we work our way through '24 and '25, that's when we're really targeting that low- to mid-single-digit total sales trajectory.

Rupesh Dhinoj Parikh - *Oppenheimer & Co. Inc., Research Division - MD & Senior Analyst*

Great. Great. And then maybe just one follow-up question, maybe for Marlo. As we look at this year, your guidance, anything you can share just from a quarterly cadence perspective?

Marlo Cormier - *Sally Beauty Holdings, Inc. - Senior VP & CFO*

Yes. So from a quarterly cadence perspective, a lot of it is about what happened this past year in 2022. As you recall, we started Q1 very strong plus 6% comp and then as we were going into the holiday season, we were up against a COVID spike. And then as we came out of that, that's about when we saw the pivot to the inflationary -- the intense inflationary pressure that really started to change customer behavior and that pretty much held on throughout the rest of the year.

So when you're looking at it from a year-over-year basis and then also taking into consideration what's happening this year with the store closures, which is happening mainly in December for the bulk of the closures. But the Q1 comp and net sales will be challenged and then we'll start to see improvement as we go through the rest of the year.

Just one more on that. If you're looking at net sales, also keep in mind FX. We had some FX movements towards the end of this year that we won't lap until we get to Q4 this year.

Operator

Our next question comes from the line of Oliver Chen, Cowen.

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

Regarding the store closure program, what's assumed for transfers and any color on how we should think about the margin impact there? Also, on the BSG division, would love further details on the gross margin and some headwinds there and what you're assuming going forward? That would be helpful as well.

And then finally, the holiday period is always somewhat promotional. So what are you seeing in the environment and how you're prepared to compete and the topic of inflation, this is very pervasive across the consumer?

Denise A. Paulonis - *Sally Beauty Holdings, Inc. - President, CEO & Director*

Oliver, there's a lot there for us to unpack. And let's work through store closures and promotion, and then we might need you to clarify the BSG question. I'm not sure exactly what you were after there.

But on the store closure front, it's about 350 stores. It is primarily U.S. Sally stores. The vast majority of those will close in December of this year. The work that we've done and the pilot that we've been running over the course of the last year delivered a good sales recapture rates actually above the industry average. And for the stores that we're going to be closing, we're assuming about a 40% sales recapture rate.

I think the important point to note in the stores that we're closing is, the stores we're closing are all EBITDA -- 4-wall EBITDA positive. And so the benefit of the closure really comes from the ability to transfer those sales and then get some efficiencies within the labor and rent types of lines coming through. So net-net, about 40% sales recapture is what we're looking for, and that will really start to play into as we get from December into January because of the timing of the closures.

On the promotional front, I think you're very right. Customers and stylists are both looking for deals. When we think about what they're doing out there, they're being pretty selective. They're looking around being choiceful in the decisions that they're making. That said, what we've really been focusing on is what most resonates with our stylists. And what we've done is more about changing our tactics versus investing more.

So what we've been doing more is going to types of promotions like bundle offers. But there is a discount involved, but it actually ends up driving more unit sales. And we actually believe it's getting us more share of wallet. When people are buying that quantity, it's less that they might buy somewhere else coming through.

But the absolute level of promotional investment has remained relatively steady. I would also say we've seen very good support from a number of our vendor partners where they are leaning in to help fund some more enticing promotions for their specific products as they want to do that through the year. But I would argue it's not been overly elevated. It's more of a mix of the tactics that we're using from what they might have been before that might have been very single unit focused.

And then the third question on BSG.

Marlo Cormier - *Sally Beauty Holdings, Inc. - Senior VP & CFO*

I think you're referring to the BSG gross margins being down. So just to talk that through a bit, what we're seeing there is really a mix shift. When you look at it at individualized basis or SKU level, the merchandising margins are strong. But what we're seeing is a mix away from stores and into full service. And a lot of that is being driven through the expansion of our Regis business. And of course, we've got a higher distribution and freight costs. But when we look forward, as a consolidated business, there's going to be puts and takes. And we see for the combined business, continued strong and healthy margins above 50% going forward.

