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Q4 2023 Fossil Group Inc Earnings Call

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CORPORATE PARTICIPANTS

Christine Greany *Blueshirt Group LLC - Managing Director*
Jeffrey Boyer *Fossil Group Inc - Interim Chief Executive Officer*
Sunil Doshi *Fossil Group Inc - Chief Financial Officer*

PRESENTATION

Operator

Good afternoon, ladies and gentlemen, and welcome to the Fossil Group Fourth Quarter and Full Year 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 ***Blueshirt Group LLC - Managing Director***

Hello, everyone, and thank you for joining us. With us today on the call are Jeff Boyer, Interim CEO; 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 as 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 today on Form 8-K and is available in the Investors section of fossilgroup.com. With that, I will now turn the call over to Jeff Boyer to begin.

Jeffrey Boyer ***Fossil Group Inc - Interim Chief Executive Officer***

Thanks, Christine, I'm pleased to be taking on the role of interim CEO having spent nearly 17 years at Fossil and both the Board of Directors and the executive leadership team. I have a deep working knowledge of the operating model, the organization and our underlying profitability potential. As Chief Operating Officer, I was one of the key architects of our Transform & Grow plan and have played a critical role in driving execution of those initiatives, which remain on track. And importantly, I've worked side-by-side with Costa for nearly two decades, which will make for a seamless transition in the coming months.

Together with our experienced leadership team, we can ensure continuity as we continue to advance our TAG plan in order to lay the foundation for a profitable business model in connection with the earnings release today, we also announced that the company is conducting a strategic review of its business model considering additional debt and equity financing options and pursuing actions to strengthen the balance sheet. What we want to make clear today is that we're taking steps to maximize shareholder value, and we have sufficient liquidity to operate the business for the [perceivable] future.

This past year has been more challenging than we anticipated, reflecting three key factors. One, macro-driven economic conditions globally, two wholesale channel dynamics, and three persistent pressure on consumer spending in China, one of our most important markets. Against this difficult backdrop, we took aggressive actions to rationalize unprofitable segments of our business. This included exiting our smartwatch business and closing underperforming stores. And excluding these actions, we ended 2023 with core top line trends contracting approximately 10%.

The most important thing we want you to hear from us today is that we're committed to improving performance, and we're all hands on deck to further advance our pack plan and strengthen liquidity as Interim CEO and prioritizing the following stabilizing the business, advancing our tax plan, strengthening our balance sheet and conducting a broader strategic review of our operating model. I'll discuss each of these in greater detail.

First and foremost, we're taking steps to stabilize the business and improve our financial position. In 2023, we closed 45 underperforming stores. And in Q4, we made the strategic decision to exit the smartwatch category. While these actions contributed to our top line headwinds, they did not materially contribute to operating margins. More importantly, these actions help us refocus the company on our most profitable and productive core categories enabled us to further streamline our operations.

In 2024, we expect to close approximately 50 retail doors as and exit underperforming locations through natural lease expirations and we expect to fully exit our smartwatch inventory in the first half of 2024. These actions will also enable us to refocus our inventory investments into higher-margin faster-turning categories like traditional watches and jewelry regarding this reinvestment in core categories.

Note that the fourth quarter execution of our revitalization strategy for FOSSIL brand drove some of the best results within our portfolio. Global traditional watch sales for the FOSSIL brand grew in Q4 of last year. In our direct-to-consumer channels, comp sales in traditional watch and jewelry grew mid-single digits. Additionally, we're seeing gross margin growth in the FOSSIL brand continue thus far in 2024 in our core watch and jewelry categories.

Our second priority is our tax plan, which remains on track to capture $300 million of annualized benefits by 2025. As a reminder, our plan to achieve these benefits is anchored by three core objectives, driving sales, productivity, re-engineering and operations and streamlining overhead costs and improving capital efficiencies.

Our teams delivered solid execution in 2023 and would capture approximately $125 million in annualized benefits this was driven primarily by company-wide headcount reductions where we streamlined our regional and corporate functions to be more centrally led and dramatically reduced our smartwatch cost structure. Additionally, our initiatives on SKU management, inventory management and price management drove improvements in inventory productivity and traditional watch product margins.

