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Q3 2023 Fossil Group Inc Earnings Call

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PRESENTATION

Operator

Good afternoon, ladies and gentlemen, and welcome to the Fossil Group third-quarter 2023 earnings conference 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.

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

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

Hello, everyone, and thanks for joining us today. With us 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 the 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, you will, excuse me -- 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 over to Kosta to begin.

Kosta Kartsotis ***Fossil Group, Inc. - Chairman of the Board & CEO***

Thanks, Christine. Good afternoon, everyone, and thanks for joining us today. The third quarter proved more difficult than expected mostly because of headwinds in the wholesale channel in Europe and because of soft consumer spending in China. From a high-level perspective, we are facing challenging category consumer and channel dynamics. While working against these headwinds, including tough macro-conditions globally, we remain focused on our objectives, most notably, the execution of our Transform and Grow Plan, which we are making solid progress on.

Three quarters into the TAG plan, which we announced in February, we are tracking to deliver the cost of goods and operating expense savings we previously outlined, which are expected to drive approximately $300 million in annualized operating income benefit by the end of 2025. Year to date in 2023, we have captured approximately $80 million in annualized expense savings.

Under the extended plan we announced last quarter, we are advancing our strategies to improve our sourcing practices and to further streamline roles and responsibilities across the organization. Both of these initiatives are laying the groundwork to help us generate improved operating margins in 2024.

Our third-quarter net sales decline of 21% primarily reflects ongoing headwinds in the wholesale channel in both the Americas and Europe and a slower than expected recovery in Greater China. The overall decline includes approximately five points of headwinds related to declines in our smartwatch business and due to store closures. Importantly, we are seeing some encouraging signs in our core FOSSIL brand where our product and marketing initiatives are bolstering our traditional watch sales, which were up 2% and up 11% in the

US and India, respectively.

To address the industry-wide pressure in the wholesale channel. We have put a dedicated team in place that is focused on driving sell-through in key accounts globally. We also have a number of initiatives underway to improve performance in third-party e-commerce. We are using our increasing digital capabilities to collaborate with our largest digital accounts in order to optimize their holiday sales on our products.

In our direct-to-consumer channel, our owned e-commerce platform continues to drive results with sales up 8% in the quarter. Our investments in people and technology are paying off as our teams were able to increase their capability to drive sales and margin in the channel.

Overall, we are aggressively addressing the challenges impacting our business in order to improve performance. We are taking actions to strengthen our operating model, rightsize our cost structure, and to restore growth. The key pillars under our growth plan include revitalizing the FOSSIL brand, maximizing our licensed brand portfolio for watches & jewelry, and expanding our premium watch offerings. Under our FOSSIL brand revitalization strategy, we are making highly targeted investments in marketing to support our key initiatives across traditional watches, jewelry, and leathers.

Over the past year, we have conducted extensive consumer insight work to better understand our target consumer. The results of this deep dive led to the successful launch of our global brand campaign in early September, which debuted with special Fashion Week events in both Paris and New York.

The campaign revealed a broad-based overhaul of creative expression across all our touch points in both traditional and digital media. Early reads tell us it's driving more consumers into the funnel, evidenced by global traffic increases to our website in the United States and in Europe. In India, our wholesale partners and end consumers also responded well to the brand's campaign and overall positioning.

More recently, we launched a FOSSIL brand collaboration with Disney in celebration of their 100th anniversary. In October, we unveiled our first release of watches, leather goods, and jewelry, including a capsule of limited-edition products made for collectors. There's more to come under this collaboration, which we're supporting with targeted campaigns leading up to the holidays.

We are fortunate to have an experienced team and a strong partnership with Alvarez & Marsal, underpinned by a highly disciplined operational approach to execution. Together, we have laid out a clear path to reduce cost, improve efficiencies, and drive sales productivity. We have taken decisive actions in 2023 to reshape our business model and focus on our most compelling and profitable opportunities to advance our goals and drive the business forward.

