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PRESENTATION

Operator

Good afternoon, ladies and gentlemen, and welcome to the Fossil Group Third Quarter 2022 Earnings Call. At this time, all parties are in a listen-only mode. 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 the Blueshirt Group to begin.

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

Hello, everyone, and thank you for joining us today. With us 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'd like to remind you that information made available during this conference call consists of 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 delivered third quarter results in line with expectations and will continue to be a volatile and dynamic global operating environment. Net sales of $436 million decreased 5% on a constant currency basis, while adjusted operating margin came in at just over 5%. Our results largely reflect a continuation of the high-level trends we saw in the second quarter. Specifically, ongoing COVID policies in Mainland China continue to pressure sales in the quarter and wholesale inventories remain elevated, although lower than Q2's peak level. The record strength of the U.S. dollar impacted our top line by over 600 basis points and affected adjusted operating margins by 190 basis points. Remember that 65% of our sales are outside the United States. And finally, record global inflation continues to weigh on the confidence levels of our consumers and wholesale partners. While the level of macro-driven factors significantly impacted our overall financial performance, during Q3, we saw encouraging results from our strategic initiatives. Our digital initiatives are having a positive impact across our direct-to-consumer channels. Improved operational, marketing and analytical capabilities are driving broad-based improvement in traffic and engagement. In Q3, website traffic was up across our global websites and revenue was up versus Q3 of last year. Our digital marketing efforts are also driving improvements in engagement metrics, leading to better customer lifetime value. We have also leaned further into social commerce capabilities, particularly in China, which has partially offset the significant declines we've experienced in that market since the onset of COVID. Building out our social commerce capabilities is important as we see the potential for significant global growth in this channel for years to come. Progress in our Fossil brand strategies is also encouraging. Globally, in Q3, we grew Fossil brand sales in traditional watches, jewelry and leathers and comp retail sales increased double digits. Our fossil heritage launch has generated strong consumer engagement across our core categories with higher AURs. More importantly, it's an early preview of where elevation in our brand positioning through design aesthetic and marketing capabilities will allow us to reach our desired consumer segments better. In 2022, our brand collaborations have created energy for the brand, bringing traffic to our websites and stores and new customers into our customer file. Our most significant and most recent collaboration with Harry Potter is off to a great start as we approach the holiday season. As we enter Q4, we expect global operating conditions to remain challenging, and we continue to manage the business conservatively in this environment. These are a few of the things affecting us. Lux category is expected to see stronger growth in luxury segments, while the under $500 price segments will remain more challenged. We know the promotional environment is top of mind for everyone, especially as consumers look for value in today's inflationary environment. The wholesale channel continues to be cautious with open to buys and will likely sell down existing inventory before replenishing that historical rates. Globally, we expect some deterioration in consumer confidence in Europe and ongoing COVID restrictions in China will continue to hinder demand. Although the macro factors are challenging, we are continuing to execute our brand and digital strategies. Notably, in Q4, we will begin leveraging our new consumer data platform. With this initiative, we recently completed a significant rearchitecture of our first-party data and implemented best-in-class technology. This marks a major milestone in our 2022 digital road map. With this new capability, we are better positioned to capture new consumers to service our existing consumers and deepen personalization capabilities. We've also recently completed essential steps in other initiatives from our digital strategy that provide opportunities to drive sales in Q4. These include our revamped outlet.com strategy for the Fossil brand and introducing new global payment options. During the past few years, our teams have navigated a challenging external environment, and we have become a more focused and nimble organization overall. Looking through Q4 and into 2023, we expect that the global operating environment will remain challenging and take time to improve. We will be taking a hard look at all aspects of our worldwide distribution and have already taken significant steps to reduce our SKU count by over 30% in 2023. These types of actions will drive efficiencies in our product, distribution and overhead costs. Further simplification in our business model will allow for sharpened focus and allocation of resources on our core growth strategies. Our 2023 digital road map is clear and furthers our objectives to transform into a digital-first company that creates category heat and meets our consumers' needs wherever they are. Having conducted a full review of our Fossil brand in 2022, our brand plans are now anchored in an updated strategy, encompassing refreshed demographics, category, channel and marketing insights. In fiscal 2023, we plan to begin implementing initiatives around this updated strategy to drive top line growth and brand heat. More to come on that in the next quarter. We have built tremendous brand equity over our nearly 40-year history, and it is clear we have an opportunity to leverage and build upon the hallmarks of our great brand. As we head into our seasonal peak period, we are grateful to our teams and associates around the world for their creativity and dedication to building upon Fossil's legacy of designing and creating products that bring joy to consumers. Now I'll turn the call to Sunil to review the financials and share our outlook for Q4.

