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Q1 2023 Fossil Group Inc Earnings Call

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PRESENTATION

Operator

Good afternoon, ladies and gentlemen, and welcome to the Fossil Group First Quarter 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.Â Now I'll turn the call over to Christine Greany of 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 areÂ Kosta Kartsotis, Chairman and CEO; Jeff Boyer, Chief Operating Officer; Sunil Doshi, Chief Financial Officer.Â 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 the 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.Â 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.Â NowÂ I'll turn the call to Kosta to begin.

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

Thanks, Christine. Good afternoon, everyone. And thanks for joining us today. The company executed to plan in the first quarter delivering financial results in line with our expectations. Constant currency net sales declined 11% and currency translation was in line with our expectations we laid out inÂ our last call. Our inventories are in good shape and are down 13% from last year, and we are maintaining our outlook for the rest of the year. Sunil will cover the financials in more detail in a few minutes.Â While the global operating environment remains choppy, we're seeing cross currents and demand regionally. In Asia, consumer spending appears healthy so far this year overall. In Mainland China traffic and our online channels is picked up quickly. And our wholesale partners are planning for stronger growth this year, as consumer spending and tourism are picking back up. In India, demand remains strong for traditional watches and sell out trends were strong across retail, e-commerce platforms and brick and mortar wholesale. With a generally strong economic backdrop in India and the reopening of Greater China we will be leaning into these businesses during 2023.

In the Americas, the consumer is showing some strength but it tends to be directed more to services and to categories outside of our core watch business. Our Q1 sales in the direct-to-consumer channel were strong. Comps were up double digits with growth in both stores and e-commerce. These DTC comps benefited from our digital investments, particularly in our own e-commerce sites. And our wholesale channel as expected year-over-year declines and shipments continue to lag sell out trends as retailers closely manage their inventory levels and maintain caution on their outlet for consumer spending.Â In Europe, consumer spending in our primary categories is down and with inflation still running high, we expect underlying consumer demand to remain soft. We are working closely with our wholesale partners to manage inventory levels, and to develop ideas to help grow their businesses. We're also focused on expanding our jewelry distribution, which we believe creates an additional pathway for future growth.

In our direct-to-consumer channels comp retail sales were up double digits. Similar to the Americas region, we're seeing benefits from recent investments in digital capabilities that are translating the sales growth, especially in our own e-commerce sites. As we go into the second quarter, we're maintaining our full year outlook for sales and operating margin, which assumes no notable change in consumer spending. We are expecting improvement from our Q1 trend due to easier comparisons due to the impact of TAG and due to the continuing sales momentum in Mainland China.Â As a reminder, the core tenets of our strategy are to simplify our business, lean into our core capabilities and distort our most significant growth opportunities. Underpinning these strategies is our goal to return the business of top line growth, drive profitability, and to maximize shareholder value over the long term. I'll update you on our key initiatives where our teams are making steady progress.

First, the transform aspect of our strategy. We made significant inroads in Q1 on cost reduction and inventory. Looking at the balance of 2023, we are actively monitoring trends and carefully managing our open to buy to maximize sales given the dynamic macro environment. As to growth we're focusing on our three key pillars, which include revitalizing the Fossil brand, growing our core license brands in watches and jewelry, and growing our premium brands.Â As we execute our Fossil brand revitalization strategy, we are making good progress on our key initiatives for traditional watches, jewelry and leathers. We invested more in marketing to drive awareness and conversion in Q1 and we're pleased with the momentum we're driving in the brand.Â We are launching a major new creative campaign in the fall that is based on our recently completed consumer research on the brand. This will be accelerated by an additional ad spend and facilitated through our dramatically enhanced global digital platform. We have ramped up the creativity and innovation in all of our Fossil categories, and have a number of exciting collaborations in the pipeline. Our launch last week of our Star Wars Limited Edition collaboration was quite exciting and brought a lot of energy, awareness and sales to our global distribution channels. We feel we have a significant opportunity to create events and campaigns that celebrate modern culture with engaging communications and exciting unique products.

