

Kontoor Brands, Inc.
Third Quarter 2023 Earnings Conference Call
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Presenters

Eric Tracy - VP, Corporate Finance and IR
Scott Baxter , President, CEO and Chair
Joe Alkire, CFO

Q&A Participants

Mauricio Serna - UBS
Bob Drbul - Guggenheim
Brooke Roach - Goldman Sachs
Will Gaertner - Wells Fargo
Peter McGoldrick - Stifel
Paul Kearney - Barclays

Operator

Greetings and welcome to the Kontoor Brands Third Quarter 2023 Earnings Conference Call.

At this time, all participants are in a listen-only mode. A brief question-and-answer session will follow the formal presentation. If anyone should require operator assistance during the conference, please press “*”, “0” on your telephone keypad.

As a reminder, this conference is being recorded.

It is now my pleasure to introduce your host, Eric Tracy, VP, Corporate Finance and Investor Relations. Thank you. Please go ahead.

Eric Tracy

Thank you, Operator, and welcome to Kontoor Brands third quarter 2023 earnings conference call. Participants on today's call will make forward-looking statements. These statements are based on current expectations and are subject to uncertainties that could cause actual results to, materially, differ. These uncertainties are detailed in documents filed with the SEC.

We urge you to read our risk factors, cautionary language, and other disclosures contained in those reports. Amounts referred to on today's call will often be on an adjusted dollar basis, which we clearly defined in the news release that was issued, earlier this morning.

Reconciliations of GAAP measures to adjusted amounts can be found in the supplemental financial tables included in today's news release, which is available on our website at kontoorbrands.com.

These tables identify and quantify excluded items and provide management's view of why this information is useful to investors. Unless otherwise noted, amounts referred to on this call will be in constant currency, which exclude the translation impact of changes in foreign currency exchange rates.

Joining me on today's call are Kontoor Brands' President, Chief Executive Officer and Chair Scott Baxter; and newly Chief Financial Officer Joe Alkire. Following our prepared remarks, we will open the call for your questions. We anticipate the call will last about an hour.

Scott.

Scott Baxter

Thanks, Eric, and thanks for all of those joining us on our call. I'm pleased to share that we delivered Q3 results above our expectations, most notably with upside to our topline. Our strategic playbook is working and is why I'm so confident in the next phase of Kontoor's evolution, even as we assume a more challenging macroeconomic backdrop.

And on the bottom-line, excluding the duty charge, which Joe will provide more detail on in a bit, operating results also exceeded our plan.

Global Kontoor revenue increased 8%, including about a point of FX benefit, with particular strengths in the US across both wholesale and D2C. Within the US market, ongoing strong POS and share gains were driven by accelerating shipments during the quarter.

From a share perspective, according to Circana, which focuses on the US total measured market, we continued to outpace the market in our US wholesale and core denim business, during the third quarter and here to start Q4. A few notable call-outs.

For the last three months, Kontoor Brands outperformed the market by approximately 140 basis points and in men's bottoms, we outperformed the market and our largest competitor by 170 and over 250 basis points, respectively.

And in women's, our Lee business gained over 60 points of share to the market, outpacing our closest competitor by 30 basis points. Importantly, even after aggressive pricing actions taken by select peers, we've continued to see market share gains.

For example, over the last month, our Wrangler men's bottoms business outpaced our largest competitor by over 250 points, while Lee's men's outperformed by roughly 150 points.

Our share gains in the core are in large part due to the strategic investments in our brands across innovation, design, and demand creation. That drives competitive separation.

I'll touch on examples of our elevated demand creation and innovation platforms in a bit. This strength in our core is complemented by category extensions as we diversify our product assortment beyond denim bottoms, global highlights on a reported basis include outdoor, up more than 30% in Q3, while western female also saw positive momentum, further proof points of our brand's health. Our D2C business once again delivered broad based strength in the quarter.

Globally, Kontoor D2C increased 6% led by our own dotcom, up 10%. In the US, own dotcom increased 11%, balanced across brands with Wrangler and Lee both experiencing double-digit gains. And international D2C remained healthy in Q3, increasing 5% with Wrangler increasing 21% and Lee increasing 2% or up 15%, ex-China.

And within international, we did see choppiness during the quarter with expected softness in China more than offsetting reported gains in Europe. Importantly, we are seeing China trends accelerate here in Q4 and continue to anticipate the region to return to significant growth in the quarter, up 20% plus.