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

Thanks, Kosta, and good afternoon, everyone. I'll first start with a review of our third quarter results and then provide an update to our full year outlook. While top line trends were challenging, better event management helped us achieve adjusted operating margins that were in line with our expectations for the quarter. Net sales came in at $430 million, down 11% year-over-year and adjusted operating margins were 5.3%. In constant currency, net sales were down 5% and adjusted operating margins were 7.2%. At a high level, 3 things are worth noting about the quarter. First, FX rates were more impactful to our results in Q3 versus prior quarters. In the quarter, FX rates contributed 610 basis points of headwind on our top line and were about 100 basis points greater than our expectation at the beginning of the quarter. The record strength of the dollar relative to other currencies also impacted our operating margins by approximately 190 basis points, primarily in gross margins. When thinking about the FX impact on our operating margins, it's important to remember that approximately 65% of our revenue comes from outside the U.S., while 55% of our expenses are based outside of the U.S. As a reminder, our hedging programs are designed to hedge a portion of our transactional U.S. dollar-based inventory purchases and not our underlying operational cash flows. The second factor of note, our constant currency sales decline of 5% continues to be most notably impacted by sales declines in Mainland China, where COVID-driven policies and travel restrictions have impacted our demand. In the quarter, sales in Mainland China were down 44% versus last year. Excluding the sales decline in Mainland China, our total net sales in constant currency were flat versus last year. Third, Q3's net sales benefited from about $10 million from some early shipments originally planned for Q4 and about $5 million from an acceleration in recognition of deferred revenue from 2023. With that backdrop, let me break down our sales by region. Net sales in the Americas region were down 4% in constant currency. Our 2 largest categories, traditional watch and leathers, were up 1% and 17%, respectively, but were offset by sales contraction in the smartwatch category. DTC channels in the region grew by 8%. Comparable sales grew by 11%, with comp sales growth in both retail stores and e-commerce, primarily driven by traffic improvements versus the prior year period. From a wholesale perspective, net sales declined 10% in constant currency in the region. As Kosta noted, many of our wholesale partners entered the quarter with elevated inventory levels compared to last year, which continued to pressure the rate of replenishment orders. Sellout trends in the channel were down 6% versus last year. Exiting the quarter, inventory levels at our largest wholesale partners have come down relative to the start of Q3, but are still higher than last year. Wholesale shipments in the quarter benefited from the timing of shipments that were originally scheduled for the fourth quarter. Moving to Europe. Constant currency sales were flat versus last year. Our 2 largest categories, traditional watch and jewelry, performed well with net sales growth of 4% each. Comparable DTC sales in the region were up high single digits, driven by better inventory positions and increased promotional activity. Sales from our wholesale channel were flat versus last year as we shipped holiday goods for key wholesale accounts earlier than last year. In Asia, sales were down 17% in constant currency, primarily impacted by sales in Mainland China, which were down 44% versus last year in constant currency. In addition, other markets that have historically benefited from mainland Chinese tourists, such as concessions in Korea and travel retail throughout the region, were also down compared to last year. Outside of these markets, we saw revenue growth consistent with Q2, and we're pleased with the wholesale trends that we saw. Sales in India, our other strategic market in Asia, remains strong as our net sales dollars in constant currency were sequentially better than the second quarter. Q3 comparisons to the prior year, however, were negatively impacted by post COVID knock back in Q3 of 2021. Year-to-date net sales in India are up double digits in constant currency. Moving from regional performance to a channel lens, our global direct-to-consumer channels were up 5% in the quarter. Global comparable retail sales, which includes our retail stores and owned websites, were up double digits with growth in each region, while sales in other direct-to-consumer channels like concessions were down. Global store count ended at 344 stores, down 30 stores versus last year. Net sales in our wholesale channel were down 9% versus last year in constant currency. Declines were most notable in Mainland China as well as the U.S. market where many wholesalers are constraining open to buy in order to sell through existing inventory. Across all of our global distribution channels, digital sales, which we define as sales on our own e-commerce sites, global third-party platforms and wholesale.com, were down 12% versus last year and represented approximately 37% of our total sales mix. Important to note that we saw growth in our owned website in wholesale.com, but that was more than offset by a decline in sales on third-party platforms. Turning now to category performance. In Q3, traditional watch sales decreased 4% in constant currency, sequentially improving from the prior quarter's growth rate. Category sales were most impacted by Mainland China sales as previously mentioned. Excluding Mainland China, traditional watch sales were up 2%. Globally, traditional watch sales