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Q2 2021 Fossil Group Inc Earnings Call

EVENT DATE/TIME: AUGUST 11, 2021 / 9:00PM GMT

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PRESENTATION

Operator

Good afternoon, ladies and gentlemen, and welcome to the Fossil Group Second Quarter 2021 Earnings Call. This conference is being recorded and may not be reproduced in whole or in part without written permission from the company.

Now I'll turn the call over to Christine Greany of the Blueshirt Group to begin.

Christine Greany ***The Blueshirt Group, LLC - MD***

Hello, everyone, and thank you for joining us. With us today on the call are Kosta Kartsotis, Chairman and CEO; Jeff Boyer, Chief Operating Officer; Sunil Doshi, Chief Financial Officer; and Greg McKelvey, EVP and Chief Commercial Officer. I would like to remind you that information made available during this conference call contains forward-looking information and actual results could differ materially from those that will be discussed during this call. Fossil Group's policy on forward-looking statements and additional information concerning a number of factors that could cause actual results to differ materially from such statements is readily available in the company's Form 8-K and 10-Q reports filed with the SEC.

In addition, Fossil assumes no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise, except as required by law. During today's call, we will refer to constant currency results. Please note that you can find a reconciliation of actual results to constant currency results and other information regarding non-GAAP financial measures discussed on this call in Fossil's earnings release, which was filed today on Form 8-K and is available in the Investors section of fossilgroup.com. With that, I'll now turn the call over to Kosta.

Kosta N. Kartsotis ***Fossil Group, Inc. - Chairman & CEO***

Thanks, Christine.

Good afternoon, everyone, and thank you for joining us today. We hope everyone is well and staying safe. We are pleased with our second quarter performance, which exceeded our guidance and reflected growth across all of our regions and categories. We achieved reported net sales growth of 59% delivered strong gross margins and maintained solid cost controls. As a result, we delivered adjusted operating income of $21 million which significantly outpaced our 2019 levels.

More importantly, our Q2 results highlight that our strategic focus is gaining traction and enabling us to begin driving profitable sales growth. Now turning to Q2. Our digital-first focus continues to deliver results. In Q2, digital sales penetration was 41%, which includes sales on our own e-commerce sites, global third-party platforms and wholesale.com sites. Digital sales increased 10% versus 2020 and were up 82% versus 2019. Each region's digital sales mix has grown substantially since 2019 and all indications point to exciting opportunities to further grow sales and deepen customer relationships. Looking at the second quarter of our region, starting with Asia. Growth in Mainland China remained very strong, up 38% versus prior year and up 82% versus 2019. Performance in India, while positive in Q2 with triple-digit growth versus prior year was still at depressed levels due to pandemic conditions. We continue to view China and India as high-growth markets with sustained long-term opportunities across all brands and categories.

The Americas region delivered our strongest growth, up 64% in constant currency primarily driven by the continued strengthening of our U.S. business. Sell out was particularly strong in our traditional watch category as we saw growth versus 2019 in our wholesale, owned e-com and pure-play channels. Our sell-out trends in this key category market are encouraging as we head into the back half of the year.

Stepping back, we are on a growth path in the United States market as a result of the significant progress our teams have made on driving digital and building brand while transforming our distribution model.

We returned to growth in the EMEA region this quarter with net sales up 44%, which is a positive outcome considering the market had a lot of closures during the quarter. We are pleased with the overall transformation of the business there and feel we are in a good position as the markets open up. Turning now to our brands and product categories. We achieved strong top line sales growth in both our owned and portfolio brands. Traditional watches performed well in all 3 geographic regions with products that celebrated iconic designs, sustainable materials and were tailored for localized consumers. It's also worth noting that we are seeing positive performance in our jewelry category, which was up triple digits versus last year and almost 68% versus 2019. While jewelry is approximately 10% of our sales, it's a high-margin category where our design and distribution capabilities make us a great adjacency for ongoing growth. Now turning to initiatives that are driving brand heat. In Q2, we leaned into key campaigns that generate significant brand heat for our brands on a global scale. First, our global Pro Planet campaign highlighted eco-friendly products and materials across multiple brands, which generated significant media impressions and created some of the highest customer engagement metrics we've seen in our own e-commerce channels.