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

Very helpful. The Regis partnership sounds encouraging. Just if you could give us thoughts on why that's the right partner? That would be helpful.

And lastly, on digital, sometimes store closures can have unintended consequences, given that they can be great recruitment opportunities for customer acquisition online as well. Like have you thought through that? And any thinking you have around that? I'm sure you tested it.

Denise A. Paulonis - *Sally Beauty Holdings, Inc. - President, CEO & Director*

Sure. So on the Regis front, I think the real benefit in the Regis business is when we think about how many people there are out there who use Regis franchise salon as their main destination. 5,000-plus salons out there in the marketplace. It's a huge reach, and they're not the only chain that is out there.

And so when we look at the penetration we've got, you've got people early in their careers as stylists. You've got customers through all walks of life who we can introduce to product that can stay with them for the long term. So whether those stylists stay with Regis or they choose to go out on their own or join another salon, they will have been nicely ingrained with all the types of products that we can offer them, and we'll be building that relationship with them.

So beyond the day-to-day sales today, the longer-term view of us becoming a more important part of our stylists decision-making is really a strong point that we're going after, and it really fits nicely into the ideas of the stylist's ecosystem that we want to build to help them grow their businesses and help them be more profitable.

So all in all, a good business to be getting into. It does primarily -- it comes at a slightly lower margin because it's more managed like our full-service business than it is our store business. But when you think about the longevity of those stylists, it's really something that we think will serve us well longer term.

In the store closures, we've spent a lot of time thinking about this. I think it's actually been a number of investors and analysts that have actually asked us why we weren't moving faster. And I think when we reflect on it, we really wanted to take the full year start to understand how those customers will behave, how they would transfer their sales, would we have any change in trajectory of new customers coming into the business.

All in all, at the 100 stores that we did the test on, we felt very good about across all of those metrics. And the piece that we're most focused on is this is clearly a larger tranche of stores to go close is that early communication to our customers about where their next closest Sally's store might be, about how they can shop online, how they can still get both BOPUS and 2-hour delivery potential, it would just be out of a different store.

So reinforcing to them by no means are we going away. We just want to transfer them to a different location or a slightly different experience. And I think the piece that when we think about how this penetration is and things like 2-hour delivery into our business model, in fact, there's really no change in behavior for the end customer in that portion of the business.

So this is definitely a larger tranche, right? We go into it understanding. We might see a few surprises or a few puts and takes that will be anticipated and really realized in how we're thinking about the numbers, but believe that the benefit we get over the longer term, we are set up and have a good chance here of seeing the results that we are believing that we will see.

Operator

Our next question comes from the line of Ashley Helgans, Jefferies.

Ashley Elizabeth Helgans - *Jefferies LLC, Research Division - Equity Analyst*

I know you touched on it briefly, but any more details you can provide us on the trends in the salon channels? And then as consumer spend has started to soften, we're curious if you're seeing a pickup in things like the DIY hair color? And then last, just any color you can give us on the recapture rate?

Denise A. Paulonis - *Sally Beauty Holdings, Inc. - President, CEO & Director*

Sure. So let's start with the salon channels and then work our way through. So in salon channels, we put in our prepared remarks some commentary about just what we're seeing in general in the business. And we think salon had a pretty good back-to-school into the fall season. The business has softened a little bit following that, more in line with what it had been mid-summer. But in general, our stylists are still stocking about having good business, but seeing their customers stretch a little bit more between services and certainly, the idea of stocking up on inventory, everyone is being very cash conscious about where else they need to use their cash in their own personal lives. So those trends haven't really changed.

If we look back to what they are trying to figure out, they are trying to figure out how to be even more efficient with their businesses, to be able to make more money and turn their chairs more quickly. So we have seen an uptick in interest and engagement around express color. And what that can do for their business in terms of being able to serve their clients a little bit more expediently. And we've also seen them shopping and looking for where those promotions make sense to them leaning in a little bit more in terms of units that they might have bought versus historical where maybe they weren't as focused on watching for those opportunities.

