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Q1 2021 Fossil Group Inc Earnings Call

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PRESENTATION

Operator

Good afternoon, ladies and gentlemen. Welcome to the Fossil Group First Quarter 2021 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; Sunil Doshi, Chief Financial Officer; Jeff Boyer, Chief Operating Officer; 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, everyone, and thank you for joining us today. We hope everyone is staying well. While COVID restrictions have been easing in several countries, our thoughts are with those being impacted by another wave of the pandemic, most notably in India, which is experiencing a tragic humanitarian crisis. Our thoughts and prayers go out to our associates, partners and the community at large being affected by the tragedy. Because the global environment remains dynamic, we are continuing to operate with concern and flexibility and we're prioritizing the health and safety of our team members, partners and local communities.

Turning now to our first quarter performance. We are pleased with our strong start to the year and feel particularly good about how the business is positioned. We are operating in a large addressable watch market and are seeing favorable trends in both the connected and traditional segments. First quarter net sales came in ahead of our expectations, driven by improving consumer demand in the Americas region. Total digital sales represented more than 40% of our global revenue mix and our own websites grew 59%, underscoring the dramatic shift in our business from a wholesale dominated model to a digital-first organization.

We also delivered strong gross margins above 50% and continue to improve operating efficiency, which allowed us to generate positive adjusted EBITDA in the quarter. We also made further progress against our cost reduction initiatives, which allowed us to reach the $250 million target under our New World Fossil 2.0 program earlier than planned. After successfully re-sizing the organization and cost structure, we remain focused on driving operating efficiency going forward. Additionally, the structural economics of our business continue to improve with ongoing and outsized growth in digital.

Looking at the first quarter from a regional lens. We continue to drive robust growth in Mainland China, with 45% sales growth versus a year ago and 81% sales growth since 2019. The balance of our Asia Pacific business was more negatively impacted by the pandemic. In the EMEA region, pandemic-related restrictions and closures pressured sales in the quarter. While conditions remain challenging in several markets, we are beginning to see some easing restrictions in select countries such as the U.K., Italy and France.

Within the Americas region, we saw low single-digit positive sales growth in the U.S., driven by easing restrictions and improving consumer confidence. Sales in Canada and Latin America were pressured by closures and restrictions in those markets during the period. In parts of the world where consumer confidence is strengthening and demand recovery is underway, we are seeing a return to growth in our brands and product categories. In Q1, traditional watches in both Kors and Fossil grew in the U.S. and captured share. In Mainland China, Emporio Armani delivered strong sequential growth driven by positive response to our tailored assortments for that region.

Globally, our jewelry category saw broad-based growth in our largest brands. Longer term, the opportunity for growth across all of our product categories and brands remain significant. In the connected category, we are pleased to see our strategic initiatives bear fruit. With more emphasis on a core set of brands and SKUs and distribution that is focused on e-commerce, consumer electronics and teleco channels, we drove growth in our Gen 5 platform in sales and margin.

In Q1, our Gen 5 platform officially expanded with an LTE product, which broadens our capabilities and functionality. Our innovation roadmap remains robust, fueled by our software and hardware capability that will further enable us to bring brand excitement and innovation to consumers. Our results in Q1 reinforced that our key strategic initiatives are working and we will continue to focus on our efforts for the balance of 2021 on these same strategies; digital acceleration, product innovation, operating efficiency and the growth opportunity in China.

Over the past few years, we brought a digital-first mindset to the entire organization and built the infrastructure needed to transform our business model. Our past and ongoing investments in capabilities and systems, coupled with an acceleration of digital consumer behavior, has gotten us to an inflection point in our business model. With digital now our largest channel, we are positioned to begin offsetting the top line pressure that has persisted in other channels for the past several years.

Importantly, we're seeing an ongoing strength within both our owned and third party e-commerce sites as well as improving trends in wholesale.com. We ended Q1 with digital sales at 41% of our global mix and that is trending higher in key markets. Given the robust capabilities we built, we believe digital will continue its strong trajectory and ultimately exceed 50% of our total sales. The current economics on this business are already compelling and we expect that to become increasingly profitable as we continue to build scale.

