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Q4 2020 Fossil Group Inc Earnings Call

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PRESENTATION

Operator

Good afternoon, ladies and gentlemen, and welcome to the Fossil Group Fourth Quarter 2020 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 thanks for joining us. With us today on the call are Kosta Kartsotis, Chairman and CEO; Jeff Boyer, Chief Operating Officer and CFO; and Greg McKelvey, EVP and Chief Commercial 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 and 10-Q reports filed with the SEC.

In addition, Fossil assumes no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise, except as required by law.

All references to sales during today's call reflect constant currency results unless otherwise indicated. Please note that you can find a reconciliation 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 Kosta to begin.

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

Good afternoon, and thanks for joining us today. We hope everyone is staying healthy and safe. 2020 was an unprecedented year for all of us and for Fossil, it was also a year of transformation. We are extremely grateful to all our team members across the organization for working through the near-term operational challenges, while also continuing to execute against the longer-term strategic priorities that will position the business for sustainable top line growth.

Before we review our fourth quarter results, I wanted to take a few moments to share our perspective on 2020. While the pandemic created significant disruption to our business, in many regards, it validated and accelerated our transformation efforts, particularly the digital acceleration that was already underway. With the loss in sales in 2020 that arose from the pandemic's impact on retail traffic, we doubled down on our digital strategies. As a result, we ended the year with approximately 40% of our global revenues coming from digital channels versus 20% in 2019.

We accomplished this by focusing on our new e-commerce platform, completing the U.S. implementation in early 2020 and extending it beyond the U.S. to other markets.

We grew our file size significantly and began testing more targeted digital marketing with positive outcomes on conversion, sales and awareness. We also greatly improved our capabilities to compete on third-party e-commerce platforms like Tmall and Amazon. In addition, we made tremendous progress in transforming the company's operations last year, utilizing our New World Fossil 2.0 initiative as a platform for change.

New World Fossil includes streamlining the organization and generating greater efficiency in our processes and work streams. As the pandemic unfolded, we expanded this program to include the reduction of our store count and the optimization of our store operating costs. Our target for New World Fossil 2.0 was expanded from the original \$200 million level and is currently on track to capture at least \$250 million of operating expense savings before the end of 2021.

We are pleased to have concluded 2020 on a stronger operational and financial footing despite the ongoing macro uncertainty. Our fourth quarter sales came in better than we expected, reflecting solid execution by our teams in a tough environment. We maintained strong gross margins, exercised careful cost control and delivered \$50 million of adjusted EBITDA in the quarter and more than \$90 million in the back half. Our cash balances at year-end were \$100 million higher than when we started the year.

During the fourth quarter, our total digital sales were 43% of our global revenue mix, primarily driven by the performance on our own websites, which grew 50% versus last year.

From a regional lens, Asia Pacific demonstrated strong sequential improvement from Q3, reflecting continued growth in China and a return to growth in India. Notably, we had strong sales on 11/11 day with our Armani traditional watch business coming in as the #1 seller among luxury watch brands. Performance in both the Americas and EMEA regions was impacted by pandemic related restrictions and shutdowns that began in November. From a brand perspective, Armani delivered strong growth in China, and both the Michael Kors and Fossil brands grew share in the Americas region.

Turning now to 2021. Our teams are focused on a number of strategic priorities, accelerating our digital capabilities, streamlining our operations, driving growth in China and India and driving product innovation. Our most critical growth priority this year continues to be accelerating our digital capabilities on a global basis. We have been investing in the digitization of Fossil for the past few years, and we'll accelerate this by investing in the resources, tools and teams to further advance and scale our digital footprint.

We anticipate that digital sales will exceed 50% of our mix over the long term. In 2021, we will complete the migration of our own websites to the Salesforce platform. Our teams have already begun utilizing more advanced digital capabilities such as AI-driven cross-sell and upsell an AR tool to enable virtual try-on and a virtual sales assistant.

