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PRESENTATION

Operator

Good morning, everyone, and welcome to the Sally Beauty Holdings Conference Call to discuss the company's second quarter fiscal 2024 results. (Operator Instructions)

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.

Jeff Harkins - *Sally Beauty Holdings Inc - Vice President of Investor Relations and Treasurer*

Thank you. Good morning, everyone, and thank you 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'd like to remind everyone 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 Paulonis - *Sally Beauty Holdings Inc - President, Chief Executive Officer, Director*

Thank you, Jeff, and good morning, everyone. Our teams navigated dynamic sales trends during the second quarter while continuing to execute against our strategic priorities and deliver engaging experiences for our customers.

Net sales came in at the lower end of our expectations at $908 million, down 1% and comparable sales declined 1.5%. Our sales results reflect notable strength and momentum in our BSG segment, offset by softer sales performance at Sally amidst weather challenges in January and ongoing customer frugality. Adjusted gross margin was 51%, which came in lower than we anticipated due to higher promotional penetration as well as an unfavorable sales mix shift out of our highest margin Sally US business.

We continue to execute solid cost controls with adjusted SG&A of 1% versus last year, in line with our expectations. The business generated solid cash flow from operations of $37 million, allowing us to return value to shareholders via continued share repurchase activity. We also strengthened the balance sheet with the refinancing of our 2025 senior unsecured notes. More on that later from Marlo.

Let's take a look at performance by segment. At BSG, Q2 comparable sales were up 2%, a bit ahead of our expectations. This represents the second consecutive quarter of positive comps and reflects continuing improvement in salon demand trends paired with a robust flow of product innovation. Comparable transactions increased 2% and average ticket value was flat to the prior year.

We are pleased to see momentum returning to BSG with color and care, both in positive territory. It is clear that our stylists are seeking value, which was reflected in the strength of our quarterly customer appreciation sales. In our Sally segment, sales were at the low end of our expectations for the quarter as our customers continue to exhibit cautious shopping behavior. Q2 comparable sales declined 4% with comparable transactions down 5% and average ticket value up 1%.

Looking at the cadence of the quarter. As we shared on our Q1 call, we started the quarter with about $10 million of weather impact to January, which put outsized pressure on transactions for the quarter. Subsequently, Sally returned to a more normalized traffic and transaction trend line at the end of the month and into early February. Although transactions continued to improve throughout the quarter, our Sally US and Canada customers demonstrated price sensitivity, leaning into promotions more heavily than we've seen in recent quarters, negatively impacting average unit retail. While promo offerings were approximately flat year over year, we believe the macro backdrop had a heightened impact on the increased take rate of promotional items by our lower income consumers who are seeking value in response to the inflationary environment, including elevated credit card and buy now pay later balances with higher interest rates.

As we have seen both our stylists and our retail customers increased their promotional purchases in recent months, we are partnering with our vendors and we are adjusting our tactics, including looking at the design, depth, and duration of our offers. We're taking these actions while remaining intensely focused on retaining and growing loyalty among our shoppers by leveraging our strategic initiatives from innovation to marketplaces and beyond. To that end, our ongoing focus on our core strategic initiatives, enhancing our customer centricity, growing our high margin owned brands and amplifying innovation and increasing the efficiency of our operations is bearing fruit.

In Q2, product innovation, territory expansion, and new services contributed over 250 basis points to our comparable sales results, and we remain on track to achieve 200 to 300 basis points of contribution from these initiatives for the full year. There are a number of highlights from the quarter and actions planned for the second half.

Starting with product innovation. This continues to be an important driver of growth and customer engagement in both our BSG and Sally segment. At BSG, we recently secured substantial territory expansion with two important brands. We added key geographies with Moroccan Oil, and we're now selling Amika across all stores and e-com in the US and Canada.

We also added two new compelling brands to our stable, Briogeo and epres, both of which have earned a cult following fueled by innovation. Considered a pioneer in scalp care, Briogeo brings a line of clean, plant-based products to approximately 500 CosmoProf locations nationwide. Founded by the scientist behind Olaplex, epres brings a new line of highly innovative bonding products to BSG, providing another efficacious tool to support our stylists as they serve their clients. From a trend perspective, blonding, glossing, and express coloring remains strong as well as conscious beauty and textured hair products.