Moving to our licensed brands, we're pleased to announce the extension of our long term licensing agreement with Giorgio Armani. This partnership is for both watches and jewelry globally for the three brands; Emporio Armani, Armani Exchange and Armani Swiss. The Armani brand has great residence all over the world and a great legacy in the watch and jewelry business and has a significant upside potential. Earlier this year, we also signed an extension with the Diesel brand to extend our watches and jewelry partnership. The Diesel brand is undergoing a resurgence and is creating excitement and buzz in the marketplace among millennial females in addition to their core consumers.Â Looking at our premium strategy, we see a significant opportunity to expand our presence in premium watches over the long term. This is a category that is projected to continue outperforming the traditional watch growth across markets globally. For 2023, we are building on our Michelle brand with new campaigns designed to drive traffic to our retail partners as well as to our direct consumer channel. Specifically, we will be amplifying our presence in wholesale through new activations and new marketing and digital activities.

We believe continued focus and execution against the three pillars will help us reignite sales in the coming years as we continue to innovate with great product and storytelling, modernize our marketing, and optimize and grow our digital capabilities. We appreciate all the diligent and creative efforts of all of our teams all over the world as we embark on our plan to transform and grow the company. We are committed to building shareholder value and look forward to keeping you updated on our progress.Â And now I'll turn the call over to Sunil for the financials.

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

Thanks, Kosta. And good afternoon, everyone. In the first quarter, our performance came in as expected on revenue, margins and inventory with no significant variations in key themes. The impact of foreign currencies on our P&L in Q1 was also in line with our expectations. Relative to the prior year quarter currencies impacted net sales by 280 basis points, gross margins by 220 basis points and operating margins by 260 basis points.Â Starting with sales. Global sales and constant currency were down 11%, with the trend in each region playing out as we anticipated. Sales in the Americas and Europe were down 15% and 11% respectively. As we noted on our yearend earnings call the decline in these regions primarily stemmed from wholesale shipping trends. In both regions, shipments into the channel significantly lagged the underlying sell out from our major retail partners.Â We attribute this pattern primarily to the continued cautious stance that most large retailers have maintained on consumer spending and inventory purchases in discretionary categories, including watches and jewelry. Partially offsetting our wholesale channels declined in these regions we did achieve solid growth in our direct to consumer channels, including double digit comparable retail sales growth. These results reflect strong execution of our digital and store capabilities and some increased promotional activity through these channels as we cleared prior year inventory.

Sales in Asia were down 2% versus the prior year quarter. Sales in India grew double digits and missed a favorable consumer spending environment coupled with solid execution in retail and wholesale. In Mainland China, we're beginning to see a comeback. Sales declined 10% a significant improvement from the trends over the past two quarters results significantly outpaced our plans as underlying sell out and direct to consumer and wholesale channels has picked up.Â Global sales for the powerful brand grew 1% with even stronger growth in traditional watches and leathers. Growth in Fossil was more robust in the Americas and India where sales were up mid-single digits. Offsetting growth in Fossil, our largest licensed brands declined, primarily driven by the trends I discussed in our wholesale channels in the Americas and Europe.

Moving down the P&L. First quarter gross margin was 49.4% up 40 basis points versus last year. Gross margins included a restructuring charge of approximately $5 million or 170 basis points for certain TAG related costs as we anticipate changes in our product offerings. Excluding these costs adjusted gross margin was 51.1%. Our adjusted gross margin benefited from timing of certain product licensing expenses, lower freight and a favorable product mix partially offset by headwinds from increased promotional activity in the impact of foreign currencies.Â Total operating expenses were flat versus last year. Restructuring expenses were $7 million primarily related to severance costs in conjunction with our TAG Program. Excluding restructuring costs and impairment SG&A was down 3% versus last year. This reflects reductions in fixed costs partially offset by variable cost increases associated with revenue growth in our direct channels, and higher marketing spend related to the growth initiatives in our TAG Program.Â Taking together Q1 operating loss came in at $37 million compared to an operating loss of $14 million in the year ago period. Adjusted operating loss was $25 million and adjusted operating margin was minus 7.7% of sales, which includes the FX driven headwinds of 260 basis points that I previously mentioned.

Turning to the balance sheet, we brought inventories down 13% from last year's levels ending the quarter at $337 million, and in cash was $127 million, and we had $91 million of availability under our revolving credit facility.Â Turning now to our outlook. We remain focused on the core elements of our transforming growth strategy, which includes growth initiatives, our plan to drive $100 million in annualized benefits over this year and next, and reducing our inventory as the primary means to improving working capital.Â At the same time, we continue to keep a cautious stance on the consumer in light of near-term macro environment, particularly in the Americas and Europe. And we are leaning into the reopening play in Mainland China. Taking these factors into consideration, we're maintaining our full year guidance for sales and adjusted operating income margin, which includes net sales to be in the range of down 5% to plus 1% and adjusted operating margin in the range of 0% to plus 3%.Â Let me outline a few more specific assumptions that are embedded in our outlook. Our annual sales guidance assumes mid-single digit to low double-digit declines in Q2 of 2023 versus the prior year and then positive growth rates in the second half of the year.