Another important element of our digital agenda is building out more advanced digital marketing and analytics capabilities, which is expected to help us drive customer data acquisition and increase repeat purchasing. In addition to leveraging our robust platform to drive sales on our own websites, we see a significant opportunity to build on the strong foundation with our third-party e-commerce and wholesale.com partners and to extend our reach to new regions and partners.

As we drive our digital agenda, we will also continue to streamline our operations to be more asset-light and efficient. In 2021, we will be moving through the final leg of our New World Fossil 2.0 program. We have an opportunity to take advantage of upcoming lease expirations and expect to reduce our own store count this year by approximately 15% to 20%. This represents 65 to 75 closures globally.

Refining our store count also provides an opportunity to improve our inventory management processes and strengthen our Indian supply chain necessary steps as we make Fossil a more agile, nimble and profitable company.

As we focus on these major priorities, we also expect to build upon our growth opportunities in China and India. We continue to see a major opportunity in these regions where we have an established infrastructure and great management teams. The rapidly growing middle class in Asia has a strong affinity for aspirational brands in the traditional watch category, like Armani, Kors and Fossil and is digitally savvy, creating an additional runway for growth.

And finally, product innovation has always been and remains an important focus for Fossil. Our teams are passionate about innovation, and we have a robust product road map that will continue to excite the customer. Our mission is to craft compelling product and brand stories and to build communities in key markets by using our new data management and digital analytic tools. In traditional watches, we're doubling down on our flagship brands of Fossil, Armani and Kors, which continue to perform well. And we also have a strong

foundation in connected watches, which includes our feature-rich Gen 5 platform, the Hybrid HR and our new LTE product that launched earlier this year and opened new channels of distribution.

Importantly, we're excited about our innovation road map on connected, including both future product launches and software updates. As we think about the long-term trajectory of the business, we anticipate that top line growth will be fueled by our relentless focus on being a digitally led company on our strength of innovation and by favorable category and geographic trends.

While there's still uncertainty because of the pandemic and its effects, we are better positioned to capture revenue growth in 2021. We expect total sales to increase by 10% to 15% from 2020, with EBITDA margins in the mid single-digit range. Importantly, we believe the business is positioned to deliver sustainable top line growth in the coming years. We are executing against a large addressable watch market, we're seeing stabilization in the traditional watch category, and the connected segment continues to grow. Additionally, we have an experienced and committed team that is focused on our opportunity.

This afternoon, we are pleased to announce the promotion of Sunil Doshi to be our Chief Financial Officer. Sunil has deep institutional knowledge of the Fossil organization and 20 years of financial expertise, including prior CFO roles. This natural progression also creates an opportunity for Jeff Boyer to focus on his role as Chief Operating Officer, which will be particularly important as we continue to transform the company and position it for ongoing growth and increasing profitability.

In closing, we are profoundly grateful to all our Fossil associates who have been relentless in helping us reach this inflection point. While there is surely more work to be done, the heavy lifting of our transformation is behind us, and our teams are energized and excited about the opportunity to restore growth and to improve the profitability in the coming years. And now I'll turn the call over to Jeff to discuss the financials.

Jeffrey N. Boyer *Fossil Group, Inc. - CFO, COO & Treasurer*

Thanks, Kosta. The fourth quarter came in better than we expected, reflecting strong execution by our global teams in a tough environment. Despite a net sales decline of 26% or 28% in constant currency, we maintained strong gross margins, reduced operating expenses, delivered a significant improvement in adjusted EBITDA and generated positive cash flow from operations. Q4 net sales totaled \$528 million, primarily reflecting continued strength within both our Fossil and third-party e-commerce channels and strong growth in Mainland China including notable performance on 11/11 day.

From a regional perspective, performance in the Americas and EMEA was softer than total sales trends, principally reflecting pandemic disruptions and heightened restrictions in key European countries. In Asia, sales declined high single digits due to ongoing pandemic impacts partially offset by continued growth in Mainland China and return to growth in India. Digital sales, which we define as our own e-commerce channels, third-party e-commerce and wholesale dot-com remains strong, increasing 25% on a year-over-year basis.

