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Q2 2023 Fossil Group Inc Earnings Call

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PRESENTATION

Operator

Good afternoon, ladies and gentlemen, and welcome to the Fossil Group Second Quarter 2023 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 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; and Sunil Doshi, Chief Financial 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, 10-Q and 10-K 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 on Form 8-K and is available in the Investors section of fossilgroup.com.

Now I'll turn the call over to Kosta to begin.

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

Thanks, Christine.

The first half of 2023 has proved challenging, affected by macro challenges and choppy demand trends resulting in softer than expected Q2 performance. Q2 net sales declined 13% as we saw continued headwinds in our wholesale channels in the Americas and Europe and a slower recovery in Greater China. Comp retail sales remained healthy with 3% growth, primarily from our own dot-com sites, where much of the benefits from our digital transformation are bearing fruit. We continue to make progress on our growth initiatives, and we'll be activating several of these for Q4 selling that will expand into next year.

Many of the macro challenges we saw in 2022 have continued into this year, most notably a cautionary tone among our wholesale partners, especially in the Americas and Europe. In addition, our smartwatch business has continued to underperform. Despite these challenges, we need to improve our financial performance, and we are taking decisive action to do this and put the company on a path toward elevated and sustained profitability.

We are announcing new initiatives under our previously announced Transform and Grow plan and undertaking a comprehensive 3-year transformation program. We will do this work in partnership with Alvarez & Marsal which has an exceptional track record of leading in retail and consumer business transformations.

Together, we will leverage the company's critical assets as we work to reignite growth on the top and bottom line. We have deep roots in the watch industry, a legacy brand with tremendous equity and a committed team that is being further enhanced by the expertise of a best-in-class external resource.

Before taking you through our detailed plans, let's take a few minutes to talk about where we've been in the recent quarters.

In the past few years, we have seen many headwinds with softness in the traditional watch market and ongoing unplanned declines in our smartwatch business. So far in 2023, the wholesale channel in the Americas and Europe has been difficult as stores have underinvested in the watch business. While we expect this channel to level out over time, the near-term impact has pressured our operating results. And lastly, China's reopening has been slower than anticipated through the year's first half.

In March of this year, we introduced our Transform and Grow plan designed to reduce operating expenses, improve operating margins and advance the company's commitment to profitable growth. We have been making steady progress with TAG, but we recognize the need to do more and acted with a sense of urgency, taking steps to drive accelerated change.

Specifically, during the second quarter, we engaged Alvarez & Marsal to assist us with developing a more comprehensive transformation plan that expands beyond tech. This new plan greatly expands the scope of work and goes beyond operating expense reductions to include aspects of the business that we had previously not included.

This expanded project will better tackle gross margin and increase our scope in operating expenses, ultimately driving operating income benefits for our business. Indeed, we now expect to capture $300 million of annualized operating income benefits over the next 3 years. As you'll hear today, we are on a definitive path to rightsize our operating model in tandem with reigniting top line growth.

We believe this new plan positions us to return to gross margins in the low to mid-50s range and is critical to helping us achieve our longer-term goal of approximately 10% operating margins.

As we begin this important work, we decided to establish a transformation office comprised of key members of our organization and the A&M team. Establishing this office leverages our joint capabilities to drive meaningful change in progress.

Five key principles are guiding the transformation. First, we are leading with a digital-first approach. After several years of investment, we have built a robust digital infrastructure and our team is operating with a digital-first mindset. Next, we are acting with speed and precision, and it is gratifying to see our teams embrace the opportunity in front of us. And third, we are prioritizing shareholder value creation. We recognize the transformation we're undertaking will take time, but we are committed to getting it right to create value for all stakeholders. Moving to number four, the strategies under our transformation are grounded in preserving our meaningful brand ethos and heritage in the watch industry. And lastly, as we evolve our operating model, ensuring we embed agility into everything we do is critical.

With that backdrop, let's discuss the dimensions of our expanded Transform and Grow plan which comprises of 3 major focus areas. These include driving sales productivity, reengineering end-to-end operations to drive gross margin expansion and generating overhead cost reduction and capital efficiency.

The first two areas are new and directly results from the rigorous and comprehensive review we undertook this past quarter. Importantly, we have identified and begun work on tactical initiatives within all 3 focus areas.