Second, our global pride campaign featured product and collaborations that not only drove engagement, but also resulted in a sellout of our limited-edition collections. Both of these campaigns helped drive over 20% growth in our customer database versus a year ago. Finally, the end of Q2 marked the launch of our Fossil Space Jam collection in conjunction with the worldwide release of Disney's Space Jam movie. The Fossil Brands Limited Edition of Space Jam Watch was one of our most successful media launches to date and highlighted our ability to bring the best of the fossil brands vintage DNA to life through collaborations with iconic characters and brands. While still ongoing, we are seeing this campaign bring in new customers to the brand. As we enter the second half of the year, we remain focused on the strategic pillars that have been driving our return to profitable growth, digital acceleration, building brand heat through product innovation and marketing, our ongoing operating efficiency initiatives and the growth opportunity in China and India.

We are making significant progress on our digital and e-commerce initiatives, and we're pleased to announce the addition of our Chief Digital Officer to the executive team. [Holly Bretas] has joined us from McKinsey, where she built exceptional expertise in driving customer-centric digital transformations for retail brands. In this role, Holly will lead our global efforts to drive digital sales scale our customer data strategy and deepen our marketing analytics capabilities. Second, with respect to building brand heat, we will lean into key markets, brand and product launches with greater investment in marketing in the third and fourth quarters to drive top line sales.

Our product innovation initiatives will continue in the back half of the year as we bring our next generation of connected watches to market. Although we are still navigating a global pandemic, we have made significant progress on the ongoing transformation of the business and feel we are well positioned to capitalize on the opportunities ahead of us. Through our New World Fossil transformation programs and careful investments in technology, innovation and talent, we have established a model that is poised to deliver profitable growth. As a result of our strong first half results and the momentum we're seeing as our strategic initiatives take hold, we are raising our sales growth outlook for the full year to a range of 14% to 17%, and our adjusted EBITDA margin outlook to 6% to 8% Sunil will provide additional perspective on our guidance during his remarks.

In closing, we would like to thank our Fossil team members all over the world for their relentless execution and focus over the past few years. Their commitment to excellence has enabled us to transform the company and set up for long-term success. Now over to Sunil to discuss the financials.

Sunil M. Doshi ***Fossil Group, Inc. - Senior VP, CFO & Treasurer***

Thanks, Kosta, and good afternoon, everyone. As Kosta mentioned, we're pleased to deliver a strong quarter, headlined by growth in all 3 regions and solid gross margins, which resulted in operating income of $14 million and adjusted operating income of $21 million, both of which outpaced 2020 and 2019 results. Q2 adjusted EBITDA was $30 million or 7% of net sales. Now turning to our review of net sales. Q2 net sales totaled $411 million, up 59% versus last year or up 51% on a constant currency basis. From a regional perspective, net sales in the Americas were up 64% in constant currency, with strong double-digit growth in the U.S. This was partially offset by ongoing pandemic-driven pressures in Canada, which experienced some temporary closures and capacity restrictions and reduced traffic.

In Europe, Q2 net sales were up 44% in constant currency despite ongoing COVID-driven restrictions that impacted performance throughout the quarter. In our Asia region, Q2 net sales were plus 41% in constant currency led by Mainland China, where sales growth was 38% versus 2020 and 82% versus 2019. Results in India outpaced our expectations and delivered growth versus last year, thanks to strong digital sales as we navigated pandemic-related pressures in the quarter. Q2 digital sales were up 10% to last year. Recall that digital sales grew significantly in Q2 of last year during the initial COVID surge, which resulted in nearly all parts of the globe placing severe lockdowns and restrictions impacting our brick-and-mortar channels.