The revised guidance we are providing today reflects the early traction we're gaining under TAG, offset by a soft consumer spending environment globally. Looking at 2024, we are confident that we will narrow our sales declines and leverage our TAG initiatives to drive year-over-year improvement in operating income performance. More on this from Sunil shortly.

We appreciate the dedication and hard work of our teams throughout the organization and the ongoing support of our shareholders. And we remain committed to delivering shareholder value as we continue to deliver against the benchmarks of our TAG plan.

I'll now turn the call over to Sunil to discuss the financials.

Sunil Doshi ***Fossil Group, Inc. - EVP, CFO & Treasurer***

Thanks, Kosta, and good afternoon, everyone. There are three topics I'd like to review as part of our Q3 update. First, our Q3 results were below our expectations with headwinds similar to those we shared on our Q2 call. We are updating our forecast for Q4 based on current ordering levels in wholesale and trends in our retail stores, and a slower than planned response to peak selling events in key markets like China.

We are making solid progress on our Transform and Grow Plan, capturing operating expense reductions that we outlined at the beginning of the year and executing against initiatives that will drive benefits into the next couple of years. As a reminder, our Transform and Grow plan outlined a total of $300 million in annualized benefits to be realized by fiscal year 2025. We are on track to capture $50 million of expense reductions in fiscal year 2023 and now estimate to capture $135 million to $150 million of benefits in fiscal year 2024.

With that, let me step through our third-quarter results in more detail. Global sales were $344 million, down 21% or down 22% in constant currency. The impact of foreign currencies in the third quarter was a 100 basis point tailwind to sales, about 1 point lower than our prior estimates based on the strengthening dollar during the quarter. From an operating margin perspective, foreign currencies were a 10-basis-point headwind. In addition, we did have approximately a $10 million or roughly 2 point headwind on our revenue results due to a timing shift from Q3 into Q4, primarily related to wholesale shipments in China.

Sales into the wholesale channel represented our biggest headwind for sales declined 25% in constant currency. Regionally, year-over-year declines in wholesale shipments into the Americas and Europe lagged their respective sell-out trends. Sales in China declined primarily due to the timing shift that I mentioned, and also reflecting a softening in underlying consumption on the primary e-commerce platforms that we operate on.

Similar to last quarter, about 5 points or approximately $21 million of the Q3 sales decline can be traced to softness in our smartwatch business as well as our store rationalization initiatives. From a year-to-date perspective, these same two factors also represented about 5 points of the year over year to sales decline.

Partially offsetting the above headwinds, global e-commerce sales were up 8%, led by growth in traditional watches and jewelry. The consistent strength of our e-commerce platform is a direct result of the investments we've made to bolster our capabilities across talent and technology in recent years.

Finally, SG&A expenses in Q3 declined by 3% as we captured benefits from actions under our Transform and Grow plan. Working capital levels were down approximately $100 million or 24% as we reduced inventories and continued to focus on our overall merchandise assortment.

Next I'll walk through some regional results to highlight key drivers of performance. First, in the Americas, net sales were down 18% in constant currency, slightly below expectations. Sales into the wholesale channel were down 23%, consistent with our Q2 trend. In our traditional watch category, the underlying sell-in was down 15%, which lagged a 6% decline in the underlying sell-out as reported by our major wholesale accounts.

Across our larger retailers in the region, inventories at the end of the quarter were down 23% versus last year. In the region's direct-to-consumer channels, comparable retail sales declined 6%, driven by declines in owned retail stores, offset by gains in e-commerce. We ended the quarter with 143 stores this year, down 7% versus last year.

In Europe, total sales declined 30% versus last year in constant currency and were below our expectations, primarily due to declines in the wholesale channel, which were down 36% and lagged underlying sell-out trends in traditional watches. Although inventory levels as reported by our key accounts continued to decline versus prior-year levels, retailers are signaling caution on consumer spending heading into Q4 with increased attention to geopolitical risk factors in the region.

In our direct-to-consumer channels, comparable retail sales grew in Q3 with double-digit gains in e-commerce more than offsetting a moderate decline in retail store comps. We ended the quarter with 87 stores this year, down 22% versus last year.