In our Sally Beauty segment, innovation is also paramount across both owned and third-party brands. Major trends include dark vivids, toners with built-in color and sustainable products which we are beginning to telegraph under a new Mindful banner.

In Q2, owned brand sales penetration for the global Sally Beauty segment was 34%, up 60 basis points over the prior year. During the second half of the year, we have additional innovation forthcoming in skin care and men's grooming.

Our latest marketing campaign, rooted in success demonstrates our focus on creating branding moments that go beyond our Sally Beauty banner. Launched in connection with Black History Month, the campaign celebrates entrepreneurism and creativity. We'll be building on this early success and the momentum we're seeing during other key moments throughout the year, including Pride Month and Hispanic Heritage month.

Turning now to customer centricity. Let me start with a few updates on our new concepts and services. Starting with Licensed Colorist OnDemand, this service is available nationwide online and is now linked to all Sally US stores. Momentum continues to build. We saw over 3,000 consultations per week throughout Q2 with growth month over month throughout the quarter. In Q2, 40% of customers who engaged in the service were new to Sally. While it remains early days to understand the long-term benefit of the service, I'd note that for existing customers, we are seeing an uptick in visit frequency in the months following their consultation. Additionally, average ticket value increased to $35 from $33 in Q1.

We're also seeing strong results from our marketplace initiatives with both Amazon and Walmart performing well. Additionally, we are up and running with DoorDash as of March, and we'll launch Instacart in Q3. We view our marketplaces as an important omnichannel offering for our customers, allowing us to meet our existing customers where they are while also building awareness with new consumers.

Looking at Studio by Sally, we are generating key insights around format, store layout, services and education, all of which is informing new ways to engage the customer. Although we're seeing pockets of strength, results are mixed, and we need more time to evaluate our KPIs before we take definitive steps to expand the initiative. More to come on this in the quarters ahead.

Moving now to Happy Beauty Co. As we test the concept and read results, we're pleased with the performance of our initial 10 pilot stores. Traffic is continuing to build as our teams implement creative marketing strategies around social media, grassroots initiative and DIY events in stores. Gifting continues to be a strong driver, and we've been seeing that in the lead up to Mother's Day this weekend. Average ticket and units per transaction are tracking strongly, and we recently started testing a luxury closeout section on items above $10. Early uptake there is positive.

Based on the strength of our initial Happy Beauty rollout, we plan to open up to an additional 10 pilot stores prior to Thanksgiving in the Dallas and Phoenix market. These additional stores will further test the demographic and co-tenancy profiles that are showing strength. As part of the expanded pilot, we will also test mall locations, which we believe could be well suited for the concept given their inherent traffic and exposure to demographic profiles that are resonating in our pilot to date. Longer term, we have conviction there will be an opportunity for more accelerated expansion in fiscal 2025 and beyond.

Profitability remains a priority across the organization, and our teams are coalesced around our Fuel for Growth initiatives. We’re on track to capture previously announced pre-tax benefits of $20 million in fiscal 2024. And as shared on our last earnings call, we have identified another tranche of potential pre-tax benefit totaling approximately $50 million in fiscal 2025 with cumulative run rate benefits in fiscal 2026, approaching $120 million.

In closing, this was a quarter with a number of learnings to build upon as we look to the future. We’re pleased to see momentum return to BSG with comparable sales in positive territory for two consecutive quarters. We believe the path to continued growth there will be driven by a combination of innovation distribution expansion and strengthening forward demand. On the Sally side, we anticipate that macro pressures will persist in the near term and remain sharply focused on controlling the controllables, which includes enhancing customer centricity through our marketplaces and Licensed Colorist OnDemand initiative.

As we remain focused on delivering engaging customer experiences and executing our strategic initiatives, we are responding to the continued shift in customer dynamics with thoughtful adjustments to our promotional cadence and maintaining strict cost discipline. We greatly appreciate the ongoing support of our shareholders, and we remain committed to serving our customers and driving long-term profitable growth and value creation for all of our stakeholders.

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

Marlo Cormier - *Sally Beauty Holdings Inc - Chief Financial Officer, Senior Vice President*

Thank you, Denise, and good morning, everyone. Our second quarter was a dynamic one. And while we saw points of strength, our profit results came in below our expectations. Of note, sales came in at the lower end of our range, while gross margin relative to our internal expectations was our pressure point, and SG&A was in line. Let me unpack the major drivers of the quarter. First, starting with sales. We were pleased to see BSG deliver slightly ahead of expectations with the second consecutive quarter of comparable sales growth.