Compared to 2019, Q2 digital sales were up 82%. As a reminder, our digital sales consist of our owned e-commerce channels, third-party e-commerce platforms and wholesale.com. Now looking at the business from our own DTC perspective, which encompasses our own e-commerce sites and stores. Comparable DTC sales were up 11% versus last year, reflecting a sharp rebound in brick-and-mortar sales from prior year's depressed levels when global lockdowns drove store closures. Globally, traffic and conversion trends have remained consistent with recent quarters with some modest traffic improvement in the Americas, offset by trends in Europe. We ended the quarter with 386 company-owned stores, down 11% versus a year ago and down 15% from 2019.

Turning to category performance. Global watch sales in Q2 increased 50% in constant currency, led by traditional watches. In our jewelry category, sales more than doubled with increases across all of our regions. Moving down the P&L. Second quarter gross margin came in at 54%, down 30 basis points to last year. As a reminder, prior year's gross margin rate included onetime benefits due to a reduction in projected liabilities for minimum product royalties on licensed products. Excluding this amount, gross margin improved versus last year, driven by favorable impacts from channel and product mix as well as currency offset by region mix. Total operating expenses, which include impairments and restructuring costs, were $208 million compared to $177 million in the prior year period. As a percentage of sales, operating expenses were 50.5% versus 68.5% in the year ago period.

SG&A expenses were $201 million in Q2, an increase of 23% compared to a year ago. As a percentage of sales, SG&A was substantially lower, coming in at 48.8% compared to 63.1% last year. Taken together, strong sales performance and solid gross margin helped drive operating income of $14 million. On an adjusted basis, adjusted operating income was $21 million and adjusted EBITDA was $30 million in the quarter. Our Q2 income tax provision was $8 million, reflecting an increase in deferred tax valuation allowances on current U.S. operating losses and provisions for foreign taxes that are also taxed in the U.S. Diluted net loss per share was $0.02 and included restructuring charges of $0.09 per diluted share under the company's New World Fossil program. In Q2 of 2020, diluted net loss per share was $0.44 which included restructuring charges of $0.16 per diluted share under the company's New World Fossil program.

Moving to the balance sheet and cash flow. We ended Q2 with total liquidity of approximately $294 million. including cash and cash equivalents of $252 million and $42 million of availability under our revolving credit facility. Total debt at the end of Q2 was $178 million. Total inventories were $352 million at quarter end, down 6% versus a year ago. In Q2, we generated cash flow from operations of $28 million and paid down debt balances by $20 million. Now turning to our outlook. Looking at the remainder of the year, we see that strength in some of our core markets is more than offsetting markets with uneven responses to the pandemic. With that context in our year-to-date results, we are raising our full year net sales growth outlook to a range of 14% to 17% versus our prior expectation of 12% to 16% growth that we previously communicated in May.

In addition, we are also increasing our expectations for adjusted EBITDA margin to 6% to 8% from our previous range of 5% to 7% communicated in May. Looking one quarter ahead for our fiscal Q3, we are expecting net sales growth of 5% to 10% versus 2020. Our net sales outlook assumes prevailing currency rates. And with that, I'll turn the call back to Christine to take us through some questions and answers.

QUESTIONS AND ANSWERS

Christine Greany ***The Blueshirt Group, LLC - MD***

Thanks, Daniel. Let's start with Kosta. Can you talk about your view of the traditional watch category and where you see that going in the coming years? It would be helpful to understand your perspective on the category in general as well as consumer demand, particularly as it relates to the pandemic?

Kosta N. Kartsotis ***Fossil Group, Inc. - Chairman & CEO***

Yes, it's very interesting to see the changes in the wash consumer globally. There are 3 things that we are seeing. First, we're seeing an increased demand in the United States, as we mentioned earlier, and the business is healthier than it was before the pandemic. We have some accounts that are seeing a double-digit growth versus 2019. Secondly, and maybe a bigger opportunity on the first is that we're -- what we're seeing in Asia, which -- especially in China, and that is that the emerging customer strong affinity for watches and accessories is coming to hold. Keep in mind, China was up 81% over 2019. As more and more people in Asia join the middle class, their increasing demand for watches and accessories is a significant long-term opportunity. And the third is the increasing overall acceptance for the consumer to buy watches online. It is now 40% of our total sales and 50% in Asia. Our digital activities enable rich storytelling engagement and will enable us to build global digital communities.