Turning to Asia, sales were down 14% in constant currency versus the prior-year quarter. As we have previously communicated, we have two primary focus areas in the region over the long term: reigniting sales in China and continuing to drive sales growth in India. Net sales in India grew by 6%, and we remain pleased with our progress in the market where we capitalized on distribution growth for traditional watches and leveraged our FOSSIL brand relaunch initiatives.

Sales in Mainland China, however, declined 30%, which included $7 million of the $10 million timing impact that I previously mentioned.

Excluding the timing impact, net sales were down 4% in constant currency, a slight improvement in trend from Q2 levels.

Early reads on Q4 indicate that consumer spending in discretionary categories is softening driven largely by economic fundamentals in the market. While we remain confident about the long-term trajectory for our brands in China, we anticipate that a softening economic outlook will create near-term headwinds in the category.

From a brand lens, as Kosta mentioned, the FOSSIL brand relaunch was kicked off in the quarter and the brand's traditional watch assortment has performed better than other owned and licensed brands. Globally, Fossil's traditional watch category was down 1% in the quarter on a comp basis. We are encouraged by progress in the brand jewelry category, which has continued to comp well in our direct-to-consumer channels with improved AURs.

Looking at our largest licensed brands, Kors was down versus last year, driven by the outsized sales declines in our wholesale channel in the Americas and Europe contrasted with year-to-date growth in Asia. Armani's declines are largely attributable to the softer trends that we've seen in China.

Moving down the P&L, third-quarter gross margin was 47%, down 330 basis points versus last year, with improvement in our core product margins more than offset by three key factors. First, Q3 had a 200 basis point impact from the timing of minimum product royalties owed, which benefited Q1 of 2023. Second, we had 130 basis point year-over-year impact from the settlement of foreign currency contracts used to hedge inventory purchases. Third, we are lapping a 160 basis point benefit in Q3 of last year relates to the completion of performance obligations under a licensing agreement related to our smart watch technology.

Importantly, and partially offsetting the above headwinds, our core product margins were up 120 basis points as we saw the benefit of inventory management and assortment architecture initiatives drive better realized AURs. This underlying benefit is something we will continue to focus on as part of our broader transformation plan.

As mentioned earlier, SG&A expenses were down 3% versus last year. The reductions in SG&A can be traced to our TAG initiatives implemented during 2023, which has enabled us to reduce SG&A, offset underlying inflation, and partially reinvest in our FOSSIL relaunch. Taken together, adjusted operating loss was $31 million and adjusted operating margin was negative 9%.

Turning to the balance sheet fixed, we continue to make progress bringing down inventory levels and lowering working capital. Q3 inventory ended at $327 million, down 28% from last year's levels, while working capital, excluding cash balances was down approximately 24% versus the prior-year quarter. The improvement in working capital has enabled us to cut operating cash use by just over $100 million year to date versus the prior year. [Ending] cash was $116 million, and we had $23 million of availability under our revolving credit facility.

Turning now to our outlook, we are revising our full year outlook for sales and adjusted operating margin to incorporate our third-quarter results and reflect a softening outlook for the fourth quarter. For the full year, we expect net sales to decline in the range of 14% to 17%, and we expect adjusted operating margin to be in the range of negative 6% to negative 8%.

Let me outline some specific assumptions that are embedded in our outlook. We anticipate that net sales declines in Q4 will be negative 8% to negative 19%. This includes expectations for wholesale declines in the Americas and Europe, similar year-over-year impacts from our store closures and smart watch sales, partially offset by growth in global e-commerce sales.

Our guidance reflects prevailing currency rates, which includes a stronger dollar relative to our prior guidance. We estimate that prevailing rates would positively impact Q4's net sales by 70 basis points compared to our prior estimate of a positive 350 basis point impact that was estimated based on prevailing rates at the time of our prior guidance. Our fourth-quarter guidance also includes the $10 million benefit from the timing shift of wholesale shipments that I previously mentioned.