Turning to Sally, sales came in at the low end of our expectations. We started the quarter with about $10 million of weather impact to January. Subsequently, Sally returned to a more normalized trend line at the end of the month and into early February. Although transactions continued to improve throughout the quarter, performance at Sally US and Canada was further impacted by a decline in average unit retail prices. As Denise pointed out, we saw customers increase their take rate on promotions, and we attribute this to the inflationary environment that continues to persist.

Turning to gross margin. Although gross margin came in above our 50% target range at 51%, this was lower than we anticipated, primarily driven by a higher take rate on promotions across both business segments as our customers sought value, combined with a lower mix of our higher-margin Sally US sales.

Now let me take you through the details. Second quarter consolidated net sales of $908 million declined 1.1%, while consolidated comparable sales declined 1.5%. Global e-commerce sales were $90 million and represented 10% of total net sales.

Looking at gross profit, we delivered solid gross margins, which came in at 51% and was flat to the prior year. Excluding last year's true-up of the non-cash inventory write-down related to the distribution center consolidation and store optimization plan that we executed last year, adjusted gross margin was 51%, an increase of 30 basis points compared to 50.7% in the prior year. Year-over-year increase reflects lower distribution and freight costs resulting from supply chain efficiencies, partially offset by a lower mix of our higher-margin Sally US sales, which I mentioned earlier.

Second quarter adjusted SG&A was up $5 million versus prior year to $395 million. Year-over-year increase primarily reflects increased labor costs as well as higher rent expense, partially offset by lower accrued bonus expense.

For the full year, we expect adjusted SG&A dollars to be up modestly versus fiscal 2023. This primarily reflects increased labor costs as well as investments in upper funnel marketing and other expenses related to our strategic growth initiatives, partially offset by the favorable impact of our fuel for growth initiatives. As a reminder, we expect to realize $20 million of pre-tax benefits to gross margin and SG&A that is weighted more heavily towards the second half of fiscal 2024. For perspective, approximately 75% of the benefits will be realized in SG&A.

We expect to incur pre-tax cash charges associated with the Fuel for Growth program in the range of $25 million to $30 million in the current fiscal year, including $14 million that has been realized year-to-date. Additionally, we are working with external partners on additional opportunities and expect to approach $120 million in cumulative run rate benefits by the end of fiscal 2026.

Turning now to earnings. Adjusted operating margin came in at 7.6%. Adjusted EBITDA margin was 11% and adjusted diluted earnings per share was $0.35. Moving to segment results. Sally Beauty comparable sales declined 4%, while net sales were down 3%, reflecting the factors I outlined earlier, including the January weather impact and ongoing frugality against the macro backdrop. At constant currency, Sally e-commerce sales were $34 million and represented 7% of segment net sales for the quarter.

For the Global Sally Beauty segment, color was down 4% and care was up 1%. At Sally US and Canada, color was down 6% and care was down 1%. Of note in Q2, we generated 79% of our Sally US and Canada sales from our 16 million loyalty members. Gross margin in our Sally segment was 59.9%, up 10 basis points to last year, reflecting supply chain efficiencies, partially offset by last year's true-up of the non-cash inventory write-down related to the distribution center consolidation and store optimization plan.

Segment operating margin came in at 15%. Moving to the BSG segment, the combination of product innovation, expanded distribution, and strengthening salon demand trends drove strong performance in the quarter. Comparable sales and net sales were both up 2%. On a constant currency basis, BSG e-commerce sales were $56 million, representing 14% of segment net sales for the quarter. The color category was up 6% and care was up 3%. Gross margin at BSG increased 50 basis points to 39.4%, reflecting supply chain efficiencies, partially offset by lower product margin, which was driven mostly by higher take rate on promotions and brand mix. Segment operating margin was 10.9%.

Turning to the balance sheet and cash flow. We ended the second quarter with $97 million of cash and cash equivalents and $62 million outstanding under our asset-based revolving line of credit. Our net debt leverage ratio stood at 2.2 times. Importantly, during the quarter, we were able to take advantage of an opportunity to further optimize our balance sheet by issuing a new $600 million 8-year senior unsecured notes due 2032.

The net proceeds from the transaction in combination with existing cash and a modest draw under our asset-based revolving line of credit were used to refinance our $680 million 5.58% senior unsecured notes due 2025. A new senior unsecured note was issued with a coupon rate of 6.75%. The lower principal amount of the new note will help offset the majority of the interest expense from the higher coupon rate.