in the Fossil brand were also up 2%. Net sales dollars in our smartwatch category were $33 million, sequentially flat to our prior quarter's volume, but down 34% in constant currency versus last year. Results versus last year reflect lapping prior year's Gen 6 launch and generally soft underlying demand trends. Q3 net sales in our jewelry category decreased 9% in constant currency as increased inventory levels and wholesale accounts in the Americas and in Mainland China weighed on quarterly results. Fossil branded jewelry continued its strong growth, anchored by a strong direct-to-consumer selling. Net sales in our leathers category increased 17% in constant currency as improvements in our stock positions drove better selling in our DTC channels. Moving down the P&L. Third quarter gross margin was 50.3%, down 250 basis points versus 2021. The year-over-year decline is primarily attributable to 4 factors: approximately 130 basis points of higher freight costs as both ocean and air freight rates were up versus last year, 130 basis points in FX driven higher inventory costs in our European and Asian subsidiaries due to a stronger U.S. dollar this year versus last year, increased promotional commitments and outlet channels and a lower China sales mix, which carries significantly higher product margins compared to our other markets. These headwinds were partially offset with gains from our currency hedging contracts and a more favorable product mix. Turning to expenses. Total operating costs were $197 million, down 7% versus last year. Impairment and restructuring costs were down versus last year as we wound down costs under the New World Fossil 2.0 transformation program. Operating expenses as a percentage of sales were 45.2%, up 220 basis points versus last year, primarily due to lower sales. SG&A costs, which includes impairment and restructuring costs, were $197 million, down 4% versus last year. The increased expense rate reflects higher labor costs, investments in our digital initiatives, and the nonrecurrence of onetime prior year store gains from early lease liability terminations, which were only partially offset by reduced store operating costs from lower store count and lower performance-based compensation costs. Q3 operating income was $23 million compared to operating income of $48 million in the year ago period. Operating margin was 5.2% compared to 9.7% last year. Adjusted operating income was $23 million compared to adjusted operating income of $54 million last year. Adjusted operating margin was 5.3% versus 10.9% last year. FX rates impacted overall operating margins by 190 basis points. Q3 earnings per share was $0.11 compared to $0.60 in the prior year period. Looking at the balance sheet. Inventory balances at the end of Q3 were $453 million, up 14% versus last year. As noted in our prior call, our flow of inventory into our warehouses was accelerated in Q1 and Q2 of this year as we worked around extended transportation lead times and mitigated potential COVID-driven restrictions from our primary supply base in Mainland China. In Q3, our inventory flow into our warehouses was down significantly versus last year, and we continue to manage this more conservatively as we work down our inventory balances. Our Q3 ending cash balance was $163 million, and we had $50 million available under our revolving credit facility. Subsequent to the end of the quarter, we amended our existing $225 million revolving credit facility, extending the term by 3 years. The amended facility now matures in November 2027 and carries the same interest rate structure other than the required transition from LIBOR to SOFR. Now turning to our outlook for fiscal 2022. Heading into Q4, we continue to maintain a cautious outlook on global consumer demand and our guidance assumes that global operating environment remains challenging. While our third quarter results were within our expectations for adjusted operating margins, we are updating our annual guidance driven by our top line outlook for Q4. For Q4, we are forecasting net sales between negative 8% to negative 17%, or negative 13% at the midpoint. Our outlook reflects 3 primary factors: first, prevailing FX rates are estimated to have a 500 to 550 basis point impact on our top line in the quarter. Second, the timing of shipments that were planned for Q4, but shipped during Q3 accounts for about $10 million or approximately 2 points of impact to sales in the quarter. Third, we anticipate that persistent macro headwinds will result in softening of the demand trends that we saw in Q3 in each of our operating regions. Taking these factors into account, we now expect full year revenue to be in the range of negative 7% to negative 10%, down from our previous guidance of negative 5% to negative 8%. On a full year basis, our revenue guidance includes an estimated foreign currency negative impact of approximately 500 basis points compared to our prior estimate of 450 basis points. Excluding the impact of FX, our revised outlook is down 2% to down 5% on a constant currency basis. From an adjusted operating margin perspective, we are tightening our forecast to be in the range of 2% to 3% for the full year compared to our prior guidance of 2% to 4%. Our adjusted operating margin guidance assumes gross margins that are lower than last year, given the expectation for increased promotional activity and also contemplates a reduction in previously planned expense investments in the quarter. With that, I'd now like to 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's move to some questions. I'll start with Kosta. Can you please take us through your view of the watch category at a high level and then talk about how Fossil's performance stacks up relative to what's happening in the market?

