

Fossil Group
Q2 2024 Earnings Call Prepared Remarks
Thursday, August 8, 2024

Christine Greany, Investor Relations:

Hello everyone and thank you for joining us. With us today on the call are Jeff Boyer, Interim CEO and Andrew Skobe, Interim 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.

With that, I'll now turn the call over to Jeff.

Jeffrey Boyer, Interim CEO:

Good afternoon everyone and thanks for joining us. I'd like to welcome Andy Skobe, our newly appointed Interim CFO, to the call. Andy joined us on July 1st and has quickly ramped on our business, allowing for a seamless transition into the CFO role.

I'll begin with a high level overview of our financial results and business performance. Then do a deeper dive on our TAG Plan and why we're confident that we will position Fossil to return to profitability. Then I'll pass the call to Andy for a more detailed look at the financials.

Second quarter results were in line with our expectations, with topline trends remaining relatively constant year-to-date. Against this backdrop, ongoing progress within our TAG Plan allowed us to deliver meaningful gross margin expansion, continue to take costs out of the business and substantially narrow our adjusted operating loss. The highlights for the quarter include 390 basis points of gross margin expansion, an 18% reduction in SG&A, and a nearly 40% reduction in our adjusted operating loss.

Let me provide some color around sales trends. Net sales declined 19% on a constant currency basis which included approximately five points of impact related to our strategic actions to exit the smartwatch category and optimize our retail store portfolio. At a high level, macro and category dynamics continue to present a significant headwind. As other companies in the consumer segment have noted, the wholesale channel in the US and Europe remains challenging, and consumption sentiment remains soft in China.

As we discussed last quarter, about half of our sales base is beginning to show signs of stabilization, with Q1 performance in this sector approximately flat and Q2 results down about 4%. The most notable areas of the business where we're seeing positive dynamics emerge are 1) Fossil traditional watches, which were approximately flat globally on a comp basis, and 2) India, where sales increased double-digits compared to last year, reflecting strong growth across virtually all brands.

The more challenging areas of our business - licensed watch brands and leathers - represented about half of our revenue base in the quarter. The pressure we're experiencing in our licensed watch brands can be traced to ongoing contraction due to licensor brand repositionings, as well as the soft consumer demand I noted in China. Encouragingly, we've started to see watch and jewelry sales trends begin to strengthen in our key licensor boutiques. Though a small percent of our overall sales, we view this as an early sign that their brand repositioning efforts are starting to gain traction. In our Fossil leathers category, as a result of softer than anticipated consumer response to our new product offerings we are repositioning the assortment to deliver enhanced functionality and increased value to the consumer.

During these challenging times, we are focusing on four core priorities to position the Company to return to growth and profitability: first, Advancing our Transform and Grow Plan, second, Strengthening our Balance Sheet, third, Stabilizing the Business and fourth, Conducting a Strategic Review of our business model.

Our teams are working tirelessly and delivering strong execution on multiple workstreams under our TAG Plan. We're encouraged by the operational and financial progress we're seeing, as reflected in our margin expansion and cost reduction year-to-date this year.

A critical foundational element of TAG is our shift to a globally-led operating model, with regional execution of consolidated brand strategies. This model, which is expected to drive greater consistency, efficiency, and accountability, is better aligned with the size of our business and our long-term strategic objectives. Standing up this new model included some rightsizing actions in the first half of the year and we're continuing to evaluate additional opportunities as we evolve the organizational structure in the coming quarters.

Importantly, the efficiencies we're capturing under our TAG plan are driving significant improvement in gross margin and operating expense. Year-to-date, we're tracking to achieve at least \$100 million of annualized benefits from TAG in 2024 and remain on track to achieve expected total plan benefits of \$300 million.

From a gross margin perspective, we're realizing benefits from SKU rationalization and pricing and promotional initiatives. From an operating expense lens, we're capturing benefits through several actions as we continue to rightsize our cost structure. These include workforce reductions, procurement and indirect cost savings, store closures, rent negotiations, and store labor optimization. The actions I just outlined are expected to generate significant gross margin and SG&A benefits in the second half of 2024 and continue into next year.

Our work to strengthen the balance sheet is progressing. As we discussed on our last call, during Q2 we received a US tax refund of \$57 million, providing us with incremental cash and strengthening our liquidity position. Second quarter ending inventory declined 38% versus a year ago and 10% compared to Q1, driving improved working capital. We're continuing to focus on the asset monetization opportunities we talked about last quarter, including the sale of real estate in Europe, while also pursuing opportunities to utilize our working capital more efficiently, leverage our inventory and receivables, and obtain liquidity opportunities for our non-ABL assets. We ended the second quarter with \$156 million of liquidity, comprised of cash and available borrowings under our revolving credit facility. Based on current business trends and anticipated working capital needs, we're positioned to maintain ample liquidity and generate positive free cash flow for the full year.