Innovation continues to be at the heart of everything we do and in Q1, we demonstrated how innovation not only drives growth, but also supports our ESG strategy. Our program, Make Time for Good, encompasses our focus on being a purpose-driven organization. Our aim is to have the highest impact possible for our people, planet and communities through our sustainability platform. I invite you to read more about our programs and initiatives on our Investor Relations website under sustainability.

From a product lens, our efforts on sustainable and innovative raw materials came together in Q1, with our Fossil cactus leather tote and limited-edition solar watches launched across several brands. In both cases, consumers reacted favorably, confirming our belief that product innovation and ESG are mutually beneficial. From a social lens, we further enhanced our Make Time for Good platform, where we are excited to announce that we will contribute 1% of our Fossil e-commerce sales to the Fossil Foundation, whose goals include helping underserved youth around the world.

Despite the ongoing global disruption driven by the pandemic, we are encouraged by improving consumer demand in key markets and our strong start to the year. As a result, we are raising our full year outlook to 12% to 16% sales growth and adjusted EBITDA margins to 5% to 7%. As always, we are grateful for the dedication and commitment of our teams globally, and we're all energized by the opportunity to deliver top line growth and improved profitability this year, while continuing to position the business for longer term success.

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

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

Thanks, Kosta, and good afternoon, everyone. We are pleased to report better-than-expected results for the first quarter, despite the ongoing disruption driven by the pandemic.

Net sales declined 7% or 10% in constant currency. Gross margin came in above 50%, and we exercised careful cost control, resulting in $7 million of adjusted EBITDA for the quarter and $94 million in adjusted EBITDA over the trailing 12 months. Q1 net sales totaled $363 million for the 13-week period, primarily reflecting improving consumer demand in the U.S., continued global strength within both our Fossil and third party e-commerce channels, offset by traffic and sales declines in our stores and wholesale channel.

From a regional perspective, net sales in the Americas was down 1%, reflecting low single-digit growth in the U.S., offset by ongoing pandemic-driven pressures in Canada and Latin America. Trends remained soft in our EMEA region due to ongoing pandemic disruptions and restrictions in key European countries. In our Asia region, Mainland China delivered strong sales growth of 45%, which was more than offset by sales decline in other countries and the region, driven by pandemic conditions.

In Q1, we saw ongoing broad-based global strength in digital sales, which increased globally by 40% on a year-over-year basis and accounted for 41% of our worldwide net sales. As a reminder, our digital sales consist of our owned e-commerce channels, third party e-commerce platforms and wholesale.com.

Now looking at the business from our own DTC perspective, which encompasses our own e-commerce sites and stores. Comparable DTC sales were down 14% versus last year as sales growth on our e-commerce sites was more than offset with traffic-driven sales declines from our retail stores. Globally, traffic and conversion trends have remained consistent with recent quarters with some modest traffic improvement in the Americas offset by trends in EMEA. We ended the quarter with 395 company-owned stores, down 12% versus a year ago.

Turning to category performance. Global watch sales declined 9% in Q1, a sequential improvement from the 29% decline in Q4 of 2020, and delivered 1% growth in the Americas region. In our jewelry category, we grew sales by 22% globally, with increases in the Americas and APAC regions.

Moving down to P&L. First quarter gross margin came in at 50.3%, that compares to 35.9% in Q1 of last year when we took significant actions to move through older generation connected inventory and incurred minimum license product royalties due to lower sales volume resulting from the onset of the pandemic. In total, these prior year actions did not impact Q1 of this year to the same extent as last year and taken together, accounted for approximately 1,300 basis points of improvement in the year-over-year comparison.

Gross margin in the first quarter of 2021 also benefited from favorable product, channel and region mix, as well as favorable currency impact of 110 basis point, partially offset by higher freight costs. Total operating expenses, which include impairments and restructuring costs were $199 million, a decrease of $75 million or 27% as we maintained our focus on strict cost control.

SG&A expense was $187 million in Q1, down $58 million or 24% compared to a year ago, and reflects structural cost reductions across several areas of the business. Cost reduction under our New World Fossil 2.0 program accounted for $53 million in savings in Q1, most of which was realized through lower operating expenses. Inclusive of Q1's cost reductions, we have now realized $279 million in cumulative cost reductions as part of the NWF 2.0 program, exceeding the program's $250 million goal earlier than planned. Taken together, Q1 adjusted EBITDA was $7 million, adjusted EBITDA margin was 2% and operating loss narrowed substantially versus the prior year.