We have identified meaningful opportunities to improve our existing sales productivity. We will be driving value through pricing and adjusting many of the historical pricing practices that remained in place for many years. We will also optimize our product assortment and mix, enabling us to invest behind fewer and higher impact stories. And lastly, we will implement initiatives to improve our store productivity, particularly in our outlets.

On the second focus area, we will reengineer end-to-end operations to drive gross margin expansion. With a greater focus on fewer products done well, we will undertake a more meaningful change to our end-to-end business operations. This starts with an integrated approach to business planning and naturally extends through redesigning our supply chain and sourcing practices. Also included is the continuation of our store rationalization program.

Our third focus area is generating overhead cost and capital efficiency. In large part, we began this work earlier this year as part of our initial $100 million program which remains on track. Our work has uncovered incremental savings opportunities as we rightsize our overall expense structure to reflect a smaller and more nimble company.

Our extensive work in recent months to identify these opportunities gives us confidence that we have ample runway to achieve our goals. The actions I just described are expected to result in a gross margin profile in the low- to mid-50s range and to help us achieve our long-term goal of 10% operating margins.

At the same time, our teams are focusing on our most compelling growth opportunities designed to recapture growth and drive the top line, all of which are underpinned by the extensive digital marketing and tech capabilities we've built in recent years.

As a reminder, our key growth pillars include revitalizing the Fossil brand, maximizing our core licensed brand portfolio in watches and jewelry and growing our premium watch offerings. We're continuing to progress against these opportunities. And as the TAG plan takes shape, you can expect us to reinvest in these areas.

We recognize that transformations like this take tremendous discipline and focus. We are committed to providing updates on our transformation and growth plan in the upcoming quarters. And finally, I want to thank all of our Fossil teams worldwide for their significant efforts to improve our business overall.

And now I'll turn the call over to Sunil to take us through the financials.

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

Thanks, Kosta, and good afternoon, everyone.

Our second quarter results came in below our expectations as we continue to see challenges in our Americas and Europe wholesale channels, a slower recovery in Greater China and increased promotional mix which pressured our gross margins.

The Q2 impact of foreign currencies on our P&L was in line with our expectations and included a 60 basis point headwind to our reported sales, a 110 basis point headwind to gross margins and a 140 basis point headwind to operating margin.

Starting with sales. Global sales in constant currency were down 13%. About 5 points of the decline can be traced to 2 factors: a decrease in our smartwatch category as we've reduced emphasis on the category and also store rationalization initiatives.

Sales into the wholesale channel represented our biggest headwind and were down 19%. In contrast, comparable retail sales grew 3%, primarily reflecting a double-digit increase in our own e-commerce sites. I'll walk through sales results in each region in more detail to highlight key drivers of performance.

First, in the Americas. Net sales were down 13% in constant currency. Sales into the wholesale channel were down 23% which was in line with our expectations for the quarter and sequentially better than Q1. The underlying sell-out as reported by our major wholesale accounts was down approximately 7% versus last year in traditional watches, consistent with the first quarter. And we exited the second quarter with retailer inventory down over 20% versus last year.

Looking at the second half, our expectations for Q3 remained conservative, and we expect sales into the channel to continue to lag underlying sellout rates. We are working closely with our wholesale partners to drive better sell-through with assortment edits and promotions, and we believe this will create more open-to-buy opportunities heading into Q4 peak selling.

Our direct-to-consumer channel remained healthy in the region but slowed sequentially from the first quarter. Comparable retail sales were positive, driven by double-digit gains in e-commerce, while store comps were down low single digits. We ended the quarter with 146 stores this year, down 7% versus last year.

In Europe, total sales declined 19% versus last year. Sales into our wholesale channel were down more significantly and came in below our expectations with heavier destocking than planned. Within the wholesale channel, our underlying sellout decreased approximately 14% in traditional watches. Although inventory levels in the trade have moderated versus the first quarter, we expect Q3 wholesale sales to be similar to Q2 as key accounts continue to work down their inventory levels.

In our direct-to-consumer channels, comparable retail sales grew double digits with positive comps in both stores and owned e-commerce. We ended the quarter with 92 stores, down 19% versus last year.

Sales in Asia were down 5% in constant currency versus the prior year quarter. As we have previously communicated, we have 2 primary focus areas in the region: reigniting sales in China and continuing to drive sales growth in India.

During Q2, sales in India increased slightly by 1% and were in line with our expectations. Sales in Mainland China, however, declined 7% on a year-over-year basis. While the trend was sequentially better than Q1, our current trend in China has pushed our overall growth expectations out to Q4.