Our near-term actions to stabilize the business are bearing fruit. In the first half of 2024, we exited 46 retail store locations at natural lease expiration, and now expect to close up to 55 Fossil and Watch Station stores by year-end as part of our store optimization initiative. Additionally, we have successfully exited the smartwatch category with almost no inventory remaining.

In the second quarter, we saw trend improvements in our own stores and boutiques for traditional watches across our Fossil brand as well as several of our major licensed brands. Of note, Fossil traditional watches were up 4% in our DTC channels on a comp sales basis in Q2. In the second half, our teams will focus on additional upper-funnel initiatives to drive awareness and heat, including brand ambassador and influencer campaigns. Just this morning we announced supermodel and entrepreneur Ashley Graham as the new ambassador for Michele, our luxury women's watch brand. She will serve as the face of Michele's latest marketing campaign. Similar partnerships are expected in the coming months.

From a licensed brand perspective, we just signed an expansive licensing agreement with Skechers, broadening the scope of our agreement and extending the term to 2029. Over the past five years, we've grown our Skechers watch business by 35% annually. We are extremely excited to continue our partnership with one of the world's fastest growing brands and look forward to driving further growth on a global scale in the coming years.

We continue working closely with our advisors on our strategic review, including an ongoing analysis of our business model, development of strategic initiatives, refinement of our financial plans, and comprehensive reviews of our capital structure and financing alternatives.

Looking ahead to the remainder of 2024, we expect to see sequential improvement in trends across sales, gross margin and adjusted operating margin. We remain on track with our TAG Plan and reiterate our full year expectation to achieve net sales of approximately \$1.2 billion, adjusted operating margin of -3% to -5% and positive free cash flow, inclusive of the \$57 million tax refund.

We're acting urgently to drive improved financial performance and remain committed to building long-term shareholder value. We appreciate the dedication of our teams and the support of our shareholders. Now I'll turn the call to Andy to review the financials and we'll conclude the call with some Q&A led by Christine.

Andrew Skobe, Interim CFO:

Thanks, Jeff, and good afternoon all. It's great to be here, and I look forward to getting to know our shareholders in the coming quarters.

Despite continued topline pressure, our TAG plan has allowed us to drive improvement across the rest of the P&L.

Second quarter net sales totaled \$260 million. That's down 19% in constant currency and includes five points of impact related to our smartwatch exit and store closures.

Gross margin expanded 390 basis points compared to last year, which primarily can be traced to improved product margins, resulting from the TAG initiatives that Jeff discussed, as well as the benefit of a lower smartwatch mix. We expect to achieve continued gross margin expansion in the second half of the year, driven by sourcing and supply chain initiatives, and ongoing benefits from SKU rationalization, pricing, and promotion.

SG&A expenses were down \$34 million compared to last year, representing an 18% decrease as we continued to focus on cost takeout. The year-over-year reductions are attributable to lower store operating costs, in fewer stores; and lower compensation and administrative costs driven by the TAG initiatives that Jeff described.

We closed 20 stores in Q2, ending the quarter with 258 stores, which is a reduction of 18% compared to a year ago. As Jeff mentioned, we have exited 46 locations in the first half of the year and expect to close up to 55 by year end. As a reminder, all closures occur at natural lease expiration.

Ongoing cost actions are expected to drive continued reductions in SG&A dollars through the remainder of 2024, with anticipated second half year-over-year comparisons down in the low double-digits.

The combination of gross margin expansion and cost reduction in the second quarter enabled us to significantly narrow Q2 adjusted operating loss to \$17 million. That reflects an improvement of 39% versus an adjusted operating loss of \$28 million a year ago.

Turning to the balance sheet, we ended the quarter with total liquidity of \$156 million, providing us with the flexibility to continue executing our TAG Plan. We brought down inventory levels by 38% versus a year ago, improving working capital. Cash flow from operations totaled \$35 million in the quarter, reflecting seasonal cash use of approximately \$22 million, which was more than offset by our receipt of the \$57 million tax refund in April.

Moving to guidance, we are reiterating our outlook for the full-year. Worldwide net sales are expected to be approximately \$1.2 billion, while the adjusted operating margin loss is expected to range from -3% to -5%.

Our net sales guidance of approximately \$1.2 billion assumes an approximate \$100 million negative impact from our strategic actions, including store and concession closures, and the exit from smartwatches.

We remain on track to achieve at least \$100 million of annualized P&L benefits in 2024 across gross margin and SG&A under our TAG Plan. Restructuring costs related to TAG are estimated to be approximately \$40 million for the full year 2024.