First on currencies. We estimate a 50-basis point headwind on our revenue in the second quarter based on prevailing rates. However, in the second half of the year, we see that impact reversing and estimate that prevailing rates will result in a 200-basis point tailwind on our revenue. On a full year basis and inclusive of Q1 that would average out to approximately a 40-basis point tailwind on our revenue.Â Second, excluding the impact from currencies, our second half of the year sales forecasts reflect better year-over-year metrics driven by three key factors. First, in the second half of last year, particularly in Q4 many large wholesale accounts in the Americas and Europe sharply curtailed their purchase levels. This year, we have easier wholesale shipping comparisons, which based on current sellout trends are forecast to provide year-over-year growth as purchase levels normalize. Second, our forecast assumes continued momentum in Mainland China as the country is reopening creates healthier spending and travel patterns.Â In addition, we will lap prior year's COVID impacted sales levels. And third, significant product and marketing initiatives contemplated in our TAG Program particularly in Fossil brands and our premium watch offerings are expected to drive growth.Â

From a gross margin perspective, our outlook assumes gross margin rates similar to last year with some improvement in Q4.Â Benefits to gross margin are expected to come from lower freight rates, favorable product sales mix, including an increased mix of high margin China sales and inventory cost benefits from prevailing currency rates. Offsetting these benefits, our forecast assumes some continued pressure for promotional activity. One final point on gross margins. Our outlook assumes that benefits related to the timing of product royalty cost, realizing Q1 will be offset in the second half of the year.Â As we previously noted, the TAG Program is expected to generate at least $100 million in run rate savings by the end of fiscal year 2024 primarily in our operating expenses with modest benefit to cost of goods sold.Â Our 2023 guidance assumes that we realized 50% to 60% of that annualized goal in 2023, which helps to offset inflation and increases in marketing investments associated with our TAG growth initiatives. Additionally, we estimate approximately $25 million to $30 million in restructuring costs associated with the TAG Program to be incurred in fiscal year 2023.Â Finally, from a balance sheet perspective, we expect to reduce working capital in 2023 as we manage our inventory levels down throughout the year. We aim to achieve this through reductions in inventory receipts, as well as through initiatives to improve our end-to-end supply chain operations. The combination of these activities are expected to significantly improve our cash flows in 2023.Â 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 - MD***

Thanks, Sunil. Let me start with Kosta. Can you talk about the major trends you're seeing across your categories on a global basis?

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

Well, as we mentioned in our remarks, we're seeing many different trends depending on the geography and the category. But overall, there seems to be three big trends out there. The first is just the overall strength of the Swiss watch business globally and especially in the United States. It's great for us to see this much interest in the category because it bodes well for the rest of the watch business. There's obviously a core user out there that loves watches, and the Swiss watch business tends to be mostly men's watches and mostly luxury sport.Â So we are focusing on the men's sport part of our assortments in order to capture the less affluent, more aspirational customer. The second one is Asia. The resurgence in China and the strength of India also bodes well for the watch business. These are again, traditional core watch customers that aspired on a great watch. The emerging customer loves watches and accessories and the increasing travel is going to spur more growth.Â We have a great position in these markets when we look forward to long term growth. And the third is the fact that in Europe and Americas our wholesale business is tough and the DTC business is very good. It shows that our marketing and digital programs are working very well and that the customer will respond to great storytelling and compelling product. The strong response to our collaboration tells us that and we are planning to do a lot more of these content driven activations.

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

Thanks, Kosta. A follow on for you. You mentioned China, could you share more color on how the consumer is rebounding there as we move through 2023? And what are the potential risks to a broad-based comeback there?

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

Well, we're obviously very excited about the consumer rebound we're seeing in China. Like many other companies, we're seeing consumer mobility, retail sales increasing at a quick rate, both online and in bricks and mortar. And we have a very strong experience team in China that drove the business over $200 million before COVID. And now they're focused on getting it back to that level and higher, the potential is definitely there. Our most significant challenge in the second half of this year is going to be our ability to ramp up inventory flow to meet the demand. And we're very focused on doing just that.