Quarter end inventory was up 1.6% to slightly over $1 billion, which is in line with our expectations and reflects a healthy overall position, including good in-stock levels. We generated positive cash flow from operations of $37 million allowing us to repurchase another 1.5 million shares at an aggregate cost of $20 million this quarter under our share repurchase plan.

Turning now to guidance. We are revising our full year operating margin outlook to reflect our second quarter results. We continue to expect full year net sales and comparable sales to be approximately flat. As a reminder, for the second half of the year, we expect BSG to benefit from continued momentum in new brand innovation and expanded distribution opportunities as well as easier compares from lapping of hair care headwinds from the last several quarters.

Additionally, at Sally, we expect incremental improvement on the top line to be driven by the ramp of Walmart marketplace as well as the addition of Instacart and DoorDash. The expansion of Licensed Colorist OnDemand and benefits in Europe from pricing and new brand launches. Given the dynamics from our second quarter results, we are sharpening our guidance on gross margin and now expect the full year gross margin rate to be in the range of 50.5% to 51%. We now expect adjusted operating margin of approximately 8.5%. Accordingly, we are also revising our operating cash flow outlook to approximately $240 million.

Lastly, capital expenditures are still planned to be approximately $100 million. Looking at the third quarter, we expect net sales and comparable sales to be in the range of down 1% to up 1%. We expect the gross margin rate in Q3 to be down slightly from Q2, driven in large part by the Q2 factors I discussed earlier around higher take rate on promotions and overall sales mix.

Third quarter adjusted SG&A dollars are expected to be approximately flat compared to our second quarter. Incremental investments in marketing will be offset by the savings from our Fuel for Growth program as expected. Additionally, we anticipate the third quarter adjusted operating margin will be in the range of 8% to 8.5%. Lastly, we expect investments in share repurchases in the third quarter to be approximately $10 million.

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) Korinne Wolfmeyer, Piper Sandler.

Unidentified Analyst

This is Sarah, on for Korinne. Could you talk a bit about what you're seeing in terms of stylist sentiment and if you're still finding stylists shopping closer to their need versus holding more inventory or if that's improving at all? And then with those recently added brands to BSG, how are you thinking about which brands you're reducing shelf space for to bring those new brands on.

Denise Paulonis - *Sally Beauty Holdings Inc - President, Chief Executive Officer, Director*

Yes. Happy to talk about that. We were extremely pleased to see continued stylist trends improve in Q2 and the strength of our BSG business overall, posting a positive comp. As you mentioned, both stylists' sentiment and our innovation and territory expansion were contributions to that.

So on the stylist's sentiment side, we're still seeing stylists to buy closer to need. With an exception this past quarter, where when there was a discounting opportunity like with our customer appreciation sale, we actually saw better stylist response to that than we had in the past, which suggests to us that search for value on the part of the stylist is the most predominant behavior right now. So certainly not stocking up for just preparing for the future, but we'll take advantage of those deals when those deals come forward. But we're pleased to hear from our stylists that their chairs are relatively busy and returning to a bit of a normal cadence.

If you think about it, the customers for those stylists are middle-to-higher income customers that are back on some of their core routines. When we look at BSG brands, the brands that we're bringing in and don't materially change the shelf space of any of our existing brands or existing products. You will trim a few SKUs from the assortment here and there, but no material changes in the reduction of an actual line.

But with Moroccan oil and Amika and Color Wow, clearly, those three entries were big ones for us. And then most recently, Briogeo and epres are nice additions, but they are limited SKU counts and can fit into our store assortment nicely.

Unidentified Analyst

Very helpful. Thank you.

Operator

Oliver Chen, Cowen.

Oliver Chen - *Cowen and Company, LLC - Analyst*

Would love your color on the difference in demand in terms of improving salons, but consumer spend at SBS being softer. And then also, how are you managing promotions as consumers remain cautious. What do you think about promotes in the back half? And then also as we think about the softer 2Q margins, at any other underlying driver for lower operating income margin guidance while you're reiterating the top line would be helpful as well. Thank you.