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

Well, there continues to be a lot of change in the overall watch market. The Swiss watch business continues to be strong and the upper end of our price points are actually selling better than the lower prices. So we're seeing that in Michele, which is showing strong growth overall and in our Zodiac brand. We're seeing it in the upper end of styles of cores, which are around the $500 price point. We're also seeing it in Fossil where our new elevated heritage product is doing extremely well. In smartwatches, trends have been challenging with softer consumer demand. Overall, the Fossil brand is doing very well, especially in our DTC, and we expect this to continue as we implement the additional digital capabilities over the next few months. India continues to be very strong for us and is a significant long-term opportunity. China is still difficult, but our indications are that we're holding share in the market. Meanwhile, we are testing new channels and digital methodologies in China and are in a position for growth when the market stabilizes, but the long-term opportunity is obviously very significant.

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

Great. Thank you, Kosta. Over to you, Jeff. Kosta mentions that the team is sharpening its focus on capturing efficiencies. Can you talk to us about how you see that unfolding in 2023 and where you might be looking for opportunities?

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

Sure, Christine. There are 4 main areas of focus for our ongoing efficiency efforts as we exit this year and we enter 2023. One, inventory and SKU productivity; two, freight and distribution efficiencies, 3 store portfolio profitability; and fourth, overall spending optimization. Regarding inventory productivity. We are reducing the breadth of our SKU base by about 30% in traditional launches beginning in 2023, as Kosta mentioned previously. At the same time, we are also shortening the lead times on our most productive SKUs in this category. These efforts will help improve our forecast accuracy, better meet consumer demand and reduce our overall product costs. Our second area of focus is freight and logistics. Given the combination of recent supply chain disruptions and the small cube size of our products, we currently ship about 90% of our product via air freight. We are seeing reductions in air freight and ocean rates, which is an indication that supply and demand are becoming more balanced and rates should continue to contract in 2023. In addition, as the ocean freight channel normalizes, we have opportunities to move a portion of our inbound receipts to this more efficient logistics channel. Third, we continue to analyze our store base to improve our DTC channel profitability. This year, fiscal '22, we'll close about 36 stores or about 10% of our store base, further reducing our direct channel operating expenses. Our store optimization program will continue into next year. We have a significant number of natural lease expirations coming up next year and expect to take advantage of that opportunity to rationalize another 15% to 20% or so of our store base focused on low-performing stores. This action will further reduce our direct operating expenses. Fourth, we continue to rationalize our overhead spending levels through a combination of simplifying our organizational structure as well as moving support functions to lower-cost locations, such as India, where we currently have about 400 associates located in our global business services center in Bangalore.