From an adjusted operating income margin perspective, our outlook reflects a range of flat to negative 5% for Q4, with SG&A dollars down versus prior year, driven by our TAG initiatives.

Now turning to some additional commentary on our Transform and Grow Plan in 2024. As a reminder, on our last call, we shared our expanded Transform and Grow Plan, which was the result of a comprehensive review of our operating model. The expanded program identified $300 million in overall annualized operating income benefits to be achieved by fiscal year 2025.

First, we remain on track to achieve the original $100 million in annualized expense savings by the end of 2024 as outlined on our March earnings call. We expect to capture approximately half of that or $50 million of expense savings this year. These expense savings are primarily reflected in lower SG&A, which is enabling us to offset underlying inflation that was in our expense base and to a lesser degree, reinvest into our growth pillars.

Second, since announcing the expanded plan on our last call, we have made significant progress on the newer initiatives we outlined, which ranged from simplification of our Oregon operating model, savings and product costing and indirect procurement, and better realized AURs through pricing and markdown management. These efforts and the carryover impact from our original set of initiatives are laying the groundwork to realize operating income benefits of approximately $135 million to $150 million in 2024.

Achieving this level of benefit will position us to deliver year-over-year operating margin improvement while allocating capital toward our strongest growth opportunities. The remaining $100 million to $115 million of expected benefits from tax are estimated to be realized primarily in 2025 with some carryover to 2026 providing further runway to improve our operating margins.

With a clear multi-year roadmap in front of us, our near-term focus is on executing this holiday season and delivering on our Transform and Grow initiatives to drive operating margin benefits into 2024 and 2025.

With that, I'd like to turn the call back over to Christine to take us through some Q&A.

QUESTIONS AND ANSWERS

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

Terrific. Thank you, Sunil. I'll begin with a question for Kosta. What are the key strategies to stabilize sales and when do you expect to see an inflection point?

Kosta Kartsotis ***Fossil Group, Inc. - Chairman of the Board & CEO***

Overall, we're moving as quickly as we can to improve the business all across the enterprise. There are a number of TAG initiatives that we have in place that will drive higher sell-throughs and profitability, including SKU reductions, improved market pricing, lower product costs, better promotional management, higher gross-to-net profit capture. In addition, we will operate with lower expense structure. So we're moving in the right direction.

Also, we're going to lean more into our strengths. Our FOSSIL brand, especially in traditional watches, the brand is showing strength, and we think that will continue. Also in our increasing digital capabilities -- the investments we've made the past few years in people and technology have become a strategic advantage for the company that will have increasingly significant benefits.

We also have a significant opportunity overall in emerging markets as well as in our jewelry business, which presents a large opportunity for the company long term. So overall, there's a lot of activity going on in the company, and we are making progress on many fronts, and our teams are focusing on strong execution and on improving the business.

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

Thank you, Kosta. Moving on to Jeff. Could you put more color around the TAG program and how that's progressing?

Jeff Boyer ***Fossil Group, Inc. - EVP & COO***

Sure, Christine. You heard in Sunil's comments, we're making solid progress on both our initial and our expanded tech initiatives. We initiated these programs earlier this year due to potential business softness, which we are now experiencing.

We have prioritized seven key work streams with three main goals or objectives. Our key objectives are to one, reduce organizational complexity; two, improve gross margins; and three, optimize overhead spending and working capital efficiency. I'll share our progress so far on each of these efforts.

Regarding our efforts to reduce our organizational complexity, we are very far along in planning the right size of the organization as well as operating on a more global versus regional basis. Unlike some other efforts we've had in the past, this initiative is focused on fundamentally changing our operating model to be more globally driven and to improve decision making and efficiency. Execution of this work stream is well underway and will continue into next year.

One of our most significant value creation pillars is improving gross margins as product cost from one of the most significant expense elements of our operating model. We are working with our current and new suppliers to reduce product costs. And so far, we're very pleased with the response and the support we're getting from our existing and new partners. We're on track to drive benefits from this work stream into the P&L in 2024.