Denise Paulonis - *Sally Beauty Holdings Inc - President, Chief Executive Officer, Director*

Great. I'll cover, Oliver, on both demand and promotions and then pass it to Marlo to talk a little bit more about margins and guidance. When we think about demand, we're really seeing a bifurcation of two different consumer populations. What we're seeing with stylists who predominantly serve a middle-to-higher income customer is a return of regular, more normalized services and cadence come through. And we're seeing that with both strength in color and care coming through our sales portfolio.

I think when you contrast that with the lower income consumer, that's a more typical Sally consumer, is they're feeling more pressure, right? We see it as people come through and are selective in their baskets fueling the just general price inflation, food inflation, not going down in the way people would have hoped.

And then your Buy Now Pay Later balances, credit card balances starting to make people make a few more choices. The good news is relatively resilient in what we believe is we maintain unit share in color in the category, but the category itself was pressured. So we're expecting that some of that consumer pressure on the Sally side will persist. But working to navigate through it and still provide good value to our customers, but notably focusing on experiences like Licensed Colorist OnDemand in our marketplaces that provide reason beyond a deal to be shopping with us and having an experience with Sally.

And to that end, you asked about promotions. It was a quarter where we saw that take rate on promotions on both the pro and the retail side increase. So the nature of everyone searching for an extra layer of value certainly came through. As we watch that happened through the quarter, we quickly started to mobilize the analytics on where we could shift to the design of some promotion the absolute depth of promotion, the duration of promotion.

And you'll see some of those changes come through as we work through the second half of the year. We're really balancing a depth of understanding of how shoppers are putting product in their basket to be able to maintain that share of wallet, while hopefully trimming a bit about AUR pressure that we saw just from that higher promo penetration. That is true on both the BSG and the Sally side in terms of the work we have going on. So we expect to see that trend to moderate a bit as we make these changes, but we're going to be very live with our choices to maintain that customer loyalty and share of wallet.

And I'll turn it over to Marlo to comment a bit on margins.

Marlo Cormier - *Sally Beauty Holdings Inc - Chief Financial Officer, Senior Vice President*

Yes, in terms of our margin update. Really, that was driven predominantly from the adjustments we made to our gross margins. Our gross margins for Q2 came in at 51%, very solid we had the benefits of our supply chain efficiencies. We did have some offset from the lower mix of the higher-margin Sally US business being a lower penetration. But overall, it was a bit lower than our expectations, not significantly, but modestly where we thought based on that performance, that it was prudent to take down our gross margin expectations for the remainder of the year.

So we're guiding to a 50.5% to 51% range, and that's what translated through to the lowering of the operating margin. That range is still historically high. It has a very strong margin. We're very pleased with that margin. But as we learn more about the shift in customer behavior and the adjustments we're making to our promotional cadence, we just thought it was prudent to make that adjustment.

Oliver Chen - *Cowen and Company, LLC - Analyst*

Okay. Very helpful. Just a follow-up. As you think about upper funnel investing in marketing, it sounds like a great idea. What do you think about how this may be different from prior? And then finally, on the comps and as we think about the back half, what are some underlying factors that give you confidence that they'll turn positive? Thanks so much, Denise and Marlo.

Denise Paulonis - *Sally Beauty Holdings Inc - President, Chief Executive Officer, Director*

Yes. So how about I take those in reverse order. So I think when we think about the second half of the year, there's two predominant sets of trends going on. When we look at BSG, we do think the continued momentum in the new brand innovation is real and will continue to benefit. We also see expanded distribution opportunities continuing and that will be there.

Underlying that, BSG is also lapping the hair care headwind we had from a big brand in early Q2. So that's going to lead to some easier compares in the second half of the year, so BSG continuing on a nice solid trajectory. And on the Sally side, as we turn to the second half of the year, we do see marketplaces, Licensed Colorist OnDemand, product innovation, own brands, all combined with CRM and some personalization activities as things that will provide a lift there as well.

So our strategic initiative's continuing to pay off, even though we'll have that undercurrent of a little bit more macro pressure. I think when we combine all of those with the fuel for growth activity and the savings that we'll have coming through in the second half of the year, we feel pretty confident about the guidance and the guidance update that we provided today.

When we look at marketing, if I go back to your first question, marketing is a very interesting space for us in how we both serve our existing customers and attract new customers. And some of the things we're trying to do are use upper funnel marketing to take people more to something like a Licensed Colorist OnDemand, right? So how can we use social media, how can we use performance marketing to direct people to an experience that will bring a new customer into Sally.