D2C and International are key areas of growth for Kontoor going forward with significant white space in each, as these segments represent only 12% and 21% percent of our last 12 month mix, respectively.

The KTB investment thesis remains highly differentiated relative to many of our peers that operate more mature D2C and international businesses, and the diversified and accretive growth that these opportunities afford is still very much ahead us.

And we will use ongoing structural gross margin accretion from these areas to help fund amplified investments and critical growth enablers such as talent, innovation and demand creation, creating a virtuous cycle for sustained topline growth, over the long-term.

So, let me touch on these a bit more in detail. First, with demand creation. Starting with Wrangler, simply put, Q3 was as big of a demand creation quarter the brand has ever experienced in its 75-year history.

Strategic partnerships with Sandro, Staud, Mini Rodini, and Barbie, not only support our efforts to reach the female and youth demos, but does so in an elevated brand enhancing manner, across the globe. The Wrangler and Barbie collection was our best and fastest-selling collaboration ever.

Inspired by powerful cowgirls, the collection combines heritage denim with bold prints, further advancing Wrangler's diversification strategies to attract new and younger consumers, while remaining authentic to the brand.

Also in Q3, 'Made by Cowboys for Cowboys' took on a whole new meaning as Wrangler became the official jeans of America's team, The Dallas Cowboys. The sponsorship will run over the next three years, amplified via an integrated media platform signage and activations at AT&T Stadium. Social content featuring players and cheerleaders, retail promotions in a monthly concert series.

This connection of two iconic American brands doubles down on our Texas Heartland, and we couldn't be more excited about future opportunities to build on the partnership.

And as began Q4, the demand creation momentum for Wrangler continues. Just yesterday, we teased the launch of our co-lab with iconic premium Bourbon brand, Buffalo Trace.

Fittingly, it kicks off with a launch party next week at New York City hotspot, Ray's Bar. And then in December, the brand once again takes over Las Vegas at the Wrangler National Finals Rodeo.

However, this year promises to be even more special, as country music superstar and our first female music endorse, Lainey Wilson, hot off her record breaking nine CMA nominations, is scheduled to open the Rodeo on December 15th.

Lainey will also host a four-night concert series sponsored by Wrangler to close out the biggest weekend in Rodeo, wearing her iconic Wrangler flares and Bell Bottom on and off stage.

Now, turning to the Lee brand. Q3 saw another quarter of tremendous return on marketing investment and, importantly, manifested on a global scale. During the third quarter, the Lee brand launched its newest and most iconic female fit, the Rider Jean, which was inspired by our very first women's denim line, the Lady Lee Rider, and made modern for today's woman.

The global campaign, shot by Mark Seliger and set to The Donna's "Who Invited You," launched mid-September and has sparked new excitement in our women's premium denim collection.

In addition, trend right collaborations with culturally relevant brands such as Dragon Ball Z, Roaring Wild, and Daydreamer also continue to extend Lee's reach to a younger, more diverse audience.

During Q3, Lee turned up the heat across Southern California as the Lee and Daydreamer partnership took over the iconic Fred Segel Shop on Sunset Boulevard with a two-week showcase of the collection. This launch leaned heavily into Daydreamer's LA cool aesthetic through the key premium distribution in Fred Segel and Revolt.

And then in September, the brand hosted a unique, one of a kind experiential event at the Ed Sheeran concert at SoFi Stadium in L.A. with attendees including tastemakers, influencers, and celebrities from all over the world. And the momentum has carried into Q4 as Lee is currently ramping digital campaigns in support of Ultralux and Extreme Motion innovation platforms.

To further drive brand separation in the marketplace, we are also amplifying our focus on innovation as our pipeline is healthy and accelerating. A perfect example of innovation that cuts across both product and manufacturing, our Indigood platform continues to scale, delivering water and cost savings.

We recently announced that we surpassed our 2025 water savings goal of over 10 billion liters of freshwater two years earlier than was targeted. This accelerated accomplishment demonstrates our commitment to sustainability and to the effectiveness of the Indigood program, which also creates an important industry standard for others to follow.

I am proud of the work we are doing to save water with platforms like Indigood and other cutting-edge technologies, such as digital printing, driving towards a future where all jeans can be created using zero freshwater.

Other innovation platforms, such as Extreme Motion, Ever Fit, and Ultralux for Lee, as well as ATG in a performance specialty fishing line, Wrangler Angler, not only diversify our offering, but does so in an elevated way that mixes up AURs and gives the brands increasing permission to play in more premium points of distribution.

