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Q1 2024 Fossil Group Inc Earnings Call

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CORPORATE PARTICIPANTS

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Sunil Doshi *Fossil Group Inc - Chief Financial Officer*

PRESENTATION

Operator

Good afternoon, ladies and gentlemen, and welcome to the Fossil Group First Quarter 2024 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.

I will turn the call over to Christine Green 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 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 today on Form 8-K and is available in the Investors section of fossilgroup.com. Now I'll turn the call over to Jeff. Please begin.

Jeffrey Boyer ***Fossil Group Inc - Chief Executive Officer, Chief Operating Officer, Director***

Good afternoon, everyone, and thank you for joining us. As we reported earlier today, we delivered first quarter net sales and operating margin in line with our expectations as we continue to navigate challenging top line trends, our ability to drive gross margin expansion and reduce costs enabled us to narrow our operating loss and improve our free cash flow from a year ago.

Benefits from our Transform & Grow Plan are at the core of our improved gross margin and our reduction in operating costs, execution of the broad-based program, which spans seven workstreams starting in 2023. P&l benefits were realized starting last year and are expected to accelerate meaningfully in '24 and carry into 25. About half of the work streams in TAG are designed to structurally improve our gross margins.

First quarter gross margin was up 300 basis points versus last year and reflects benefit from the exit of our smartwatch category, improved product margins in our core categories and lower freight costs. Our work streams on product sourcing and supply chain are expected to generate benefits in the latter part of 2024, enabling us to deliver year-over-year improvement in gross margin.

Importantly, our tag initiatives have us on track to return to historical gross margin levels in the mid 50s over the next two years. The balance of our tech workstreams are focused on taking costs out of our expense structure with the goal of a recalibrating our operating model for greater efficiency and lower fixed costs, b, driving savings in our procurement practices and see optimizing our direct channel operating costs.

Our Q1 operating expenses declined 20% compared to a year ago, reflecting savings across headcount, labor and services, which were initiated in 2023. We anticipate that our initiatives will continue to generate year-over-year OpEx declines in the remaining quarters of 2024, notwithstanding the progress being made across all of the work streams in TAG, our sales remained under pressure, and we are working urgently to stabilize the trend line.

Broadly speaking, we see three major themes playing out in our revenue base, which we anticipate will continue throughout 2024. First, about half of our revenue base is beginning to stabilize. Performance in the following areas of the business was approximately flat to last year in Q1, FOSSIL traditional watches and jewelry globally on a comp basis, India, which overall remains a solid market for us.

Our value brands sold through value channels like general merchandisers and off-price, and our higher priced products that are sold through more proven specialty channels. Let me provide some color on those. From a macro perspective, we see consumers generally favoring value.

Wholesale customers are leaning into value products as seller remains reasonable in this price tier at the same time, sell in and sell out of more premium priced products have also shown durability, the India market, where we've invested significantly over the years continues to grow with our marketing and brand-building investments across parts, of course, and Armani Exchange.

Lastly, we continue to see improvement in our Fossil traditional watch business, fueled by our digital strategies and capabilities, broad distribution and investments in marketing and product over the past several quarters, Fossil traditional watch, which is among our largest categories, has been one of our most stable.

Second thing in Austin and the civil court I just described is persistent challenges into other parts of our business, our licensed fashion watch brands and our leathers category. Collectively, these two areas comprise over 40% of our revenue and were down about 30% in Q1 in the US and Europe.

Our most recent industry data highlights that fashion watches contracted in the mid-priced category in the wholesale channel. Additionally, Greater China continues to be down high double digits as economic challenges are impacting consumer demand in the category. We anticipate these headwinds will continue in 2024, and I reflected that in our revenue outlook.

Looking longer term, we expect this segment of the traditional watch business to stabilize and rebound behind the repositioning efforts of our major licensed brands.

Lastly, and as we've previously communicated, we've been closing low to negative profit contribution retail stores at lease expiration and have exited the smartwatch category while these deliberate actions create a headwind to sales in 2024, they are operating income accretive on our year-end earnings call.