And when we think about that Licensed Colorist OnDemand and the results of having pushed that initiative this past quarter, which we saw 40% of the customers who participated in that were new to Sally. We've started to see a little bit of increase in frequency in the month after those customers experienced that.

So marketing really tailored to say what’s different about Sally and why Sally can make a difference to you is what we’re focused on as we’re headed towards the back half of the year. We also are pleased we’re about six months into having a new performance marketing agency supporting us and see that a lot of the work they’re doing to best target our efforts is going to pay off as well.

And I guess the last piece there is, we’re also purposefully doubling down on a bit of a test into nine of our markets where we think we have a share of wallet opportunity and understanding that if we put a little bit more fuel behind communications and messages in those markets. What can we do to see that push the needle a little bit more and hopefully convert a few more customers and drive a bit more frequency. So a number of pieces and parts there, but really trying to stay true to what’s unique about Sally and pushing experiences, product offering, expertise in those communications.

Oliver Chen - *Cowen and Company, LLC - Analyst*

Thanks very much. Appreciate it.

Operator

Olivia Tong, Raymond James.

Olivia Tong - *Raymond James & Associates, Inc. - Analyst*

A few questions here. First, on the Sally Beauty Stores, what did you see as you exited the quarter? Maybe talk through some of the initiatives to spur foot traffic? On the BSG side, can you help us understand how much of the territory expansion added to sales and whether there's any pipeline fill doesn't repeat.

And then just last question is on operating margin, a point of clarification. I understand the margin guide change as a result of the mix shift that impacted Q2 and likely impact the second half, but are you adjusting second half expectations for margins by segment? And if not, can you talk about what's going to be the offset to keep second half margin targets unchanged if you want to have a little bit more flexibility on adjusted promotion. Thank you so much.

Denise Paulonis - *Sally Beauty Holdings Inc - President, Chief Executive Officer, Director*

Happy to take those. We'll try to take them in order. Sally, when we think about driving traffic to the stores and driving transactions overall, I think we're thinking about it very holistically in a very omni-channel. So as we look to the second half of the year and we look to the end of our second quarter, marketplaces ramped up for us. So we were able to add in DoorDash to our mix, along with Walmart and Amazon and saw nice early results there. Instacart is getting turned on in the beginning of Q3. That's nice traffic. It's traffic that actually goes through our stores.

As you know, as those will get shopped in the stores, particularly for the DoorDash and Instacart piece and delivered to the customer, when we look beyond that, things that are generating those experiences and those reasons to shop with us were performing well at the end of the quarter.

So as I mentioned earlier, Licensed Colorist OnDemand, our own brands and bond bar that are driving new customers into our store and building that loyalty piece as well. And then our CRM activities as we continue to get more targeted and more personalized for the reason for somebody to come back and shop with Sally, so looking at it a very omnichannel way.

And then when a customer gets into the store, that store associate being knowledgeable, having the information that they need to really drive conversion. And we have seen a modest uptick in conversion as we have come through the quarter as well. So trying to capitalize on all fronts there as we also look to say a customer is shopping with a bit of frugality. And so pleased with what we are working on and the traction that we are starting to get and think that that will bear more fruit as we come into the second half of the year.

On the BSG front, in terms of what's contributing to the upside, it's a broad-based set of things, right, that span from innovation gains, new innovation gains, distribution gains, and we have also talked a little bit about the stylist demand. We haven't broken out those individual component pieces beyond talking about the Goldwell New York acquisition that we are kick-starting Q4, so it still has another couple of quarters to run there. I believe that that was – it's $10 million to $15 million in top-line sales that will be on an annualized basis.

All the other pieces we really believe are in the run rate and that is these items start to lap. We do have continued innovation in the pipeline behind them. So Amika and Moroccan oil and Color Wow, great strength today, and we think there is more to come. But adding in things like Briogeo and epres, we just want to continue that flywheel of innovation coming into the BSG ecosystem.

And Marlo, do you want to talk a little bit about the margin guide?

Marlo Cormier - *Sally Beauty Holdings Inc - Chief Financial Officer, Senior Vice President*

Yes, the margin guide in terms of -- I think your question was directed at the segment. So a key component is the mix shift that we saw in Q2, and we expect that to continue again with the solid momentum around BSG and a little bit of softness in Sally, mainly from that AUR pressure. And then the gross margin guide, as we mentioned, again, being a little more prudent there as we continue to work through our adjustments to our promotional offerings as we try to continue to drive traffic and gain share of wallet.