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

Terrific. Thank you, Jeff. Greg, could you please elaborate on the progress you've made on the digital road map this year and talk about some of the strategic initiatives planned for 2023?

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

Absolutely. As you've heard us share previously, in 2022, we focused on 3 core pillars within our digital journey. First is shoring up our direct-to-consumer foundation; second is building a marketing analytics powerhouse, third is enabling our teams to transform through digital tools and education. Within the first pillar, shoring up our DTC foundation, we have put a ton of work in improving our sites in meaningful ways for our consumers. This includes things like reducing how long consumers have to wait for our sites to load, improving on-site navigation and filter functionality and enhanced product sets and displays. Excitingly, we have also recently added Klarna as our global payment partner, offering our consumers even more ways to buy and pay online. Within pillar 2, from a marketing and analytics perspective, we've seen incredible growth in social commerce. In China, for example, social selling is driving nearly 1/3 of all sales in some of our biggest brands. We're leaning into this innovation in North America as well, where we've integrated live commerce capabilities into fossil.com and have completed over 15 shows this year. This includes a recent Harry Potter collaboration hosted by castmates from the films. The marketing work hasn't all been front end. As you've heard Kosta share, we've also just launched our new consumer data platform. This is important because for the first time, we had a unified source of data across all segments and channels to more effectively target and personalize our content and offers to consumers. This unlocks a huge opportunity for us in the CRM space, but we are particularly excited about getting insight into consumer behavior prior to the behavior happening, as well as the ability to better engage our active and lapsed consumers. Last but not least, it continues to be very important for us to bring our employees along with us in this digital journey. In addition to creating opportunities for our consumers, we've also invested on our teams, growing our footprint to over 120 digital experts globally, enabling agile development processes, activating A/B testing at scale across sites and marketing channels as well. So as we look to next year, expect us to drive return on investment from all of these recent investments we've made this past year and build on those successes, deepen personalization and continue to innovate around how and where we participate in the ever-evolving digital ecosystem.

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

Thank you, Greg. We'll wrap up with a question for Sunil. We're seeing inventories continue to grow faster than sales. What are you doing to improve turns? How should we think about working capital levels in Q4 and into 2023?

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

Thanks, Christine. Yes, our inventory levels and those of our largest wholesale customers are a key focus for us. As we mentioned, our inventory levels at the end of Q3 were up 14% versus last year, which is too high relative to our sales forecast. While the inventory levels are higher than we would like, our business model carries less seasonal risk than many other apparel or accessory brands. That said, we are focusing on a few things heading into Q4 and into 2023. First, with seasonally higher demand levels in many parts of our global distribution channels, we will lean more into temporary promotions to sell down select inventory throughout our global distribution network. Second, we are working closely with our factory partners on several initiatives to reduce manufacturing lead times, which has resulted in many of our core products operating on shorter lead times. That allows us to place orders later and closer to demand signals and recalibrate our inventory ordering levels. Third, as Jeff mentioned, we have reduced our active SKU assortment, which helps us drive better turns in our overall assortment. The combination of these activities lowers our overall expectation for working capital needs with material drops in inventory levels versus Q3 levels as we wrap up the fourth quarter and as we head into the first quarter. Longer term, we think these initiatives should lead to lower structural levels of working capital in the model and improve cash flow.

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

Terrific. Thank you. I'll just turn it back over to Kosta to close us out with some final comments.

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

Well, thanks for joining us for this call, and we look forward to speaking with you again early next year for our Q4 call. Thanks very much.

Operator

This concludes today's conference call. Thank you for participating. You may now disconnect. Everyone, have a great day.

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