In March, we outlined four near-term priorities critical to driving our turnaround. As a reminder, those include advancing our tech plan, strengthen our balance sheet, stabilizing our business in conducting a strategic review. Let me update you on each of these areas.

Our first priority is the sharp execution of our Transform & Grow plan. As we've previously shared with you tag as a comprehensive restructuring program across nearly all elements of our operations. The organization has been hard at work across seven workstreams and the program is driving material results into the P&L in 2024.

The headline here is that we're on track to achieve $100 million of annualized benefits in 2024. In addition to last year's $125 million on the gross margin side, the largest source of value are expected to come through our product sourcing and supply chain initiatives beginning in the second half of the year.

As I mentioned earlier, we've also started to realize benefits from SKU rationalization as well as pricing and promotional initiatives actions to simplify our organization in 2023. Translated to a significant reduction in our expenses in Q1 will continue to benefit SG&A throughout 2024. We executed meaningful workforce reductions in 23, which are driving benefits into the P&L this year.

The leadership and resiliency of our teams through these changes has been strong and very much appreciated within our tax plan. We are also tackling the cost of service providers through a significant number of RFPs are in the process of driving cost reductions through efficiencies in our labor models across both stores and concessions.

So we have accomplished much under our current TAG program. We are identifying additional operating model efficiencies and expect to go after incremental opportunities across channels, categories and geographies.

Turning to our second priority, we're making progress towards strengthening the balance sheet and improving our liquidity position during the first quarter, we had minimal cash usage and as expected, we received the US tax refunds of $57 million in mid-April derived from provisions within the CARES Act, which provides us an important source of incremental cash to execute our plans in 2024.

Additionally, we're continuing to pursue asset monetization opportunities, including the sale of real estate in Europe, which we estimate could yield about $10 million to $15 million in net cash proceeds by the end of this year. With these actions and through continued disciplined management of working capital, we expect to be free cash flow positive in fiscal year 2024.

Next, we are taking aggressive actions to stabilize the business. We will continue to pivot resources and capital into segments of our business that were more stable and have room to grow. As I mentioned, this includes investing behind possible traditional watches and jewelry, India, our value brands and our premium priced brands.

We're also working closely with our licensors to manage contraction in our fashion brands, admits category declines in these price points, brand transitions and challenging macro conditions in large markets like China. We are managing these brand contractions by protecting the price and margin architecture in our category for the long-term health of our business.

We're seeing some bright spots from new product introductions, merchandising initiatives and emerging markets. They are not yet significant enough to offset the broader category and brand challenges in our major markets. And finally, while our strategic actions create a top line headwind. We will continue to optimize our store portfolio. It should be nearly fully out of the smartwatch business by the end of Q2.

Lastly, we continue to work with our advisers on a strategic review of the business, including an ongoing review of our business model and comprehensive use of our capital structure and capital allocation strategies. We are acting with urgency as we focus on these priorities.

During the first quarter, we appointed two independent board members, which in tandem with recent leadership changes usher in new oversight and fresh thinking these individuals bring significant value to the organization with decades of experience in retail and consumer operations, turnarounds and finance.

We look forward to their contributions and support as we move as quickly as possible to stabilize the business and pursue avenues to maximize shareholder value. We greatly appreciate the dedication of our teams and the support of our shareholders during this transformational time for Fossil. We look forward to keeping you updated on our progress and driving value for all of our stakeholders.

With that, I'd like to turn the call over now to Sunil to step through the financials.

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

Thanks, Jeff. First quarter net sales totaled $255 million, down 21% in constant currency, with better gross margins and lower SG&A, both driven by our TAG program. We narrowed our adjusted operating loss by $6 million to $19 million.

First quarter cash flow from operations was slightly positive, a significant improvement versus last year when we used $86 million. The improvement in cash flows was primarily due to closely manage working capital, timing of payments in the current year and lapping heavier than normal seasonal working capital needs.

Last year, we ended the quarter with $113 million in cash and $123 million in liquidity. Diving deeper into our Q1 trends. As Jeff noted, there are three underlying themes that we have seen playing out across our business for several quarters now, which continued into Q1 First, about five points of our 21 point revenue decline in the first quarter was attributable to the year-over-year decline from closed stores and the exit of our smartwatch business.