Operator

Ashley Helgans, Jefferies.

Ashley Helgans - *Jefferies LLC - Analyst*

To start, maybe you can just give us a little bit more color on the specifics around the innovation that you saw this quarter that really helped drive the strength at BSG. And then any innovation that you are seeing within Sally would be helpful. And then I know you mentioned like promotions and people shifting towards buying more on promotion. But anything you can tell about just the promotional rate this quarter versus last year would be great.

Denise Paulonis - *Sally Beauty Holdings Inc - President, Chief Executive Officer, Director*

So let me take those in reverse order. So promotional rate this year versus last year, no meaningful difference in the offers that we had out there on the Sally side, BSG probably had a slight bit more promotion, but we have been seeing that with our vendors leaning in over the last few quarters. But in the Sally World, offers were out there, they were just being more consistently pursued by our customer base. And in BSG, the most notable was our customers leaning in against the customer appreciation sale, which is a once a quarter event that we do. But to put it in proportion, this quarter versus the quarter a year ago, the same two-day customer appreciation sale, our sales were up 17%. So really leaning in and looking for that value is what came through, but the offers themselves very, very similar year over year.

On the innovation front, as I have said, we are extremely excited about the innovation cycle we are in and what we can bring in. And when you think about the drivers of the innovation on the BSG side, certainly continue to have some strength from core brands like Wella that we are bringing out new innovation. But a lot of the strength came from Moroccan oil, Color Wow, Amika. In some cases, that was expanding territory rights in some of those brands.

And in other cases, it was expanding to our entire store fleet and then cycling behind that a new level of innovation with the launch of Briogeo as well as epres. All of these are hair care products that are on the styling side, on the core care side, they just offer new and different alternatives for our stylists as they think about serving their customers and their clients, some of which are bonding, some of which are other functional solutions, but all of which are really resonating through our customer base.

On the Sally side, we continue to look favorably to opportunities around our Mindful brands. So things that are more conscious beauty choices are inspired by nature products performed well. We continue to see bond bar perform well and grow from our own brands perspective.

And then we see interest remains in vivid color, it was about 22% of our penetration in the quarter. So that has also leveled off in those low-20s, but there is still a nice pipeline there. The innovation to come in Sally is exciting around some things that we are doing on skin care, continue leaning into textured care that will all come as we are entering the second half of the year. So great pipeline on both sides of the business that we actually think are fantastic offerings for our customers.

Ashley Helgans - *Jefferies LLC - Analyst*

Great. Thanks for all the color.

Operator

Jenna Giannelli, Morgan Stanley.

Unidentified Analyst

This is Sarah, on for Jenna. Can you update us on your capital allocation priorities if your leverage target of 1.5 to 2 times still holds and how you are balancing that with repurchases? Thanks.

Marlo Cormier - *Sally Beauty Holdings Inc - Chief Financial Officer, Senior Vice President*

Thank you. So our leverage range of the 1.5 times to 2 times, we do believe that's appropriate for our business going forward. So we will continue to work towards that. This quarter, we were pleased to be able to further optimize our balance sheet with the recent refinancing. We did take $80 million of principal out of that secured note as we refinance into a new secured note. Just given the timing of our cash flow, we are generally much heavier in the back half and certainly in Q4 in terms of our free cash flow generation.

So we did use our ABL to help complete that refinancing. We have got about $60 million outstanding on that ABL. So we will continue to balance debt pay-down and share repurchase. But we do look to get out of that ABL as we progress through the coming quarters and as we get into our heavier cash generation quarters. But we will take a balanced approach as you heard us comment, we are guiding to about a $10 million share repurchase for Q3.

Unidentified Analyst

Great. Thanks. And then just a follow-up, can you speak to the extent to which the weakness on higher ticket items continues to weigh on sales and when we might start to comp out of that?

Denise Paulonis - *Sally Beauty Holdings Inc - President, Chief Executive Officer, Director*

Yes. The way that I would think about it is we guided Q3 sales down one to plus one. So in general, progress in returning to the total business headed towards a positive comp. So as I mentioned earlier, our focus as we saw the uptake in promotion through Q2 take hold was really to think about our planning for Q3 and Q4. Those actions and changes are underway now as we are engaging with our customer and providing them with offers. So progressively see comps improving as we go into Q3 and getting us back into flat performance, which is what we expect for the full year.