Within our direct-to-consumer segment, sales growth of 50% in our own e-commerce channels partially offset traffic declines in our brick-and-mortar stores. Net sales in our Fossil retail stores declined 44%, which primarily reflects pandemic headwinds and lower store count. Globally, traffic and conversion trends remained consistent with recent quarters.

Turning to category performance. Watches were down 29% versus last year, with the performance in our APAC region outpacing Americas and EMEA. In connected watches, we achieved net sales growth in our most recent Gen 5 display watches, which partially offset declines in older generation products. Fourth quarter gross margin came in at 49.2%.

Excluding the inventory write-down in Q4 of 2019, our fourth quarter performance of this year represents an improvement of 60 basis points on a year-over-year basis. This increase was primarily driven by favorable channel and region mix, as well as fewer markdowns compared to prior year. Total operating expenses, which includes trade name impairment and restructuring costs, decreased by \$68 million or 22%, as we maintained our focus on strict cost control. Excluding trade name impairment and restructuring costs, SG&A expense was \$230 million in Q4, down 24% compared to a year ago. This reflects structural cost reductions across several areas of business, including payroll, marketing, travel, professional fees and services in contract labor and included a \$12 million noncash gain related to early lease terminations.

As a reminder, cost actions have been a key component of our New World Fossil 2.0 program, which delivered savings of \$175 million for full year 2020. From an earnings perspective, adjusted EBITDA came in at \$50 million, and operating income increased to \$18 million versus an operating loss in Q4 of last year.

Our Q4 income tax provision was \$15.2 million compared to \$0.7 million in the prior year period, primarily driven by valuation allowances against deferred tax assets. Diluted net loss per share was \$0.08 compared to a diluted net loss of \$0.14 a year ago. Both the 2020 and 2019 periods included New World Fossil restructuring charges of \$0.17 and \$0.08 per diluted share, respectively.

Moving to the balance sheet and cash flow. We're pleased with the ability of our teams to navigate the pandemic and manage for liquidity during the past year. In 2020, we generated \$101 million of operating cash flow and ended 2020 with total liquidity of approximately \$360 million. Cash and cash equivalents totaled \$316 million, and availability under our revolver was \$42 million. Total debt at year-end was \$227 million. We carefully managed inventory in Q4, ending the year with total inventories of \$295 million, down 35%. And we successfully cleared through our Gen 4 inventory.

Heading into 2021, we are better positioned to meet anticipated demand as we move through the year due to improvements in our inventory flow this year versus last year. We are maintaining strong discipline from a liquidity perspective. In Q1 2021, in addition to normal course working capital needs, we expect that our uses of cash will include pay down of a portion of our revolving credit facility and the normal quarterly amortization of our term loan. In subsequent quarters, we anticipate that our cash use will follow a normal seasonal pattern.

As we continue to pivot away from store growth and look to rationalize the portfolio, we expect our capital expenditure requirements to remain light in the near term. In 2021, CapEx is planned at approximately \$20 million.

As we continue our digital transformation work, we believe the business is well positioned from a strategic, operational and financial perspective and look forward to returning to top line growth in 2021. For the full year, we anticipate that net sales on a reported basis will increase in the range of 10% to 15%. On a full year basis, we expect to strengthen gross margins and leverage operating expenses, resulting in adjusted EBITDA margins of approximately 4% to 6%. Looking at the first quarter, we anticipate that the net sales for the 13-week period will decline in the range of 17% to 12% compared to last year's 14-week period.

In addition to lapping the extra week in Q1 of 2020, the year-over-year decline reflects the persistence of pandemic headwinds in both the Americas and EMEA for most of the quarter, and only partially offset by easier comparisons in the second half of March. Now I'll turn the call back to Christine to take us through some questions.

QUESTIONS AND ANSWERS

Christine Greany *The Blueshirt Group, LLC - MD*

Thanks, Jeff. I'll start with Kosta. Kosta, you talked about the importance of your digital business and initiatives to further accelerate that channel. You also stressed the importance of driving product innovation. How should we think about the importance of those strategies and how they're interrelated?