The revenue impact was roughly four to six points in each of our regions. As a reminder, the stores we are closing are at lease expiration and in aggregate did not have a material contribution in terms of four-wall profitability. Since announcing our exit from the smartwatch category, we've more aggressively work to move through our remaining inventory.

Second, we are seeing signs of stabilization and about half of our Q1 revenue base across this portion of our revenue base, net sales in the quarter were down 1%. Global net sales and fossil brands, traditional watch and jewelry categories were negative 4% on a comparable basis.

This reflects comp growth in the direct channels and our and in our Asia region, offset by declines in the indirect channels in the Americas, and Europe. Growth in India remains robust for traditional watches, where we achieved double digit growth in the strategic markets, anchored by strong sell-out trends and expanded distribution in our value priced brands and more premium price brands were about flat to last year.

However, as Jeff noted, we've experienced persistent challenges in our licensed fashion brands and leather category that carried into the first quarter of this year. Sales across this portion of our revenue base was down approximately 30% in Q1 and reflects both challenging operating conditions in China in distribution and category headwinds in traditional wholesale channels, particularly in the Americas and in Europe.

Turning to gross margins, Q1 gross margins were up 300 basis points versus last year, primarily driven by benefits from our tax plan. Gross margin improvement versus last year can be traced to two factors. First, the prior year results included a one-time 170 basis point drag from a tax-driven restructuring charge in our cost of goods related to liabilities from certain product categories.

Two; the balance of the gross margin improvement of 130 basis points came from product margin improvement in our core categories where initiatives from skew 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.

Sg&a expenses in the first quarter were down approximately $39 million year over year or 20%. Reductions were primarily attributable to lower store operating costs on fewer stores as well as lower compensation and administrative costs resulting from our eTag initiatives. We ended the quarter with 277 company-owned retail stores, down 15% from the prior year.

Turning now to our outlook. Our first quarter results for sales and adjusted operating margin were in line with our expectations, and our full year forecast remains unchanged from our prior guidance of approximately $1.2 billion in sales and an adjusted operating margin loss of 3% to 5%. 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.

As we noted on our last earnings call, we expected Q1 to be the softer sales quarter of the year. Benefits from our tax plan continues to be a key driver of our 2024. Our gross margins and SG&A forecasts. We expect to achieve over $100 million of P&L benefits.

In 2024, stemming from annualized savings achieved in 2023 and expected to be achieved in 2024 under the tax plan. These benefits are expected to materialize in both gross margin and SG&A within gross margin or tag initiatives are expected to contribute to gross margin expansion, particularly in the second half of the year.

The improvement is primarily expected to be driven by initiatives within our product sourcing strategy, coupled with ongoing initiatives around assortment architecture and SKU rationalization as well as product mix benefits resulting from minimal smartwatch sales in 2024.

Looking at the balance of the year, we anticipate that SG&A dollars will be down in the low to mid 10s on a year-over-year basis for the remaining quarters of 2024 as we begin to recognize the annualized benefits of our tax plan. Restructuring costs for fiscal year 2024 are estimated at $35 million. We are also laser focused on strengthening our balance sheet. We ended the first quarter with $113 million in cash and $10 million available under our revolver.

And we have a solid roadmap for generating free cash flow for full year 2024, a significant improvement versus last year's use of cash of approximately $70 million. Note that our expectation to be free cash flow positive this year includes the one-time benefit of the $57 million tax refund.

It's also important to note that the seasonal nature of our business and projected sales declines will require operating cash use in Q2 and Q3 in the near term with limited availability on our ABL facility and until cash flows turn positive in the fourth quarter, we believe it is prudent to preserve our financial flexibility until the business strengthens at the same time.

As part of our current strategic review process, we are taking a holistic review of our capital structure along with our strategic and operational plans in order to aggressively improve the longer-term capital structure of the Company. We will share more detail in future calls as our plans and programs are developed. We appreciate the support of our shareholders and look forward to keeping you updated on our progress in future quarters.

Operator

Ladies and gentlemen, that concludes today's call. Thank you all for joining. You may now disconnect.