We're also focused on increasing our average AUR with customers by refining our pricing architecture, enhancing our promotional and markdown programs, and reviewing terms with our wholesale partners. Lastly, we are conducting deep dives on our demand signing programs, inventory levels, and product lifecycle management areas and expect additional economic benefits from improvements in each of these areas.

On the spending side in supporting our overhead optimization and working capital efficiency initiative, all spend areas are being reviewed from marketing to information technology spend to indirect procurement. We've instituted an expense control tower process to review all significant expenditures requesting lower costs in issuing RFPs for major purchases.

Our overhead optimization program also includes initiatives in our retail channel. We are taking a harder look at store rationalization and in-store process optimization. We're also revisiting our DC operations, logistics, and parcel management progress to identify incremental cost savings opportunities. Working capital initiatives currently being worked on include improving our inventory turnover, reducing customer account DSO and moving a major supplier to more standard industry payment terms.

As you can tell, the transformation part of our tech program is extensive and has impacted nearly every area of our business and economic model. After several months of further work, we remain confident in our ability to deliver our TAG goal of $300 billion in benefits that we shared back in August.

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

Thank you, Jeff. Very helpful.

Sunil, how does that $300 million of TAG savings flow through the P&L? And what does the cadence look like beyond that initial $100 million of benefit that you expect to capture?

Sunil Doshi ***Fossil Group, Inc. - EVP, CFO & Treasurer***

Yeah. Thanks, Christine. A quick recap on that first $100 million in annualized benefits. We expect to capture $50 million in 2023 and $50 million in 2024. For the 50 million in 2023, a couple of additional points. First, $45 million of the $50 million is in SG&A and $5 million of that benefit or that expense reduction is in gross margin as it pertains to freight costs.

From an SG&A perspective, the $45 million in savings represents about 5.5% of our FY22 actual SG&A expenses. Our current year forecast reflects about a 4% reduction in SG&A. The other 1.5 points from our TAG savings is primarily offsetting underlying inflation that we had coming into the year.

With respect to 2024, we will capture the remaining $50 million and another $85 million to $100 million related to the initiatives that Jeff just spoke about. That brings the total benefits in fiscal 2024 to approximately $135 million to $150 million. There will be some offsets to these benefits as we rationalize some segments of our business and based on our current views of sales trends into 2024. But taken together, the actions from TAG will provide a meaningful improvement to our adjusted operating income expectations for FY 2024.

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

Thanks, Sunil. One last question for you. How do you think about capital allocation in the near term given your expected sales declines?

Sunil Doshi ***Fossil Group, Inc. - EVP, CFO & Treasurer***

Yeah. Thanks, Christine. So in the near term, our capital allocation priorities are to focus on business operations and to execute our Transform and Grow initiatives. It's also important to note that in 2023, we've been able to offset our operating losses by managing our inventory and overall working capital down from 2022 levels. Working capital is down approximately $100 million versus last year.

In 2024, we expect a more normalized working capital flow where Q1 to Q3 tend to require some working capital. We do have initiatives included in our Transform and Grow plan that are focused on driving structural improvements in our inventory levels, but those benefits are more back-end weighted and into 2025 based on our development cycle and lead times.

So with those factors in mind and considering our most recent revenue trends, we think in the near term, it's important to preserve capital for business operations while we execute our Transform and Grow plans. Longer term, as we capture planned TAG benefits, work down restructuring costs, and resize the revenue base, free cash flow should be healthier, and we'll be in a better position to consider a broader set of capital allocation options.

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

Great. Thank you, team, for the Q&A. I'll just turn the call back to Kosta for closing comments.

Kosta Kartsotis ***Fossil Group, Inc. - Chairman of the Board & CEO***

Well, thanks, everyone, for joining us today. We appreciate your support. We look forward to speaking to you again about our fourth quarter early next year. Have a good day.

Operator

Ladies and gentlemen, this concludes today's conference call. Thank you for your participation. You may now disconnect. Everyone have a wonderful day.