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

Jeff moving over to you. How are you progressing on the transformation efforts? Can you talk to us about how you're tracking against the $100 million in expense savings under the TAG Plan? And how should we think about the cadence of those cost reductions in 2023? And then lastly, could you spend some time on specific actions you're taking beyond the workforce reduction and store closures?

Jeffrey N. Boyer ***Fossil Group, Inc. - Executive VP & COO***

Sure. First of all, we're progressing really well on all the key elements of our transformation program, Project TAG as we refer to it. Very importantly, this program includes several transformation pillars, as well as the growth initiatives that Sunil and Kosta have been talking about.Â On the transformation side, in addition to improving our store and organizational productivity, we're also heightening our focus on the categories and the brands that can have the most substantial impact on our business, which this really means focusing in on our Fossil corps, Armani, in Diesel businesses in our core watch and jewelry categories. This additional focus is already showing up in the strong first quarter performance of our own brand, and our own Fossil brand as Sunil mentioned.

More specifically, we're optimizing our watch jewelry and smartwatches assortments, rationalizing our SKU base against those categories as well and aligning our inventory decisions to those higher productivity offerings. Over the longer term, these efforts will improve our sales productivity and gross margin performance. While the wholesale channel in North America and Europe are constraining sales growth in the near term, we are seeing early signs of improved gross margin performance on these lower inventory levels.Â As Sunil mentioned, we are on track to achieve our target of $100 million in annualized run rate benefit by the end of next year. We're being thoughtful in our reorganization and profitability improvement efforts to ensure that we can importantly strengthen our overall business performance at the same time, we are becoming more efficient. As a result, we expect to see between 50% and 60% of the run rate benefits this year weighted mostly to Q3 and Q4 with the remainder of our efforts on TAG analyzing next year.

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

One more quick follow up for you regarding a specific issue that has challenged a number of retailers. Jeff what is the current supply chain situation at Fossil?

Jeffrey N. Boyer ***Fossil Group, Inc. - Executive VP & COO***

I mean overall our supply chain actually operate relatively well during the pandemic when a number of other retailers had high periods of disruption particular flow of goods. For us our most significant issue has been increased freight costs rather than lead times. Recall that due to our relatively small cube size and high dollar value, most of our product volume and dollars shipped via air freight and with a smaller portion mostly leather goods shipping via ocean containers.Â Post-pandemic we are seeing lead times shorten and freight costs come down particularly on leathers which again is shipped via ocean, ocean freight. The inbound freight savings both air and ocean freight that we're seeing are one important element that will support our gross margin expansion in the second half of the year and into next year.Â As we look forward, we'll build on our solid supply chain foundation, with additional work on structural reduction store overall inventory levels in improvement in our turnover performance. The category and brand focus that I mentioned in my TAG comments is helping to reduce the level of our unproductive SKUs, thereby improving turns in generating better gross margin performance.

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

Moving over to Sunil. Great to see the reduction in inventory levels in Q1. How should we think about inventory composition and working capital needs as you work down inventory levels throughout the remainder of the year? And how does that correlate to cash flow generation in 2023?

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

I think it's helpful to walk back to the end of last year first. We ended 2022 with elevated inventory levels and heading into 2023 we were planning reductions in inventory in two buckets. First, the more tactically, we immediately reduce the future flow of inventory. And second, we're executing against initiatives that we believe will take us to structurally lower levels. The second step involves initiatives that will span a couple of years. Q1 tells us that we're generally on track as inventory levels were down 13% in cash use improved year-over-year.Â So this will remain a key focus as we execute our plans in 2023 and in doing so, we would expect to see a working capital benefit and significant improvement in cash from operations for the year. Zooming out a bit the improvement in working capital and cash from operations is very relevant as we think about investing in our near-term priorities and TAG where our goal is to return to top line growth and better adjusted operating income margins. We think this is the best way to drive shareholder value in the near term. Longer term, of course, this provides an opportunity to evaluate additional pathways to return capital to shareholders.

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

I'm going to turn it back over to Kosta to close out the call.

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

Thanks for interest in Fossil and we look forward to speaking with you on our second quarter call in August. Thanks very much.

Operator

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