Needless to say, we have a ton of brand momentum for the balance of the year and into 2024, just one of the factors that gives me great confidence in the go forward. You don't develop this heat without investing behind the brands in a highly productive way.

From talent to design, to innovation, to demand creation, and we will continue to amplify strategic spend in support of diversified growth across categories, channels, and geographies. But make no mistake, we love how we are positioned in taking share within core US wholesale with incredible partners such as Walmart, Amazon and Target, as well as Western Specialty.

Retailers that align in support our brand's value proposition with consumers are especially important given the macro challenges around the world. Structurally accretive growth, particularly in D2C and International, helps fund these key investments, as does constantly evaluating our operating model, finding ways to reduce non-strategic spend, simplify processes and enhance efficiencies, including within our supply chain.

Our proactive restructuring actions last quarter and amplified inventory actions we are taking now are good examples of investments of healthier foundation of which to build.

But rest assured, we are just in the beginning stages of transferring our model for the future, with substantial opportunity to unlock value, over time. Stay tuned for more here.

And these actions also help accelerate cash generation, creating significant opportunity to return cash to shareholders. As evidenced by our recently announced increase to the dividend, our capital allocation optionality remains robust.

This cash flow optionality, when taken with our resilient fundamentals, even during a challenging macro environment, creates a powerful combination that should support superior TSR over time.

We look forward to sharing more on our long-term strategic vision at our Investor Day.

Joe.

Joe Alkire

Thank you, Scott, and thank you all for joining us today. Before I review the third quarter, let me say how honored and appreciative I am to have the opportunity to serve as CFO of Kontoor Brands.

I am thrilled to reunite with the Kontoor family, and I want to express my gratitude to Scott, the Board, and the organization for the support as I transition back into the business.

I feel a tremendous amount of responsibility and stewardship to all Kontoor employees around the globe, as well as those that have come before me and built the strong foundation that is in place today.

I'd also like to extend a special thank you to Rustin, who has been a strong resource for me during the transition. He will be missed, and we wish him and his family all the best in retirement.

With that, let's review the third quarter. Global revenue increased 7%, compared to the prior year as broad-based growth in the US in both wholesale and DTC was partially offset by a decline in International.

Our third quarter results again reflected the strong momentum of our brands, as evidenced by continued market share gains and POS strength across key accounts and distribution channels.

On a regional basis, US revenue increased 12%. Direct-to-consumer increased 7%, including 11% growth in digital. In the wholesale channel, revenue increased 12%, with strong performance from both brands.

In addition to strength in our core categories, we also drove growth in outdoor and non-denim bottoms, as category expansion remains a top strategic priority. And while retailers remain cautious, inventory levels in the channel continue to improve and are more balanced as POS and shipments work towards equilibrium, as we enter the holiday period.

As expected, International revenue decreased 8%, driven mainly by China, which declined 19%.

As we discussed last quarter, the recovery in China will not be linear as a result of COVID-driven lockdowns and re-openings from a year ago. In terms of our outlook, we anticipate more than 20% growth in the fourth quarter and, importantly, as we enter 2024, the underlying fundamentals of our business in the region have improved.

Inventory levels across our retail network have returned to more normalized levels, and we are entering next year with a stronger foundation from which to grow.

We see significant long-term potential in China and expect growth to accelerate next year, due in part to an increase in the strategic investments we are making in the region.

In Europe, revenue decreased 4%, as double-digit growth in DTC was offset by a decline in wholesale. While we expect the macro environment to remain difficult in the region near-term, we are encouraged by the strength of our DTC business across both brands supported by investments we have been making in the platform.

Turning to our brands, global revenue for the Wrangler brand increased 9%, driven by growth in both wholesale and DTC.

The ongoing diversification into non-denim categories continues to drive brand momentum with particular strength in outdoor and non-denim bottoms. The brand's targeted investments in demand creation, strategic partnerships, and innovation are continuing to drive strong market share gains, across the retail landscape.

In the U.S., revenue increased 10%, with wholesale, own dotcom, and brick and mortar all contributing to growth. Wrangler International Revenue increased 2%, driven by 21% growth in DTC and a modest increase in wholesale.

Now turning to Lee, global revenue increased 3%. Growth was driven by strength in the U.S., with wholesale increasing 23% and own dotcom increasing 11%. In addition to growth in core denim, non-denim bottoms also performed well in the quarter and contributed to growth. Lee International Revenue decreased 13%.