We ended 2023 with inventory down 33% better overall inventory composition and improved product margin architecture heading into 2024 and 2024, we expect to capture a another $100 million, potentially more in annualized benefits from our tax plan. The largest area of savings is expected to come from our supply chain activities where we have successfully renegotiated a number of significant sourcing contracts. Cash benefits begin in the first quarter of this year with P&L benefits materializing in the second half. These actions are expected to drive gross margin expansion this year and help us return to historical gross margin levels which were in the mid [50s] over the next two years.

A third priority, we are focused on to strengthen our balance sheet. We are pursuing opportunities to better leverage and monetize the company's assets through additional financing and the sale of our European facilities. In addition, we're expecting to receive a US tax refund of approximately $56 million associated with NOL carryback provisions from the (CARES) Act more on these efforts from Syneos shortly.

Lastly, as we outlined in our earnings press release today, we announced a strategic review of our current business model and capital structure. This review will include efforts to further optimize our business model with appropriate changes to our overall operations as well as additional structural cost reductions. We expect this effort will further expand on our current tax plan and could include additional debt and equity financing options, including monetization of various assets.

Our action plan for 2024 is focused with a high sense of urgency on top line stabilization and improved profitability.

The guidance we're providing for 2024 is based on the underlying trends we saw exiting 2023, as well as the strategic actions we're taking to stabilize the business.

Our outlook calls for worldwide net sales of approximately $1.2 billion, which includes about $100 million in year-over-year negative sales impact resulting from store closures and our exit from the smartwatch category. We expect that underlying business trends will continue to be challenged by macro-driven pressures affecting consumer spending category and channel softness and brand dynamics among some of our key licensing partners.

We're acting quickly to leverage our core strengths and people implement our tax plans and improve our financial condition to make fossil a leaner, stronger and more durable business. We are fortunate to have incredible teams across the organization who are passionate about the Company committed to our purpose and dedicated to winning as we continued to execute our tag plan. We appreciate the support of our shareholders and look forward to updating you on our progress throughout the year.

Now, I'll turn the call over to Sunil to discuss Q4 results and provide more [granularity] around our financial objectives and outlook.

Sunil Doshi ***Fossil Group Inc - Chief Financial Officer***

Thanks, Jeff. Fourth quarter net sales totaled $421 million, down 16% versus last year or down 17% in constant currency. Adjusted operating margin was negative 2% for the quarter and negative 6.5% for the fiscal year fourth quarter cash flow from operations was $49 million, and we ended the year with $117 million in cash and $181 million in liquidity for the full year, cash flow used in operations was $59 million and improved versus the prior year as we manage working capital levels down during the year.

Diving deeper into our Q4 sales trends in the fourth quarter, approximately 7 points of the overall [17%] constant currency sales decline came from store closures and lower smartwatch sales. As Jeff noted, in the fourth quarter, we exited the smartwatch category and began to more aggressively move through our inventory.

We also completed the rationalization of our smartwatch infrastructure costs in Q4. With the decision to [exit] the category, we have pivoted our future inventory purchases to drive better ROI and fast return categories like traditional watch and jewelry heading into 2024, we will lap approximately [$60 million] in smartwatch sales from 2023 with minimal expected liquidation sales in 2024.

While this will be a top line headwind to our fiscal year 2024 sales. We believe the reduced infrastructure costs in placing more inventory and higher margin sales in traditional watches, jewelry will drive better longer term financial outcomes for the Company. Excluding the seven point impact that primarily came from store closures and smartwatches, fourth quarter net sales declined about 10 points versus last year.

The majority of that 10 point sales headwind came from our largest licensed brands where sales in traditional watch and jewelry were down versus the year ago period in both our wholesale and direct channels in the wholesale channel, particularly in the Americas and Europe. Q4 sales declines did moderate from the very steep sales declines we saw earlier in the year, consistent with our retail customers reporting more balanced stock levels.

Underlying sell-out trends, however, remained negative in the quarter as inventory levels appear to be more balanced. We anticipate that retailers will maintain a conservative inventory purchasing behavior to limit overstocking risks. In Asia Licensed Brand revenue in the wholesale channel was down modestly, with declines in Mainland China and other distributor markets offsetting double digit growth in India, Japan and Korea.