As we accelerate our investments and capabilities in our global digital platform, this is a long-term game changer for the company.

Christine Greany ***The Blueshirt Group, LLC - MD***

Thanks, Kosta. Great to hear your commentary on consumer demand in the U.S. and the improving trend there. Now let's move to Greg. Can you talk about the demand signals you're seeing across all of your channels, e-com, wholesale and third-party partners? And where do you see that going as we head into the second half and holiday in particular?

Gregory A. McKelvey ***Fossil Group, Inc. - Executive VP & Chief Commercial Officer***

First, the most important demand signal we're seeing is broad-based strength in traditional watches across channels. And in Q2 in the U.S., we achieved positive sell-out comps versus '19 in our core channels, including traditional wholesale, licensor boutiques, e-commerce and others. The reemergence of traditional watches is all about innovation and storytelling amplified by digital marketing.

In Q2, we launched new products focused on sustainability, important cultural moments like Pride Month and limited edition collaborations like Space Jam. Across all of our brands, we are also distorting product icons, which both celebrates existing iconic watch designs and launches new designs inspired by each brand of authentic DNA. There's no better example of this than Michael Kors, where their consumer is responding to newness in iconic boyfriend and heavy pave watches $40 to $50 price range, which is creating brand heat and meaningfully lifting AUR. Although we are pleased with the Q2 performance, we're just getting started ramping up our product innovation and accelerating our marketing spend, leveraging the capabilities we've built over the last few years. We believe we're at the beginning stages of a consumer trend in traditional watches that will carry us into the back half of the year and beyond.

The second demand signal worth noting is the emergence of jewelry as a category that's meaningfully contributing to growth. Globally in Q2, jewelry is up triple digits versus 2020 and 68% versus '19. And is hitting growth rates even higher than this in the U.S. We expect growth in jewelry to continue into the back half of the year and beyond. Collectively, we believe jewelry, our new imminent Gen 6 smartwatch launch and opportunities we see in leather goods will nicely augment the strength we're seeing in our core traditional watch business. The third consumer demand signal the callout is digital, where we are up 82% versus in 2019 globally, and seen similarly strong performance in the U.S.

We've been investing in digital channel development and marketing for several years and believe we're finally nearing the point where growth in digital will more than offset the headwinds from brick-and-mortar. We're very pleased with growth in our owned e-commerce and pure play e-commerce businesses, but we've also been very pleased with the strength in our licensor.com and wholesale.com businesses as well. And believe we're poised to continue to leverage this channel trend into the future. The last thing I'd like to note in the U.S. is the healthy margin structure we're delivering, which is due to 3 things: First is product mix with the strength in high-margin traditional watch and jewelry businesses. Second is increasing AURs and product margins as a result of a reduction in markdowns and a more controlled approach to our off-price channel. We're just simply much healthier and cleaner in our channels. And third, a step function reduction in our infrastructure expense. Collectively, these things are delivering healthy margins we haven't seen in our U.S. business a while. While this commentary is U.S.-focused, we're also seeing margin health in our other regions as well. We couldn't be more proud of what our teams are accomplishing and expect to build on this momentum throughout the rest of the year.

Christine Greany ***The Blueshirt Group, LLC - MD***

Over to Sunil now, could you provide some color on the sales and EBITDA guide you provided today?

