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CORPORATE PARTICIPANTS

Gregory A. McKelvey *Fossil Group, Inc. - Executive VP & Chief Commercial Officer*
Jeffrey N. Boyer *Fossil Group, Inc. - COO*
Kosta N. Kartsotis *Fossil Group, Inc. - Chairman & CEO*
Sunil M. Doshi *Fossil Group, Inc. - Senior VP, CFO & Treasurer*

CONFERENCE CALL PARTICIPANTS

Christine Greany *The Blueshirt Group, LLC - MD*

PRESENTATION

Operator

Good afternoon, ladies and gentlemen, and welcome to the Fossil Group Third Quarter 2021 Earnings Call. (Operator Instructions). This conference call 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 Blueshirt Group to begin.

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

Thanks, Shannon. 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. Now I'll turn the call to Kosta to begin.

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

Thanks, Christine. Good afternoon, everyone, and thanks for joining us today. We are pleased to deliver another quarter of strong performance, driven by continued momentum across our key categories and regions. Our Q3 net sales grew 13% or 11% in constant currency. Gross margins remained strong at 53%, and we delivered double-digit adjusted operating margins of 11%. We are proud of our teams for continuing to deliver superior execution and remaining focused on our strategic priorities in what has been a dynamic environment for nearly 2 years.

Our top line performance is being fueled by our digital-first focus, ongoing product innovation and favorable watch category dynamics. Importantly, over the last several years, we have become a much more efficient organization, effectively transforming our company and positioning us to deliver profitable growth and to create long-term shareholder value. Most recently, we further strengthened our financial condition with the successful completion of a $150 million senior notes offering. More to come on this from Sunil later.

It is great to see our digitally led mindset drive measurable results in 2021. In the third quarter, digital sales grew 28% and doubled from 2019. Our digital sales penetration remains strong at approximately 40% of our own sales mix. As a reminder, digital sales include sales on our own e-commerce sites, global third-party platforms and wholesale.com sites. During the quarter, we completed another key element of our strategic road map on digital. All 27 of our global websites now reside on our Salesforce platform.

These websites cover our Fossil, Skagen, Watch Station, Michele and Zodiac brands. Specifically, having our sights on one common platform allows us to more effectively scale our strategies to drive consumer engagement and personalization through digital means. Longer term, this will also enable us to deliver superior customer experiences across both digital and nondigital channels. Looking at the business from a regional lens, starting with the Americas. Consumer demand in the United States remained strong, which continued to be led by our traditional watch category in jewelry.

Better inventory management, reduced reliance on off-price channels and an emphasis on digital channels is driving healthier, more profitable performance in the region. As we head into the holiday selling season, our inventories are in a good position as we were able to pull forward some inventory buys. For added context, we have not experienced a significant impact from shipping headwinds in watches and jewelry. We have historically shipped these by air since they have a relatively small cube size and a low freight cost per unit.

In leathers, we have experienced some delays and increased costs in shipping, but our plans have been calibrated accordingly. Our EMEA region reported a strong quarter of growth, with net sales up 21% despite continuing pandemic-related closures affecting brick-and-mortar traffic in certain locations. Led by digital channels, we captured demand for traditional watches and jewelry in the region. Looking ahead, we expect to see momentum build as markets continue to open up in key countries, including France, Germany and Italy.

And now turning to Asia. Q3 saw a notable change in sales trends between Mainland China and India as pandemic factors shift to the markets. During the quarter, Mainland China was impacted by new COVID-driven restrictions. And 2 weeks ago, China announced a new wave of closures and travel restrictions due to an increase in COVID cases across several provinces. In Mainland China, sales in the quarter were down 1% compared to last year and up 55% versus 2019. Conversely, in India, an improving trend in COVID infections and vaccination rates across key cities resulted in improved traffic and spending.

With solid inventory positions and effective marketing campaigns, our third quarter sales rebounded sharply, up 95% to last year and up 24% compared to 2019. While we navigate pandemic-driven traffic disruptions in the short term, we continue to view China and India as attractive high-growth markets with sustained long-term opportunities across our categories and brands. The demographics in this region are very compelling where the significant middle class has a strong affinity for branded watches and accessories.

And over many years, we have invested significant resources and built strong capabilities in both China and India. This has enabled us to deepen our understanding of the consumer and build brand equity in these markets, which we believe gives us a long-term sustainable advantage. Let me now turn to Q3 performance by brands and product categories. Importantly, the traditional watch category remains healthy and continues to show signs of strengthening consumer demand. During the quarter, we saw broad-based strength across all 3 regions and achieved strong double-digit growth in both our Fossil and Kors brands, as our iconic styles resonate with consumers.