So net-net, as we said, we haven't dramatically increased our promotional intensity and where we are offering promotions. Our vendors have been a great support in building both of our businesses together and doing that. So we're anticipating, as we go through the coming year at that same level of a slight bit of sluggishness is going to be what continues to persist in the salons, and we'll be watching quite closely for any trends and changes that might come about there.

On the DIY front and about customers' coloring, I think the most notable trend that we saw over the past quarter is we saw a 9% increase in our gray coverage products and gray coverage sales. We saw about a 1% increase in dividend.

So to me, as I look at that, we really are seeing a customer who's saying, I'm going to do my own hair a little bit more. I'm willing to be buying and knowing that that's going to be the path that I'm on. We felt very encouraged about that great coverage number, while visits still hung in as we've seen them at about 27% penetration. So I think that I'd say, interesting trend shift towards the gray coverage, but perhaps not unexpected when you think about what's happening in the macro environment.

And then I think your third question was on recapture rate. And I'll let Marlo talk a little bit about the details of what was built up into there and what we believe go forward. So, Marlo?

Marlo Cormier - *Sally Beauty Holdings, Inc. - Senior VP & CFO*

Yes. From a recapture rate, as you know, we've spent a lot of time studying this built a very sophisticated model that proved out with results even better than what we had going in assumption.

So the one thing to keep in mind is we have data on 75% of our Sally customers, our Sally's sales are coming from customers we know; 100% on BSG. So we can track them very closely and really give some robust insights as to what's happening there and if you combine that with our CRM capabilities to be able to personalize messaging, talk to them, market to them, make sure they understand where they can go when we close the stores.

So we feel pretty good about -- well, first of all, the 40% that we're quoting now is all coming out of our tested pilot and from a go-forward basis in terms of being able to continue to deliver that. Feel pretty good about our capabilities to do that.

Denise A. Paulonis - *Sally Beauty Holdings, Inc. - President, CEO & Director*

And I'd just add one point. I think one of the most interesting observations through the pilot period was, we originally had a model that assumed the customer would only potentially think about 1 additional store or maybe 2 additional stores that might be in their sphere of where they would go instead of their current store. We actually thought to be a much wider radius. We would see most of our stores that we closed, the sales were transferred to 4 or 5 different stores. So back to that idea of the ability of that recapture to be fairly sticky, and that was actually a very good indicator for us.

Operator

(Operator Instructions) Our next question comes from the line of Olivia Tong, Raymond James.

Olivia Tong Cheang - *Raymond James & Associates, Inc., Research Division - MD & Research Analyst*

I wanted to talk a little bit about the margin targets. Your expectation for fiscal '23 for 8.5% to 9.5% versus a long-term target for low double digits. Can you talk about how much of this is just a function of some of the macro pressures that are out there as opposed to the desire to obviously increase investment in some of the strategic initiatives and then just the timing that you expect sort of a glide path to get to the low double-digit target over time?

Denise A. Paulonis - *Sally Beauty Holdings, Inc. - President, CEO & Director*

Yes. So how about -- I'll let Marlo start with kind of the current state and where we are, and then we will follow up with the long-term trajectory.

Marlo Cormier - *Sally Beauty Holdings, Inc. - Senior VP & CFO*

Yes. So just as we're looking forward to 2023, we really see that as a transitory year. The reality is we've been operating for the past few years in a very challenging consumer environment. But through that all, we've been pleased to be able to deliver the healthy gross margins upwards in more than 50%, really where we're seeing the pressures on expenses.

We are planning for 2023 higher expected and mainly driven through the wage pressures that we've seen. And just to point out there, it's a conscious investment in wages. We are not talking about added headcount, but really just looking at the labor market, especially for the retail workers, it's been challenging over the past couple of years. And really where we see our differentiator is in our associates, the expertise of our associates and in our stores to be able to really help our customers understand and give confidence to take the leap and do the Do-It-Yourself color. So we think it's an important element of our growth driver going forward, and we believe it's a very important investment for us to make.

So when we're looking at next year, it's really about investing in our associates as well as refilling our values, right, we need to refill our bonus pool. So -- but beyond optimization efforts, we are continuing to look for more efficiencies.