We have made adjustments in our go-forward inventory mix and marketing tactics heading into Q4, which we expect to help us to drive growth in that market. From a brand lens, the Fossil brand is performing better than the balance of our portfolio. The most consistent performing category in Fossil brand is traditional watches, which increased 1% in Q2 and has grown 2% year-to-date. We are also encouraged by progress in the brand's leathers and jewelry categories where comparable retail sales performance has been positive, a good indicator that we are on the right path with our initiative to drive consistent growth in our largest brand.

Looking at our largest licensed brands, Kors, Armani and Diesel, we were down versus last year driven by the outsized sales declines in our wholesale channel in the Americas and Europe regions. In Asia, we have had steadier performance across the region.

Moving down the P&L. Second quarter gross margin was 48.7%, down 290 basis points versus last year. Gross margins included a restructuring charge of approximately $3 million or approximately 90 basis points of impact for certain costs attributable to our Transform and Grow program and approximately 110 basis points of headwind from FX rates, as I mentioned earlier.

Excluding these costs and the impact of FX rates, gross margin was 50.7%, down about 90 basis points versus last year. The decline in gross margin generally reflects a higher promotional mix in our sales, partially offset by lower freight costs.

Total operating expenses were down 5% versus last year. Restructuring expenses were approximately $5 million, primarily related to severance costs in conjunction with our Transform and Grow program. Excluding restructuring costs and impairments, SG&A was down 6% versus last year. This reflects reductions in fixed costs, partially offset by variable cost increases associated with revenue growth in our direct channels and higher marketing spend related to growth initiatives in our TAG program.

Taken together, Q1 operating loss came in at $35 million compared to an operating loss of $11 million in the year ago period. Adjusted operating loss was $28 million and adjusted operating margin was minus 8.6% which includes the FX-driven headwinds of 140 basis points that I previously mentioned.

Turning to the balance sheet. We made good progress managing our inventory and working capital. Q2 inventory ended at $324 million, down 26% from last year's levels, while overall working capital was down approximately 12% versus the prior year quarter. The improvement in working capital enabled us to significantly reduce operating cash use in the first half of the year versus the prior year. Ending cash was $132 million, and we had $73 million of availability under our revolving credit facility.

Turning now to our outlook. As we look to the balance of the year, there are two overarching updates that we would like to share. First, I'll walk through our updated outlook for the year. And second, I would like to share additional color on the expanded Transform and Grow plan.

First, we are revising our full year outlook for sales and adjusted operating margin. Our full year sales outlook is estimated to be in the range of down 5% to down 10% and adjusted operating margin in the range of minus 2% to minus 4%.

Let me outline some specific assumptions that are embedded in our outlook. We anticipate that net sales declines in Q3 will be similar to our year-to-date trend. This includes expectations for wholesale declines in the Americas and Europe, similar impacts from our store closures and reduced emphasis on smartwatches, partially offset by growth in global comparable retail sales. Our guidance reflects a sequential improvement from Q3 to Q4 and includes approximately 350 basis points favorable impact from prevailing FX rates.

Notwithstanding the FX impact, the estimated sequential improvement in trend from Q3 to Q4 is expected to be driven by 3 primary factors. In Q4, we are lapping prior year's constant currency sales decline of 12%. In contrast, in Q3 of this year, we are lapping the prior year's constant currency sales decline of 6%. Second, we expect to return to positive sales growth in China in Q4. And third, we have significant product and marketing initiatives contemplated in our broader Fossil brand growth strategy. And we are delivering newness in our premium watch offerings for Q4, supported by increased marketing.

From an adjusted operating income margin perspective, our outlook reflects a negative adjusted operating margin in Q3 with a low single-digit positive adjusted operating margin in Q4. Please note that Q3 gross margins will include approximately a 180 basis point headwind related to a change in accounting related to the timing of certain product royalty expenses. The offsetting benefit from this change was realized in Q1 of this year.

Now turning to some additional commentary on our Transform and Grow plan. Building on Kosta's comments, we made meaningful progress in our Transform and Grow plan.

First, we continue to execute on the plans that we outlined in our last call. We are on track to achieve our $100 million in annualized operating income benefit by fiscal year 2024 and currently estimate that approximately 50% of the annualized operating income benefits will be captured in the current year.