We also continue to see momentum in our jewelry category, which also delivered robust performance across all regions in the quarter. In the connected category, although sales were down versus last year, we executed against our strategy to focus on best-in-class products with key brands sold primarily through DTC and our digital distribution channels. This strategy has resonated with consumers and is driving better economics for the category. In September, we launched Gen 6, which represents a meaningful step forward in our product road map.

With this latest generation based on Qualcomm's 4100 chipset, battery life continues to improve with 30-minute charging. Consumers now have more flexibility to leverage the full potential of the device. In 2022, our Gen 6 product will bring to market advanced Wear OS technology as well as Amazon's Alexa and our own companion app. While early in its launch, we are pleased with the global consumer response to Gen 6 as we enter the holiday season. As we previously shared, we have been investing in marketing to reignite brand heat.

The global campaigns we launched this year have been fueling sales growth and bringing additional customers into the Fossil ecosystem. We are focusing on storytelling with a consistent brand voice and emphasizing icons, collaborations, partnerships and sustainability. We are encouraged by recent market data and strong sellout trends, which indicate that our efforts are bearing fruit and helping us gain share. This holiday season, you can expect to see us lean into key markets, brands and gift-giving options with an emphasis on digital and social marketing campaigns.

We expect a strong finish to the year based on our current momentum, which is driven by the energy and focused execution of our teams around the world. To that end, we are raising our full year outlook and now expect to deliver sales growth of 17% to 19% and adjusted EBITDA margin in the range of 8.5% to 9.5%. As we look ahead to next year, we expect to achieve strong top line growth as our categories have only partially rebounded from pandemic due to their discretionary nature. We also anticipate that our programs to improve our operations and capture efficiencies will enable us to continue driving leverage in the model. And now I'll turn the call over to Sunil for more detail.

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

Thanks, Kosta, and good afternoon, everyone. Starting with our third quarter results. Our third quarter was strong, highlighted by better-than-expected top line growth, solid gross margins and ongoing cost discipline, which collectively drove adjusted operating margin of nearly 11% and EPS of $0.60. First, let me highlight net sales. Q3 net sales were $492 million, up 13% or up 11% on a constant currency basis. From a regional perspective, net sales in the Americas were up 10% in constant currency, with stronger growth in the U.S. market, driven by continued strength in consumer demand.

In Europe, Q3 net sales were 21% in constant currency as the region began to emerge from pandemic restrictions. Our teams have adeptly navigated store closures and reduced foot traffic, with strong digital execution to drive overall top line sales growth. In our Asia region, Q3 net sales increased 5% in constant currency, led by strong growth in India as the country continues to recover from pandemic-driven conditions that impacted demand in the first half of this year.

Conversely, in Mainland China, sales were down 1%, reflecting a slowdown in trend from Q2 due to accelerating pandemic lockdowns in the third quarter. Other markets like Japan, Korea and Australia have not seen a significant improvement in trend. From a channel perspective, Q3 digital sales remained strong, up 28% versus a year ago and 2x compared to the third quarter of 2019. Additionally, we continue to see our digital sales mix at about 40%, up significantly from 2019 levels.

Looking at sales in our DTC channels, which encompasses our own e-commerce sites and stores, comparable DTC sales were flat versus last year. Globally, traffic and conversion trends have remained consistent with recent quarters with traffic improvement in both the Americas and Europe. We ended the quarter with 374 company-owned stores, down 13% versus a year ago and down 18% from 2019. Turning to category performance. Overall, global watch sales in Q3 increased 9% in constant currency, led by traditional watches, which grew in the high teens.

Traditional watch sales were up in all 3 regions. And from a brand lens, our strongest performance was in Fossil and Kors. Partly offsetting that growth, our connected watch business contracted versus last year. As a reminder, in our connected watch business, this year, we are lapping a significant amount of liquidation sales from the prior year related to earlier generation products. Net sales in our Jewelry category grew 79% in the quarter with growth in all 3 regions. In Q3, jewelry represented approximately 11% of sales.

Moving down to P&L. Third quarter gross margin came in at 52.8%, which was flat to last year. Gross margins benefited from favorable currency impact on our cost of goods sold and a better channel mix. Offsetting this was a less favorable geographic mix, product mix and onetime inventory reserve reductions in the prior year period. Turning to expenses. Our teams did a good job on cost control, delivering improved ratios on both SG&A and total operating expenses. SG&A dollars in Q3 totaled $206 million, up slightly from $202 million a year ago. SG&A as a percentage of sales leveraged by 460 basis points, coming in at 41.8%.