Turning to income taxes. Our Q1 income tax provision was $2 million, reflecting an increase in deferred tax valuation allowances on current operating losses and an increase in withholding for foreign taxes. In Q1, diluted net loss per share was $0.47 compared to a diluted net loss per share of $1.69 a year ago. Both the 2021 and 2020 periods included New World Fossil restructuring charges of $0.12 and $0.15 per diluted share, respectively.

Moving to the balance sheet and cash flow. We ended Q1 with total liquidity of approximately $250 million, including cash and cash equivalents of $247 million. Total debt at the end of Q1 was $195 million. We ended the first quarter with total inventories of $322 million, down 27% versus last year, as we closely managed inbound receipt in light of ongoing pandemic-driven impacts and have driven improvements in our overall SKU productivity and inventory turns.

From a capital allocation perspective, in addition to normal course working capital needs, Q1's use of cash included the pay down of a portion of our revolving credit facility and the normal quarterly amortization of our term loan, capital expenditures remain tightly controlled and totaled $2 million, which is in line with our full year plan of approximately $20 million.

Turning now to our outlook. Given our better-than-expected performance in Q1, we are raising our full year 2021 outlook. We now expect full year net sales to increase in the range of 12% to 16%. In the second quarter, we anticipate that net sales will increase in the range of 50% to 55% compared to Q2 of 2020. As a reminder, year-over-year comparisons are easier in Q2 of '21 due to the extreme pandemic impacts in the second quarter of last year. Additionally, we now expect full year adjusted EBITDA margins of approximately 5% to 7%.

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

QUESTIONS AND ANSWERS

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

Thanks, Sunil. Let's move to some questions. Jeff, you achieved the $250 million target under the New World Fossil 2.0 program actually exceeded that, what should we anticipate in terms of further cost savings and where are you looking to capture further efficiencies?

Jeffrey Boyer

Sure, Christine. Over the past few years, we have successfully resized the organization and our cost structure to better align with the fundamental shifts in transformation of the business model which Kosta had mentioned earlier. We'll continue our efforts to further streamline our cost structure through lower overhead costs and also a smaller, but more profitable and more efficient store portfolio. In addition, we are expanding our programs to also improve gross margin performance through enhancing our sourcing and inventory management initiatives, as well as taking some select pricing actions, where that's appropriate. We expect the benefits of these various programs will enable us to invest in our digital-first strategy, drive top line growth, while still expanding our bottom line operating margins

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

Great. Thank you. Turning to Kosta, what is your view of the consumer as the pandemic begins to taper? As consumers become increasingly comfortable with going out and returning to stores, what do you think the optimal mix of digital business looks like going forward?

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

When the U.S. and China, we're starting to see a return to normal with more people out and about and participate in a social activities. There obviously is pent-up demand and the stimulus checks in the United States are making an impact on retail. We're very pleased to see a renewed interest in accessories. The exact size and timing of the consumer rebound globally is difficult to call at this point, but we're encouraged by the strength of the business in both the United States and in China. We're also doing very well in Europe, when you consider it's mostly closed down. You can tell the consumer there is ready to start shopping again. Regarding the optimal mix of business, digital versus bricks, it's very interesting to see the changes in the consumer. They are ready to buy and more likely to buy online even as things open up. We expect this trend will continue and over the next few years, over 50% of our sales will be conducted in digital channels with a further expansion highly likely. With that as the consumer shopping landscape of the future, we continue to invest in digital capabilities and channels to meet the need. As Jeff mentioned, we believe we can make the necessary digital investments and improve our operating margin as we transform our business model to be more digital first. This is a game-changing opportunity for the company.

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

Great. Thank you. Sunil, how should we think about the puts and takes around expenses this year? And what are you seeing relative to some of the big labor and freight headwinds that a lot of companies are talking about?