Looking at cash flow, we anticipate that seasonal working capital needs, coupled with continued sales declines, will require operating cash use in the third quarter. As we enter the holiday period and our initiatives continue to take hold, we expect to generate positive free cash flow in Q4. We also expect to be free cash flow positive for the full year 2024, inclusive of the \$57 million tax refund.

While we're pleased to see our TAG initiatives showing up in the P&L, the business is not where we know it has the potential to be. We're remaining laser-focused on the priorities that Jeff laid out, which include actions to stabilize the business, and the exploration of opportunities to improve the capital structure. We're moving as quickly as possible on all fronts.

Now, I'll turn the call back to Christine for Q&A.

Christine Greany, Investor Relations:

Thanks, Andy. I'll take us through some questions that we've been getting from shareholders.

Jeff - What are you doing to stabilize the topline, and when do you expect to start growing again?

Jeffrey Boyer, Interim CEO:

We are directing programs and funding against our key topline opportunities. We have increased our upper funnel marketing programs on a number of brands to generate additional brand heat and demand. As I mentioned previously, earlier today, we announced Ashley Graham as the new ambassador for Michele, our luxury women's watch brand, with additional influencers and endorsers planned for our own brands as well as for our licensed watch brand partners. On the inventory front, we are distorting inventory into the brands, categories, and markets that are showing the most substantial growth potential, such as traditional watches in emerging markets such as India and Mexico. These efforts are the primary drivers behind the stabilization and growth in about half of our Traditional Watch business.

Christine Greany, Investor Relations:

Jeff - Can you help us understand what is happening in your core traditional watch business and how that tracks to overall industry performance?

Jeffrey Boyer, Interim CEO:

During Q2, about half of our traditional watch business performed consistent with the industry, based on NPD data. This includes the Fossil, Armani Exchange, Tory Burch, and Skechers watch brands. The remaining parts of our watch business, including Armani, Kors and Diesel, remain pressured. This is primarily due to softness in China resulting from the weak consumer environment, as well as ongoing brand repositioning efforts by some of our licensed brands. Recognize that our topline is also impacted by the strategic decisions we've made to close stores and exit the smartwatch category

Christine Greany, Investor Relations:

Jeff - Given your liquidity levels, are you considering buying back equity or bonds?

Jeffrey Boyer, Interim CEO:

We believe our current valuation levels are not reflective of the long-term potential we see for the business. However, we believe it's very important to maintain financial flexibility given the current macro environment. Under our capital allocation framework, deploying resources toward strengthening our business is our highest priority. As you can see in our year-to-date results, the investments in and the execution of our TAG Plan are driving operational and financial improvements, including better bottom line results.

Christine Greany, Investor Relations:

Andy - How many quarters of runway do you have to execute your plan?

Andrew Skobe, Interim CFO:

We believe we have ample runway to continue executing our TAG Plan. We will complete a majority of the TAG initiatives by the end of 2024, with annualized operating income benefits of at least \$100M materializing this year. We will also see additional benefits in 2025 and 2026.

In March 2024, we also initiated a strategic review to optimize our current business model, which includes efforts to find additional structural cost reductions, as well as exploring debt and equity financing options.

Christine Greany, Investor Relations:

Andy - What is the status of a potential refinancing ahead of your upcoming debt maturity?

Andrew Skobe, Interim CFO:

We are assessing potential debt and equity financings as part of our strategic review, and have retained a financial advisor to assist with this process. Importantly, we are reviewing options to put a new financing strategy in place, well before the expiration of our current ABL facility in 2027 and our senior notes in 2026.

Christine Greany, Investor Relations:

Andy - Could you walk us through the puts and takes on cash flow this year?

Andrew Skobe, Interim CFO:

The seasonal nature of our business and the projected sales decline will require operating cash use in the near term, but we expect to generate positive free cash flow in Q4.

Based on the seasonality of our business, cash collections compared to the first half of the year are anticipated to increase for the remainder of 2024. This is consistent with the implied sales increase from the first half to the second half, based on our full year 2024 guidance.

Additionally, there will be inventory, freight, and marketing expenditures to support the increased sales in the second half. There will also be increased payments to our licensing partners, as well as higher tax payments.

From a full year perspective, we have the one-time benefit of the \$57 million tax refund received in Q2, in addition to a reduction in overall operating expenses anticipated for the year, as we continue to realize the benefits under our TAG Plan.

Christine Greany, Investor Relations:

Thanks, Andy and Jeff. We appreciate everyone listening in today and look forward to updating you next quarter. The team is available for follow ups. Please reach out to me with requests. My email is included at the end of the earnings release – christine@blueshirtgroup.com.