In Europe, revenue decreased 3%, with 15% growth in DTC, more than offset by a decline in wholesale.

In APAC, as expected, revenue decreased 18%. And finally, from a channel perspective, U.S. wholesale increased 12%, while non-U.S. wholesale decreased 10%. Global direct-to-consumer was up 6%, including a 10% increase in own dotcom and brick and mortar up 2%.

Turning to gross margin, as we shared in this morning's release, the quarter was impacted by an unanticipated 200 basis point charge from duty expense related to prior periods. The issue was identified late in the quarter and arose from the ERP implementation dating back to 2021. Excluding the duty expense, gross margin was flat versus the prior year at 43.5%.

Gross margin in the quarter also included the impact of proactive inventory management actions. These actions relate to clearing through non-core inventory as we aggressively focus on reducing overall inventory levels and exiting 2023 in a clean inventory position.

While these actions have a negative impact on gross margin near term, they improve the quality of our inventory and yield additional cash generation.

Further, excluding the impact of these actions and the duty charge, gross margin increased versus last year, which was largely consistent with our expectations. The increase in gross margin was driven by channel mix, pricing, and lower transitory costs such as air freight.

SG&A expense was \$186 million. As a percentage of revenue, SG&A decreased 30 basis points to 28.4% versus adjusted SG&A in the prior year. Strategic investments in DTC and demand creation, as well as increased distribution costs, were partially offset by disciplined management of discretionary expenses and operating leverage.

Operating income was \$85 million as reported, or \$99 million excluding the duty charge, an increase of 10%, compared to adjusted operating income last year. Excluding the duty charge, operating margin increased 30 basis points to 15.1%.

Earnings per share was \$1.05, compared to adjusted EPS of \$1.11, last year. The quarter included a 17 cent negative impact from the duty charge. Excluding the duty charge, Q3 EPS was \$1.22, representing a 10% increase versus the prior year, ahead of our expectations.

Now, turning to our balance sheet, third quarter inventory decreased 11%, compared to last year. We made more progress than expected on inventory during the quarter, due to stronger than expected revenue and the inventory management actions. While inventory levels are still elevated, we remain comfortable with the quality of our inventory and the ability to support our forward growth plans.

We expect inventory levels to decrease by approximately \$100 million by the end of the year to approximately \$500 million. We finished the third quarter with net debt, or long-term debt less cash, of \$708 million and \$78 million of cash on hand.

Our net leverage ratio, or net debt divided by trailing 12-month adjusted EBITDA, was 1.9 times at the end of the quarter, within our targeted range. We expect net leverage to approximate 1.6 times by the end of '23.

And, as previously announced, our Board of Directors declared a regular quarterly cash dividend of 50 cents per share, representing a 4% increase. And finally, at the end of the third quarter, we had \$62 million remaining under our share repurchase authorization. We did not repurchase shares in the third quarter.

On to our outlook, revenue is expected to increase approximately 1%, compared to 2022. This compares to our previous outlook of a low single-digit increase. Our updated outlook includes the following expectations.

First, we continue to anticipate a more challenging U.S. macro environment in the fourth quarter. We are pleased with the strength we delivered in the third quarter and are encouraged that positive POS trends have continued to start the fourth quarter. We do, however, believe it prudent to plan the business conservatively, given the macro uncertainty.

Second, we expect relatively stronger performance in international markets in the fourth quarter, driven by China, as well as continued growth from our global DTC business.

Gross margin is expected to approximate 42.5% on an adjusted basis, including a 40-basis point impact from the duty charge, as well as the proactive inventory management actions. This compares to our prior outlook of 43.5% to 44%.

Our updated outlook implies fourth quarter gross margin expansion of approximately 300 basis points, driven by ongoing structural mix, strategic pricing, and a decrease in input costs, partially offset by inventory management actions.

As we look to 2024, based on current visibility, we expect the combination of lower input costs and structural margin mix, mainly DTC and International, to drive significant gross margin expansion.

While we expect this to result in accelerated earnings growth, it also provides the investment capacity needed to continue investing behind our brands and enterprise strategy. SG&A is now expected to increase at a low single-digit rate on an adjusted basis, compared to 2022.

We will continue to prioritize investments in our brands and capabilities in support of long-term accretive growth, while remaining diligent with regard to discretionary spending.