In the quarter, we did increase our marketing spending by 230 basis points versus a year ago, which was more than offset by 680 basis points of leverage in the balance of our SG&A expenses. Total operating expense, which in addition to SG&A includes impairments and restructuring costs, were $212 million or flat compared to the prior year. Operating expense as a percentage of sales came in at 43%, down 570 basis points to last year. Taken together, our top line performance, solid gross margin and expense leverage allowed us to deliver adjusted operating income of $54 million and margin of 10.9%.

Third quarter adjusted EBITDA came in at $63 million and adjusted EBITDA margin reached 12.7%. On a trailing 12-month basis, our adjusted EBITDA is coming in at $150 million, nicely rebounding through 2020. Our Q3 income tax provision was $9 million or 22% of pretax income, reflecting higher provisions for foreign taxes that are also taxed in the U.S. Diluted net income per share was $0.60 and included $0.08 per diluted share in restructuring charges under the company's New World Fossil program. Moving to the balance sheet and cash flow. Quarter end inventories were $398 million. That's up 11% to last year and puts us in a healthy position for Q4 and holiday.

We ended the quarter with over $300 million of liquidity. That includes cash and cash equivalents of $182 million and $123 million of revolver availability. Total debt was $139 million, including $122 million under our term loan credit agreement. Subsequent to quarter end, we successfully completed a $150 million senior notes offering and have used the proceeds to repay the borrowings under our term loan. Now turning to our outlook. We are raising our outlook for fiscal year 2021 and now expect to achieve net sales growth of 17% to 19% and adjusted EBITDA margin of 8.5% to 9.5%.

This reflects the anticipated net sales growth of 18% to 25% in the fourth quarter. As a reminder, our outlook assumes prevailing currency rates. As we approach 2022, favorable category and channel dynamics, continued execution of our strategic priorities and an improved capital structure provide us with confidence in our ability to continue driving profitable growth. Now I'll turn the call back to Christine to take us through some questions.

QUESTIONS AND ANSWERS

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

Thanks, Sunil. Let me run through a few questions that we've been getting from investors. I'll start with Kosta. We heard in the prepared remarks that traditional watch outpaced connected watches in Q3. Can you share more about your outlook on both of these categories?

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

Sure, Christine. First of all, in traditional watches, our analytics are showing that the overall category is healthy and growing. We're seeing strong growth in all 3 of our regions, with brand performance varying by market. The Kors and Fossil businesses are both doing quite well in the Americas and also surprisingly strong in Europe, considering the closures we've seen in the region. In Asia, our Emporio Armani business has been a consistent grower for us, especially in China. In India, as the market opens up, we are seeing increasing activity in the category, especially in our Fossil and Emporio Armani brands.

We believe the long-term market potential for traditional watches is significant in Asia, given the growing number of emerging customers who have a strong affinity for brands, watches and accessories. Broadly speaking, the traditional watch business is a growing category. And we're well positioned across brands, product categories and geographies. From a near-term perspective, we are approaching holiday with product innovation, healthy inventory levels and increased margin spend to drive awareness and sales.

Smartwatches is also a fast-growing category. Over the past 12-plus months, we have executed on our strategy to prioritize key brands and digital channels. We successfully worked through our older generation product last year and brought innovation to the market in 2021. We are seeing positive consumer response to the improved functionality and performance of our latest Gen 6 product, which was launched in September. So we'll have more features and greater functionality coming to market in 2022 when we introduce an advanced version of Google's Wear OS in the market. At a high level, we've made good progress on realigning our strategy, and we're well positioned to drive improved performance next year.

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

Thanks, Kosta. Greg, how are you thinking about brick-and-mortar versus digital over the next few years? What does the optimal mix look like? And what percentage of sales do you ultimately want to do in the wholesale channel?

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

Thanks, Christine. First, I believe that we've reached an important inflection point, where the watch category has strong consumer engagement, again, which is providing a broad-based lift across channels. Our digital-first strategy, in particular, is also now at a point where the combination of our progress on digital sales, plus positive comp performance in top brick-and-mortar locations has created a growth story in traditional watches that we see as sustainable. As mentioned earlier, digital sales penetration is currently 40% of total revenue, growing 28% year-over-year and doubling over the same period in 2019.

We expect digital sales to represent at least 50% of sales over time as we continue to invest in our digital teams and in the technology, content and analytics capabilities to support them. Second, when we talk about digital, we aren't just referring to channels of distribution. The capabilities we've built and continue to build out in digital include the disciplines needed to convert at high rates in e-commerce, on global online marketplaces and in supporting our wholesale accounts with online sales.