Unidentified Analyst

Thank you so much.

Operator

Simeon Gutman, Morgan Stanley.

Simeon Gutman - *Morgan Stanley Co. LLC - Analyst*

I wanted to ask Denise about the industry. There seems to have been this like synchronous slowing little bit in beauty and then a lot from – it looks like middle and lower income, and I missed some of the prepared remarks, but curious on the industry, if it's – we have reached some kind of peak in innovation and consumption or it's just the macro and the wallet pressure is waning. Is there anything with innovation that's not there? And why do you think that we might be seeing this pullback now?

Denise Paulonis - *Sally Beauty Holdings Inc - President, Chief Executive Officer, Director*

Yes. Simeon, happy to share at least some perspectives that I see through the data that I can examine in our business. What we talked about a little bit in the prepared remarks was a bit of the bifurcation of the customer, which is interesting that on the pro side, which serves more middle to more of an upper income customer demographic is that client sitting in the chair. We have actually seen pretty healthy stylist demand, which nice business there. And underneath that, the innovation cycle on the hair care, care color side for the pro is pretty robust. And particularly what we are picking up in distribution on some core performing brands has been solid.

And so as we look to the second half of the year, we see that continuing and at least at this point, while we are monitoring it quite closely, our stylists feel pretty good about their book of business and where they are headed. I think the bifurcation comes and what we can see through our Sally data is that our lower income customer in Sally because we do serve all income levels, but we mix a little bit more lower income. That lower income customer has been the customer where the frugality is coming through more that when they are buying, they are looking for the deals, they are looking for ways to stretch those dollars a little bit more or be a little bit more frugal. I don't think that the challenge is really an innovation cycle towards the lower end.

As we mentioned, we also have our Happy Beauty pilot, which serves, I would call it right now primarily a middle-income customer and you weren't necessarily seeing that same pull back or challenge with transactions and ticket there that we are seeing more on the Sally side. So I don't think the innovation cycle is really the cause. I think it's more of the customer pocketbook and that lower-income customer just feeling that much more pressure.

Simeon Gutman - *Morgan Stanley Co. LLC - Analyst*

And I know you mentioned a little bit about the back half of your year. I don't want to get into quarter-to-date, but curious if the trends have continued or what we were seeing in the last, like, I don't know, four weeks to six weeks could have been a bit of a blip, I don't know, pent-up demand, consumer spending on other things because the weather got better, and maybe now the wallet can return to normal because we have seen some head fakes before, whether it's the industry and/or in the consumer. Curious if you are seeing any pivots again, not to get too granular into quarter-to-date, but of a different perspective.

Denise Paulonis - *Sally Beauty Holdings Inc - President, Chief Executive Officer, Director*

Yes. If I look out over the longer term, we have seen a very dynamic customer on both sides of the business, right, different choices being made at different times. And I think as you mentioned, these cycles that seem to happen around pockets of spending and then maybe pockets of a bit more frugality. What I would more say is we certainly -- we guided to the minus one to plus one, which is a bit of a sequential improvement from where we were this past quarter in terms of our sales performance. That reflects our quarter-to-date results and what we are seeing happen with the business.

And I would say, in general, seeing continued solid performance on that BSG side and with a little bit of the softness continuing on the Sally side is what's underneath those numbers. We expect that for us, a factor as we are going through the year as well is now on the BSG side since we lapped one of the challenges with one of our hair care brands in the second quarter. But that's just an underlying good guy to deliver us back into the territory of the flat sales, flat comp that we guided to for the full year.

So everything about the trend of the start of this quarter is reflected in our guidance. And feel like following the new news of a little bit softer AUR that came through, we set another inflection point here with the customer that we are managing through.

Simeon Gutman - *Morgan Stanley Co. LLC - Analyst*

Thanks. Good luck.

Operator

I'm sorry. That's the final question.

Denise Paulonis - *Sally Beauty Holdings Inc - President, Chief Executive Officer, Director*

Great. Well, thank you all. We appreciate all of our shareholders and appreciate all of you tuning in to hear more about our quarter today. And as always, thank you to all of our associates around the world for serving our customers. And we look forward to connecting with everyone again next quarter.

Operator

Thank you. And ladies and gentlemen, that does conclude our conference for today. Thank you for your participation and for using AT&T teleconference. You may now disconnect.