Sunil M. Doshi ***Fossil Group, Inc. - Senior VP, CFO & Treasurer***

Christine, yes, sure thing. From a sales perspective, Q1 and Q2 fairly better than our expectations, driven by outperformance in the Americas. And that helped to offset some of the ongoing pandemic pressures that we saw in other parts of the globe that are slower in the recovery from the pandemic. When looking at the balance of year net sales projections, we think it's helpful to consider trends versus 2019. Our Q3 2021 net sales growth range of 5% to 10% versus 2020 implies minus 12% to minus 15% versus 2019, which is a sequential improvement versus our Q2 results, which were down 18% to 2019. From a regional perspective, we continue to see strength in the Americas, particularly the U.S. market, driven by healthy consumer, significant vaccination efforts, underlying operational strength that Greg spoke about. These trends as well as trends in Mainland China continue to outweigh lower near-term expectations out of the balance of Asia, given the pace of recovery from current pandemic conditions.

Lastly, actual FX rates through the second quarter have been slightly favorable versus our expectations. But at this point, moving forward, prevailing rates are generally closer to last year. So all told, with a better Q1 and Q2 and an improved outlook for Q3 and Q4, we've been able to lift our net sales guidance to 14% to 17%, which is up from our May estimate of 12% to 16% and also up versus our beginning of the year estimate of 10% to 15%. From an adjusted EBITDA margin standpoint or perspective, year-to-date results are just shy of 5% adjusted EBITDA margin, driven by stronger gross margins and solid expense controls and some temporary expense savings and timing shifts that were a result of the pandemic conditions in some parts of the globe. On a full year basis, however, our adjusted EBITDA margin guidance of 6% to 8% is an increase from our most recent prior guidance of 5% to 7% and our beginning of the year guidance of 4% to 6%. Included in our revised adjusted EBITDA margin guidance, we factored in some of the following: some projected cost increase for transportation and labor costs given the current trends in the operating environment, which we expect to persist. And we've also increased the marketing spending key markets as we invest behind strong consumer demand signals to drive continued growth in Q3 and Q4.

On balance, our outlook on expenses -- for the balance of the year, while up versus 2020 levels are expected to leverage as a percent of sales versus 2020. And when you compare expenses to 2019, expenses will still be down versus 2019, and we'll also leverage 2019 as a percent of sales.

Christine Greany ***The Blueshirt Group, LLC - MD***

Terrific. My last question is for Jeff. Sunil mentioned macro headwinds around shipping and wage inflation, which are well documented. Can you provide us with some additional granularity around those factors, how it's impacting thoughtful and how you're planning for that?

Jeffrey N. Boyer ***Fossil Group, Inc. - COO***

Certainly, Christine. On the shipping front, we are seeing minor disruptions but nothing really material at this point. Most of the shipping disruptions, other companies are reporting, are due to imbalances in ships and containers in the ocean trade channel coming out of Asia. Our most significant product categories, watches, smart watches and jewelry are shipped via airfreight, given the relatively small size of our product in high average unit retail. Our other products, however, are shipped via ocean freight and have experienced some delays. Our teams are doing a great job getting product from Asia to the West Coast. But we have had a few minor misses in delivery schedules for some handbags and small leather goods. That said, given the relatively small size of our leather business, it represents under 10% of our sales, along with a limited number of disruptions. These delays have not had a sizable impact on the results so far.

On the inflation front, we are seeing some cost pressures mostly in the shipping area, as Sunil mentioned, in both the air and ocean freight channels. Wage increases and product cost hikes have been more muted versus what we're seeing in the freight area. However, with these various cost pressures we are experiencing, we are planning on price increases in our largest product categories, in watches. With these planned pricing actions along with our enhanced inventory management programs, we expect to fully offset expected cost pressures with a net accretive impact to gross margins.

Christine Greany ***The Blueshirt Group, LLC - MD***

Okay. Thank you, and thanks to the Fossil team for the Q&A. I'll turn it back to Kosta to close this out.

Kosta N. Kartsotis ***Fossil Group, Inc. - Chairman & CEO***

Thank you, everyone, for joining us today, and we greatly appreciate your support and look forward to updating you again on our third quarter call. Have a good evening.