As a reminder, the benefits realized in fiscal year '23 are enabling us to reduce operating expenses, offset underlying inflation in our expense base and reinvest into our growth pillars. We have deferred the timing of some store closures from '23 to 2024 due to generally favorable terms realized on short-term lease renewals, and the revenue, margin and expense from these stores are included in our updated guidance.

Second, as Kosta noted, we have completed a comprehensive review of our business model, which highlighted that we have an opportunity to drive more significant operating income benefits through our transformation program. With this wider scope, we have increased our program size to $300 million, which includes the original $100 million in expected benefits we outlined in March.

From a P&L perspective, our efforts are expected to not only reduce our operating expenses but also drive significant improvement in our gross margins. Although we are in the early days with this expanded effort, our objective is to capture the entire $300 million in annualized operating income benefits by the fourth quarter of 2025.

The total benefits of the program will help improve gross margin, reduce operating expenses and enable reinvestment into our growth pillars as well as offset underlying inflation and revenue declines from business exits. Ultimately, we view this expanded program as a key enabler for us to achieve our longer-term financial goal of 10% adjusted operating margin. We look forward to updating you with more details of the program and future earnings calls.

With that, I'd like to turn the call back over to Christine to take us through some questions and answers.

QUESTIONS AND ANSWERS

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

Terrific. Thank you, Sunil. Kosta, could you tell us how you're thinking about the probability of success here? What gives you confidence that the organization can execute against this transformation and achieve all of the goals that you laid out for us today?

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

Well, this is a robust transformation plan that touches multiple dimensions of the business. And we've developed a detailed multiyear project designed to retool the company for efficiency and growth. With A&M's team working closely with ours over an extended period of time, we'll be able to tackle opportunities in the company that can unlock significant improvements in profitability that will enable us to focus more on investing in growth.

We will always be mindful that the key to our future is innovation and branding, and this project will enable us to invest more significantly in driving brand awareness and product excitement. And more importantly, our teams are aligned with our objectives focused on delivering superior execution and energized by the opportunity to win as we work collectively to transform and grow the business.

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

Thank you. Moving over to Jeff. Could you take us through the key elements of your end-to-end optimization program? Where do you see the greatest opportunity there?

Jeffrey N. Boyer ***Fossil Group, Inc. - Executive VP & COO***

Sure, Christine. There are there key focus areas under this pillar of our expanded TAG program. The first area is inventory management, the second is sourcing and the third is our supply chain. I'll start with inventory management.

Historically, we have often had conflicting sales and demand plans, have taken a spread the risk approach when it comes to planning and allocating inventory. The result is often too many SKUs spread too thin to appropriately support growth opportunities.

Going forward, we're working on enhancing our merchandise spending capabilities, including improvements to the company's assortment planning and life cycle management processes, which will enable better focus and depth on critical SKUs and improve overall SKU productivity.

Also, we're taking actions to improve alignment and effectiveness of our various planning functions. And where beneficial, we'll use technology and analytics to improve the demand-sensing capabilities, increase the new product introduction success rate and develop stronger planning integration.

Next, on sourcing. We have a solid portfolio of vendors and suppliers located primarily in Asia. For many years, we worked mostly on a relationship basis given the maturity level of our manufacturing base.

As we look ahead, we'll be evolving our approach to partner with them on a more analytical and data-focused costing program. Given underlying material costs and productivity trends, we see opportunity to improve profitability for both our suppliers and for Fossil Group.

We also believe we have a number of opportunities to improve our procurement process to ensure we're obtaining the lowest cost and various components within our traditional watch business and in other categories. And finally, we'll be expanding our sourcing options to look at other areas of the globe for lower-cost products and assembly support.

Lastly, in our supply chain function. We see a number of opportunities to optimize operations and logistics and within our DCs. There are three major dimensions: first, optimizing our shipping lines between air and ocean channels. During COVID, we defaulted to air shipments to ensure on-time delivery given ocean and port issues. As volatility in the shipping channel has abated, we can shift a portion of shipments back to ocean freight for material savings, which is incremental to the current federal rate trends we're seeing in both channels.

Second, our internal DCs operate with solid productivity, but we believe there is opportunity to capture another 5 to 10 points of productivity improvement through further consolidation of providers and internal productivity programs.

Third, we provide a significant level of value-added services for our wholesalers and third-party e-com customers as well as the end consumer. We'll be increasing fees to cover the higher cost of these value-added services, such as drop ship and engraving.