EPS is now expected to approximate \$4.35 on an adjusted basis, including an approximate \$0.15 negative impact from the duty charge. Excluding the duty charge, full-year adjusted EPS is expected to approximate \$4.50.

We expect full-year operating cash flow of approximately \$335 million. We expect to end the year with approximately \$500 million of inventory, representing a more than 15% decrease, compared to the prior year.

We also expect to end 2023 with approximately \$200 million of cash on hand and roughly \$700 million of liquidity, supporting significant capital allocation optionality, as we move into next year.

I'd like to take a few moments and highlight the fundamental profile of our business in the second half of '23, based on our updated full-year outlook. Our quarterly results, this year, have been volatile from a comparability standpoint, making it somewhat difficult to understand the true underlying trajectory of our business as we move into next year.

Looking at our business by half presents a cleaner picture and one that is more representative of our expectations moving forward, the earnings power of the business, and the uniqueness of our model.

For the second half, we expect approximately 2% revenue growth and, excluding the duty charge, close to 200 basis points of gross margin expansion and double-digit operating earnings growth.

While we expect macro challenges to persist through at least the first half of 2024, the drivers of our second half '23 fundamentals, mainly gross margin expansion, will carry over into next year and support accelerated earnings growth and cash generation.

Additionally, we expect to achieve more steady-state levels of inventory, further contributing to an increase in cash generation, and we have a balance sheet that can support significant capital allocation optionality.

While we will remain disciplined and rigorous with regard to capital deployment and balance sheet management, we have a number of levers to pull to continue driving strong total returns for stakeholders, regardless of the operating environment.

To wrap up, I'd like to offer some perspective based on my observations through the first couple of months at Kontoor.

First, I am confident in Kontoor's opportunity to deliver sustainable growth and returns on capital. The brands are strong, we are appropriately investing behind a focused strategy, and there is significant white space to drive accretive growth through expansion in under-indexed channels and categories.

Second, there is significant opportunity to expand gross margin. We have visibility to lower input costs next year and structural margin drivers, such as DTC and International, will support sustained gross margin expansion, over the medium to long term.

Further, our global supply chain strategy is evolving, and we have identified a number of initiatives, including SKU rationalization, that we expect to drive incremental gross margin benefit and net working capital reductions over a multi-year horizon beyond our previous expectations.

These benefits are both upstream and downstream and will fundamentally change how we go to market and our operating model.

Third, we are committed to driving greater efficiency in the business. We will pursue a number of initiatives to reduce complexity, leverage our platforms, increase agility, improve profitability and, importantly, create additional investment capacity for our brands.

These initiatives will unfold over a multi-year horizon and will further transform our operating model and unlock significant value. We look forward to sharing more details on these topics in the context of our updated strategic plan at our Investor Day next year.

This is an important time for Kontoor. We are focused on fundamentals, execution, and long-term TSR. I am confident we have the team in place to deliver on the opportunities ahead and excited to partner and drive the next chapter of growth and value creation for Kontoor.

This concludes our prepared remarks. I will now turn the call back to the operator.

Operator

Thank you. Ladies and gentlemen, the floor is now open for questions. If you would like to ask a question, please press “*”, “1” on your telephone keypad, at this time. A confirmation tone will indicate your line is in the question queue. You may press “*”, “2” if you would like to remove your question from the queue. For participants using speaker equipment, it may be necessary to pick up the handset, before pressing the star Keys. Again, that’s “*”, “1” to register a question, at this time.

Today's first question is coming from Mauricio Serna of UBS. Please go ahead.

Mauricio Serna

Thanks. Good morning and thanks for taking my questions. Maybe just to start with the duty expense, can you give us more color around it? Should we think about the fiscal year 2023 EPS guide now at \$4.50, really? And then on the gross margin and inventory actions, it's great to see the sequential improvement there.

Could you talk more about the amplified inventory actions taken? Still seems that you want to be proactive and make sure you come out in a clean position out of 2023. Is that the way to really think about it? Thank you.

Joe Alkire

Hey, Mauricio. Good morning. It's Joe. Maybe I'll start with the duty and I'll let Scott kick off the inventory conversation. So, yeah, on the duty, the issue primarily relates to prior periods, '21 and 2022, specifically. As we stated in the prepared remarks, we identified the issue late in the quarter, and it really dates back to the ERP implementation.