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

Great question, Christine. The key to it is giving consumers customized communications that are more relevant to them. Our digital platform gives us a greater capacity to show innovation and tell stories to our consumers. So keep in mind that about 70% of our customers in our stores are -- already shopped online before they go into the store. With our data and analytic capabilities, we're able to personalize communications, which gives us a more engaged consumer. And that has a significant impact on conversion as well as the lifetime value of that consumer.

The technology also enables us to build a much larger community that we can speak to on a regular basis, which again gives us a larger audience for new ideas and watches and accessories. It is a significant game changer for how we do business.

Christine Greany *The Blueshirt Group, LLC - MD*

Terrific. Jeff, moving to you now. Could you help us understand your expectations for cash flow in 2021? And what are the capital allocation priorities?

Jeffrey N. Boyer *Fossil Group, Inc. - CFO, COO & Treasurer*

Sure, Christine. This year, we continue to expect to generate solid cash flow and improve our overall liquidity position, much like we did this past year. This financial flexibility will allow us to reduce our revolving credit balance and will also allow us to amortize our term loan by approximately \$40 million in 2021. The net impact of all this is expected to be a modest increase in our year-end cash level and also a material decline in our debt outstanding. As we go throughout this year and as we strengthen our financial position as we come out of the pandemic, we'll continue to make important investments in our core operations. Specifically, we'll fund our critical digital initiative that you've heard some about today as well as a part of our business with normal inventory, expense and capital resources. Our planned digital investments are within our current operating plan and our 2021 CapEx budget of approximately \$20 million in 2021.

Christine Greany *The Blueshirt Group, LLC - MD*

Great, Jeff. Greg, could you talk more about your digital agenda what type of investments you plan to make in the near-term and over time, to become that digitally led company that Kosta talked about?

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

Sure. Our goal is to become a digital-first powerhouse, where product innovation and brand storytelling, combined with leading digital marketing and e-commerce capabilities to unlock accelerated growth. And we're seeing meaningful results in our underlying performance metrics based on the investments we've made to date.

In our direct-to-consumer channel, which includes our own brands such as Fossil, Skagen and Michele, as well as our multi-brand Watch Station online and store concept, we're seeing, #1 an e-commerce Salesforce platform that has unlocked a doubling of our conversion rate and increasing average order value through AI-driven personalization and post-purchase customer engagement; number two, a highly engaged community of more than 8 million customers in our CRM database which increased 45% year-over-year despite brick-and-mortar stores being closed or materially impacted for most of the year; and number three, a high customer lifetime value to customer acquisition cost ratio that has created a compelling business case that we're investing behind.

In our indirect channels, we've also been successful in establishing category leadership and getting share with the top pure-play e-commerce companies across the world and are also driving significant growth in digital sales with our top wholesale customers as well. To build on this momentum, we have an aggressive multiyear investment plan focused on further accelerating sales growth by installing industry-leading capabilities in 4 key areas.

Number one, digital marketing and activation, which allow us to deliver targeted and personalized media campaigns that build brand heat, community and traffic. Number two, personalized omnichannel customer experience in commerce, which will allow us to serve our customers in whatever combination of online and offline interactions are best for them, deliver a much more engaging and personalized shopping experience and expand the geographic footprint of our platform across all of our markets.

Number three, an artificial intelligence-driven CRM capability, which allows us to leverage first-party data capture to drive post-purchase engagement, including cross-sell and upsell opportunities, and deliver hyper-personalized marketing campaigns and e-commerce experiences across search, social, e-mail, text and on our sites. And finally, number four, advanced marketing and e-commerce analytics, where our methodology helps ensure that our investments drive the right short-term and long-term value for our business. Together, these capabilities are creating a platform that we believe will unlock a new wave of accelerated digital growth in our business.

Christine Greany *The Blueshirt Group, LLC - MD*

Great. Thanks, team. Kosta, just back to you for closing comments.

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

Well, thanks, everyone, for joining us. We look forward to talking to you on our next call. Have a good day.

Operator

Ladies and gentlemen, this concludes today's conference call. Thank you for participating. You may now disconnect.

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