But also includes how we build brands, launch new products and create category heat online and through social and digital marketing channels with compelling content. How we use proprietary analytics to identify fashion trends and then quickly respond with new products enabled by a quick response supply chain we've geared up for digital. And how we integrate online and physical shopping tools to create great customer experiences and engagement with our brands. And the combination of these digital capabilities is driving digital sales growth, but also reinvigorating brick-and-mortar sales as well and together, creating a net positive growth trend we expect to continue for the foreseeable future.

The last point I'd like to hear is that the wholesale channel in our own brick-and-mortar locations remain core to our growth strategies. In both instances, the optimization of our portfolio over the last few years has brought us to a point where the remaining stores are much more productive. And in both wholesale and our own brick-and-mortar stores, the attention is now on creating engaging shopping experiences that merge our digital capabilities with the benefits of physical shopping and store associate interactions that you can only get in store.

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

Thanks, Greg. Jeff, there's a significant amount of discussion these days regarding disruptions in the supply chain across many businesses. This is happening from ocean container delays to port congestion and onto the lack of truckers to clear the ports and deliver product to retailers. How have all the various supply chain issues impacted Fossil's business, particularly as we enter the holiday season?

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

So we're not fully immune from the supply chain issues you mentioned, Christine. We are fortunate these issues are not nearly as serious here at Fossil Group as they are at many other companies. As Kosta mentioned earlier, we benefit greatly from the actual dimensions of our product as nearly 90% of our product line is relatively small in size, and the vast majority of our products are shipped by air. The combination of relatively small dimensions and solid AURs, average unit retails, means that our watches, smartwatches and jewelry can be packed and shipped very efficiently via air, largely avoiding much of the port and trucking disruptions you mentioned.

We have added additional time to our delivery schedules, and we have incurred additional costs as we've shifted to more air versus ocean freight. But to put some dimension on the cost impact, shipping disruptions actually started in 2020 to absorb some of the shipping cost increase last year. The incremental freight cost for the past 2-year period is estimated at several million a year. While we are never happy about these types of external incremental expenses, this low level of impact is manageable for a nearly $2 billion business.

Our most significant challenge is on delivery time for leathers, which is about 10% of our business. Leather ships primarily via ocean freight. And even with doubling the delivery times, we find ourselves getting our product just in time, not ideal, but again, it has been manageable so far. Overall, we feel very good about our current inventory levels and the flow of product with limited risk regarding the timing of leather deliveries. And we feel we are very well positioned to continue to meet consumer demand during this upcoming holiday season.

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

Terrific. That's helpful. Thanks, Jeff. Turning now to Sunil. Can you share a bit more color on the bond offering for us? What was the driver behind the offering? And how are you thinking about the capital structure as we go forward.

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

Sure thing, Christine. We issued $150 million in a public debt offering. The bonds are 5-year bonds that mature in 2026 and carry a coupon rate of 7%. The proceeds of the offering have been used to pay off our term loan, whose balance was $122 million at the end of the third quarter. We are pleased with the outcome of the transaction as we lowered our cost of capital, increased flexibility, reduced covenants and extended maturity, while maintaining a similar leverage profile of 1 to 1.5x gross debt to EBITDA.

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

Terrific. One last question for you, Sunil. How should we think about the puts and takes on the increased guidance you provided today? And can you comment on your thoughts around the longer-term growth algorithm for us?

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

Yes, sure. First, on the guidance. With 3 quarters under our belt, it's obviously about the fourth quarter. For Q4, our top line growth estimate of 18% to 25% is an acceleration from Q3's 13% sales growth. Versus 2019, however, Q4 is down 10% using the midpoint of our range, similar to Q3's results. We do expect some currency headwinds in the fourth quarter relative to the third quarter's tailwind based on prevailing rates. In terms of adjusted EBITDA margins, our full year guidance of 8.5% to 9.5% assumes a fourth quarter range of 10% to 12.5% or 11% at the midpoint.

The midpoint is slightly lower than our third quarter results as we are accounting for some seasonally driven gross margins that are historically lower in Q4 versus Q3. As for our longer-term algorithm, we expect to continue delivering net sales growth as we have not fully recovered to 2019 levels. In addition, key categories are growing, and the overall global outlook appears favorable. Also, we've demonstrated our ability to achieve leverage in the model as we rightsize the cost structure and continue to focus on driving efficiencies. With this combination, this will allow us to deliver expanding operating margins over time. As we finish off Q4 and finalize our plans for 2022, we look forward to sharing more specific guidance in our next quarterly call.

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

Terrific. Thanks, Sunil. Thanks, everyone, for the Q&A. I'm going to turn it back over to Kosta for closing comments.

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

Thanks for joining us for our call today, and I appreciate the interest in Fossil. We look forward to speaking with you on our next call for the end of the year, and have a good holiday. Thank you.

Operator

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