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

Yes. Thanks, Christine. Yes, kind of narrowing down on expenses when you think about this year. The company's -- it's helpful to think about the bigger picture over the last couple of years. The company has undertaken significant effort to reduce its OpEx as part of its New World Fossil program. A lot of that reduction took place in 2019 and 2020, and we saw some of the benefits of that come through in this first quarter. As we move through 2021, we'll begin to lap some of those cost reductions that were put into place in the prior years and some of the temporary expense savings from last year's extreme COVID-driven shutdowns, which will result in some variability in the year-over-year comparisons relative to Q1. On a sequential basis, we expect some dollar increases in SG&A relative to Q1 for normal variable expenses that flex with sales and for marketing investments to drive sales. But this will still translate to leveraging our expenses relative to 2020 and 2019. With respect to cost inflation, while we haven't seen any material impacts from inflation at this point, it might be helpful to break it down for our business. From a wage rate standpoint, the potential impact from hourly wage rate inflation in the U.S. market is low, given that our store fleet and store payroll is a relatively small part of our infrastructure and given that our effective hourly wage rate is already well above current minimum wage. On the cost of goods side, we haven't seen any significant changes in raw material pricing that would impact the overall cost of goods, but we'll keep our eye on that. More broadly, we do believe there are opportunities to consider to offset inflation in the future, whether that's in pricing or other productivity opportunities throughout the supply chain.

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

Okay. And could you provide some additional color commentary on the revised guidance that you provided today?

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

Yes, yes, sure. In sharing -- maybe it's helpful to kind of go back to the original guidance -- in sharing our original sales guidance a couple of months back, which was 10% to 15% revenue growth, we have been seeing some improvements in the underlying demand coming out of the fourth quarter as vaccine deployment was becoming more of a reality. What's been clear in Q1 is that the vaccines are a critical step in getting the pandemic under control and stepping through the first quarter, we saw outperformance in the U.S., our largest market, and continued momentum in Mainland China. However, we've experienced some extensions of lockdowns in most of the EMEA countries and most recent, we've seen some severe spikes in the pandemic in India and other countries in our APAC region. So taking this into account, we have flowed through the results from Q1, while for the balance of the year reflected improvements in the U.S., with some tempering in parts of APAC and EMEA. And all of that's reflected in the full year expectations of 12% to 16% net sales growth. From an adjusted EBITDA perspective, we expect that the increase in full year sales to flow through and to leverage and improve our overall adjusted EBITDA margins to the 5% to 7% that we shared.

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

That was helpful. Thank you. And just to wrap up with a question for Greg. We've heard a number of comments regarding Fossil digital first strategy. Can you just talk about kind of the key pillars of the program again for us?

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

Yes. As Kosta mentioned in his prepared remarks, our goal is to become a digital-first powerhouse, where product innovation and brand storytelling combined with leading digital marketing, analytics and e-commerce capabilities, will unlock accelerated growth. The 3 key pillars of our digital initiatives are, 1, expanding the success of our DTC owned brand websites to the rest of the world on our global scalable cloud-based platform. 2, continuing to build on and scale the success we're already having with our third-party e-com and wholesale.com programs, and adding new partners to those programs. And 3, building brand heat and accelerating demand through high ROI digital marketing initiatives. On our last call, I shared with you that 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 WatchStation online and store concept, we're seeing an e-commerce Salesforce platform that resulted in a doubling of our conversion rate and increased order value. A highly engaged community in our CRM database, which increased 45% last year and which we expect to increase another 50% this year. A high customer lifetime value to customer acquisition cost ratio that has created a very compelling business case that we're investing behind. Now, let me spend a minute or two on a couple of our other near-term initiatives, the expansion of our third-party e-commerce marketplace offerings and the scaling up of our wholesale.com efforts. These expansion programs are effectively additional points of distribution in the digital e-commerce space. In these indirect channels, we've been very successful in establishing category leadership and gaining share with the top pure-play e-commerce companies across the world, while also driving significant growth in digital sales with our top wholesale customers as well. We have plans to aggressively expand our offering of traditional watches, smartwatches, leather and jewelry offerings on these platforms that we're already on, and at the same time, expand the number of marketplaces and wholesale.com sites in each of our 3 regions, Americas, EMEA and APAC. These expansion plans provide us with a number of additional sales opportunities in the second half of this year and will be further expanded on as we enter 2022. We're incredibly pleased with the progress that our teams are making and look forward to sharing more positive results in the quarters ahead.

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

Thanks, Greg. That was very helpful color. I'm going to turn it back to Kosta to close this out.

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

Thanks everyone for joining us. We look forward to speaking to you again on our second quarter call.

Operator

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