I'll let Denise touch a little bit more on the longer term, but certainly are keeping eye on cost control.

Denise A. Paulonis - *Sally Beauty Holdings, Inc. - President, CEO & Director*

Yes. And then when I think about the longer term, what we're focused on this year, as Marlo said, was making sure that we're set up for our initiatives to be as productive as they can and reinvesting wages into the organization. But as we turn into 2024, the opportunity with owned brands, it is quite significant and will be an important contributor to gross margin expansion in 2024 and beyond.

We talked about on the call moving from a 33% owned brand penetration in the Sally business, north of close to 50% over the next 4 to 5 years. That comes with anywhere from 1,000 to 1,500 basis points of margin difference versus branded product. So that really will pick up more in 2024 as we continue our work in that space.

When we think about the Fuel for Growth initiative that I commented on at the end of the call and one of our third pillars about becoming more efficient in what we do. This is not about flashing short-term costs. This is about actually thinking very differently about the way we work, continuing to look at network optimization, continuing to look at sourcing, looking at opportunities around outsourcing, looking at the structure of things like our loyalty programs. And we think that, that's also going to start to play out towards the end of 2024 and into 2025 with some improvements on the margin front as well.

And then I think [underscores] all of that, that I know you guys know very well that as we move past the net sales decline of this year that is happening with the store closures impacting us. And into 2024, start to see net sales turn positive and continue on that trajectory, we'll get some natural SG&A leverage that will come through in the P&L as well.

So a combination of cost savings longer term, bigger picture cost savings efficiency initiatives, owned brands and then sales trajectory turning positive, really add us up to that low double-digit operating margin that we are pushing towards.

Olivia Tong Cheang - *Raymond James & Associates, Inc., Research Division - MD & Research Analyst*

That's super helpful. Maybe if I could follow up just in terms of the health of the hair care category, it does feel like there's a fair bit of interest and quite a bit of activity in the category to the extent that the number of new entries can be used as the guide, and obviously, you have your own bondbar launch. So at home color bonding, your own brands.

So can you talk a little bit about the balance between driving growth for external brands versus your own brands? And perhaps what drives customers in, thinking about the profit profile, obviously, relative to -- between your brands and externals? Just a little bit of color there would be super helpful.

Denise A. Paulonis - *Sally Beauty Holdings, Inc. - President, CEO & Director*

Absolutely. I mean, first and foremost, we greatly value our vendor partners, whether those be entrepreneurs that we bring through the first time through some of our support programs for newer innovators or whether that's with some of our long-standing vendor partners.

So our objective is to keep a very healthy mix between owned brand and vendor products in our Sally businesses go forward. So when we think about that, the owned brands and what we're able to do is bring to bear products that are a great price point, great efficacy that resonate with our customers coming into the stores, we see that, we feel that, we want to grow that.

A lot of new innovation, a lot of very -- maybe perhaps more technical products, things tied to textured hair and other elements, our vendor partners continue to bring great innovation, they do a great job communicating with consumers, and we want to support them as well. So we actually think that both should be able to grow and be a good balance go forward.

And then on our BSG business, we have great vendor relationships, a lot of exclusive relationships. And the focus of our BHG business is continuing to support our vendor partners. And I just want to be crystal clear about that front. When we think about anything that is our owned brand within BSG, you're only talking about bowls and brushes, the very -- the basics. We are not talking about color and care in that space. That is a great partnership that we have with our external vendors.

Operator

And at this time, there are no other questions in queue.

Denise A. Paulonis - *Sally Beauty Holdings, Inc. - President, CEO & Director*

Great. Well, thank you all for joining us today. We are very excited about pursuing our new strategic initiatives to drive growth into the business. Our team members, our associates out in the field are our most valued asset and more excited about bringing these strategic initiatives to them and growing our businesses together.

So I wish all of you a happy holiday season, and we'll talk again in January.

Operator

And ladies and gentlemen, this conference will be available for replay in the company's press release. That concludes our conference today. Thank you for your participation and for using AT&T conferencing service. You may now disconnect.