In the FOSSIL brand, fourth quarter sales in traditional watches and jewelry were flat year over year, and comparable retail sales in these categories were positive, low single digits. Brand sales and leathers and smart watches were down year-over-year. Underlying performance was supported by strong execution of our made for you campaign digital enablement tools and a sharper product assortment which drove breadth, better results in our direct to consumer channels.

In Michelle, our owned premium brand for women's watches, sales were up double digits as wholesale customers took advantage of better spending dynamics in this consumer segment.

Turning to gross margins, Q4 gross margins were up 40 basis points versus last year. Most of the gross margin gains came from product margin improvement in our core categories where initiatives from SKU rationalization, assortment architecture and reduced promotions in our direct to consumer channels drove better results. Lower freight costs also contributed to the year-over-year gross margin improvement. Partially offsetting these gains were declines in gross margin in our smartwatch category and anniversarying gains from the settlements of forward currency contracts in the prior year period.

SG&A expenses in the fourth quarter were down [$25 million] year over year or 11%. Reductions were primarily attributable to lower store operating costs on fewer stores as well as lower compensation and administrative costs resulting from our TAG initiatives.

Stepping back and looking more broadly at our attack plan with the organizational headcount reduction in late 2023, we realized approximately $125 million in annualized benefits. Approximately $50 million was realized in year, which helped us drive an overall SG&A decline of 6%. Restructuring costs incurred in fiscal year 2023 or $49 million.

Now turning to our outlook for fiscal year 2024. In 2024, our outlook includes worldwide net sales of approximately $1.2 billion with an adjusted operating margin of negative three to negative 5%. As Jeff shared, we are focused on executing our TAG plan and strengthening our balance sheet benefits from TAG are a critical component to driving improved financial performance in fiscal year 2024 and offset the underlying decline in revenue that we have forecast having captured approximately $125 million in annualized benefits in 2023.

We are focused on capturing at least another $100 million in annualized benefits in fiscal year 2024, which would significantly accelerate our progress toward achieving our $300 million target. Importantly, our guidance for fiscal year 2024 reflects our expectation that our TAG initiatives will help drive gross margin expansion and SG&A reduction versus the prior year. Gross margin improvement is primarily expected to be driven by sourcing benefits from our tag initiatives, coupled with a continued focus on assortment architecture and SKU rationalization as well as product mix benefits resulting from minimal smartwatch sales in 2024.

Lower SG&A in 2024 is expected to be driven by benefits from our tax plan and lower store operating costs. Our net sales guidance of approximately $1.2 billion assumes approximately $100 million of negative impact from our store and concession closure plans and the lapping of last year's smartwatch sales.

We anticipate that performance in our core traditional watch category will be down with comp growth in the FOSSIL brand, offset by declines in our largest license brands in part due to brand repositioning and also reflecting our expectation for softer consumer spending in our categories in Europe and in China Additionally, we anticipate growth in traditional watches in India and other smaller but emerging markets.

Looking at the cadence of the year, we expect Q1 sales to be the softest, partly due to timing of wholesale shipments between Q1 and Q2 with sequential improvement for the remainder of the year. We are also focused on strengthening our balance sheet to provide additional cushion to our liquidity. We are in the late stages of the process of receiving an approximate $56 million tax refund from the US government associated with provisions in the (CARES) Act we are also actively pursuing financing options and monetization of our remaining two owned building assets in Europe.

Free cash flow, which we define as cash from operations less CapEx, is estimated to be positive in 2024, reflecting a modest reduction in working capital from lower inventory and the expected receipt of the tax refund I just described 2024 will be a year of transition for Fossil Group as we are in the middle of our TAG program and continue to aggressively restructure our business model, lap the exit of less productive categories, rationalize our store portfolio and focus on stabilizing our core revenue trends in a challenging macro economic environment.

With that, I'd like to turn the call back to Jeff for some closing remarks.

Jeffrey Boyer *Fossil Group Inc - Interim Chief Executive Officer*

Thanks, Sunil. Sunil and I shared with you, we're working diligently and taking prudent actions to stabilize the business and maximize shareholder value, all of which is underpinned by our commitment to returning Fossil Group to profitable growth as quickly as possible. Thank you to everyone for listening in today.

Operator

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