In terms of savings opportunities, Christine, sourcing has the most significant opportunity, given the underlying dynamics I mentioned earlier. We expect to see 5% to 10% savings on our product spend levels as we execute our planned initiatives. Better inventory management is expected to deliver the next level of savings starting in 2024. There are sizable savings forecast for this program and are estimated at approximately 50% of the sourcing opportunity.

Overall, this portion of the Transform and Grow program, optimizing our end-to-end operation, is expected to deliver nearly 1/3 of our total program benefits.

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

Thank you, Jeff. Sunil, how quickly do you start to expect capturing the operating income benefits here?

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

Yes. Thanks, Christine. And to a degree, building on Jeff's comments, when we started our transformation work earlier this year, we outlined $100 million in annualized operating income benefits to be realized by the end of 2024, and that was primarily focused on operating expense reductions. We are making steady progress on this front. Benefits will primarily help reducing operating expenses, offset underlying inflation, as I mentioned, and also enables reinvestment into our growth initiatives.

With the expanded program, our goal is to capture the entire $300 million of annualized operating income benefits by the end of 2025. From a P&L perspective, this means capturing benefits from 2023 through 2026.

While it's early, we expect to see significant benefits in 2024, which will help to reduce expenses, begin to generate some gross margin benefit by the back half of the year and to offset underlying inflation and revenue declines associated with streamlining product categories and distribution.

We are ramping up our team for this expanded effort and we'll have more specifics to share in the upcoming quarterly calls.

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

Got it. So Jeff, what is the game plan? Just switching gears here. What's the game plan for the smartwatch business? Have you considered exiting this business altogether given the ongoing weakness that you've seen there over the past several quarters?

Jeffrey N. Boyer ***Fossil Group, Inc. - Executive VP & COO***

A fair question, Christine. Very recently, we've made a decision to significantly reduce our overhead investment in smartwatch development and support. As we pull back on future development, we will be working with select partners to determine potential options for our display and hybrid product, and we are evaluating alternatives to carry forward the development work we currently have underway.

We expect to continue to sell and distribute Gen 6 and Hybrid HR products over the coming quarters and plan to support both our display and hybrid products for the next several years during their warranty period.

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

Helpful. Moving back to Sunil. What does the shape of the working capital look like over the next several quarters? And what's the cash flow outlook?

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

Yes. Thanks, Christine. Our working capital levels started to come down in the first quarter and came down even more in Q2, primarily as we manage our inventory levels down from last year. As our sales in the wholesale have been challenging, we have been keeping a more conservative flow of inventory into our warehouses. These actions have reduced our use of cash through the first half of the year compared to last year. And in the second quarter specifically, cash from operations was slightly positive. CapEx remains relatively small as well.

Looking at the balance of the year, as we manage our inventory levels down, we expect to see a continued decrease in our working capital versus the prior year, which will be a benefit to our overall cash flows. CapEx plans are generally limited to maintenance-type activities. And more broadly, our Transform and Grow plan contemplates initiatives that will structurally improve our working capital efficiency into the future.

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

Great. I just have one final question for Kosta. Can you provide us with a progress report on the growth pillars? What should we be looking out for in the second half of this year?

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

Well, it's important we move forward on our growth agenda. The Fossil brand was relatively strong again this quarter, especially in watches, and we expect that trend to continue. We have a major product and marketing launch in the Fossil brand coming in September that has a totally new look and it's tuned to the additional cohorts that we have not catered to in the past. This came from research we did last year that identified new potential customer segments for the brand. Into next year and longer term, we'll be focused on driving awareness and brand heat with engaging marketing and communications, leveraging our digital capabilities.

In our core licensed brands portfolio, we recognize the current headwinds that exist in wholesale. That said, we're also set up for ongoing growth in our jewelry businesses and plan to emphasize men's watches within these brands as we are seeing stronger consumer response in men's versus women's of late. We are also seeing better performance in Asia, which can serve as an offset to balance the near-term headwinds in Americas and Europe.

In our premium watch business, we have significant runway ahead over the years to come through product, marketing and additional distribution to capture revenue and margin growth. The premium segment has outperformed the broader category, and we believe it has tailwinds into the future.

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

Great. Thanks, Kosta. Well, that concludes our Q&A session for today. I'll let you, Kosta, wrap up the call with any closing remarks.

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

Well, thanks for joining us today. We greatly appreciate the interest, and we look forward to speaking with you on our third quarter call in November. Have a good day.

Operator

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