And so, perspective here, I think may be helpful. The duty charge was \$13 million over a two-and-a-half-year period on total cost of goods sold over that same timeframe of several billion dollars. So, we won't get into the accounting technicalities as to why the charge is presented as GAAP versus adjusted, but the charge was a prior period adjustment, really a correction of an error and just out of period.

So, clearly this charge was not contemplated in our prior outlook. And as you think about the appropriate baseline for underlying earnings in '23, we view \$1.22 and \$4.50 of adjusted EPS, respectively, as more representative going forward.

Scott Baxter

Fantastic. Thanks, Joe. Mauricio, thanks for the question. We thought about what we wanted to do to position ourselves for 2024 and put our teams in the A position. And we started this process a little bit, Mauricio, with our manufacturing downtime in the beginning of the year. And then we had such broad-based strength in our business that we knew we could do this.

We knew we could be aggressive and we could clean everything up. It was the right thing to do from a hygiene standpoint for our business. And as you know, it frees up a tremendous amount of cash that we can invest back in the brands and back in our people, which is really great.

We're investing back in the business because of this. It optimizes our distribution centers and our supply chain, which is great. And, when you think about an action like this, what it does is it has benefits in almost every aspect of our business. So, we're really excited about where we stand from an inventory standpoint heading into 2024. And it's been difficult for a lot of people the last couple of years but right now, we are in a fantastic position. Joe, any additional comments there?

Joe Alkire

Yeah, maybe just a few. These actions, as Scott said, were proactive. These were the right decisions for the business. We're clearing through non-core inventory. The majority of our inventory remains core, over 85% or so. And in terms of these actions, our inventory levels continue to normalize; we're almost there. In some respects, these actions are evergreen. But in terms of the more elevated impact, we'll be through that pretty much by the end of this year.

Mauricio Serna

Got it. Congratulations. And thanks for answering the questions.

Operator

Thank you. The next question is coming from Bob Drbul of Guggenheim. Please go ahead.

Bob Drbul

Hi. Good morning, guys. And Joe, welcome back. Congratulations. I guess, I have two questions I'd like to really focus on. The first one, Scott, from your perspective, when you look at the macro, you touch a lot of different price points now and distribution channels. Can you just give us maybe your perspective on a high level around the consumer, around the macro, sort of even more recent and in the sort of the next few weeks as you think about the holiday season?

And then the second question I have is, you talked a lot about the share gains and some of the point of sale strength that you've seen in the third quarter. It seems like you're seeing it in the fourth quarter. Can you just talk a little bit more about sort of the dynamics, maybe pricing, competition, anything more around what you see unfolding around these share gains and the sort of categories that you're competing in? Thanks.

Scott Baxter

Sure, you bet. Good to hear your voice, Bob. Thanks for the question. I'll start and then I'll toss it over to Joe. We'll kind of do a little bit of both on this one. But from a macro standpoint, we've talked a little bit about the fact that we thought the consumer was going to be a little stressed here as the year went on.

And hopefully, that'll start to mitigate here going into '24. But I actually think that we're going to have a good holiday season. The consumer always shows up around the holiday season. And why I think that for us is that we've taken a lot of share here in the last couple of years, which has been really important for our brands. So what that means is you see our brands in a more elevated way. And you also see our brands in a bigger distribution from a real estate standpoint.

And what's happening for us is you talk about our brands are priced right. You get a tremendous amount of value at a really good price. But there's two other components that have been really important for us. One, we've taken our demand creation to another level.

So people are walking into our big customers and our big consumers are walking in and saying, hey, where are Wrangler and Lee? I have to have them. I'm seeing them everywhere. I'm seeing them if I go to a Dallas Cowboys game. I'm seeing them if I go to Austin City Limits. We see these big Barbie kickoff and collection.

So, we're seeing some really interesting things and people are migrating to our brands at a really good pace. So I think we've positioned ourselves really well as we've thought about how we distance ourselves from everybody else. But there's one other little piece here that's really interesting for us as a company, as we move forward; and that's that from a D to C standpoint.

And Bob, you've been with us on this journey. And you remember we talked a lot about leading with digital, leading with digital, leading with digital, because we never invested in digital in the old world, five years ago. And so we did that, and we've got that platform up and running. But now we're really spending some of this extra cash that we have and the investment dollars that we have on building our D to C network, globally.

In addition to that, really building out our international platforms, too. And the key for us is that it's pretty evergreen because we're fairly new in both of those, and we have a lot ahead of us versus some of our competition.

So that's why I feel really good about our consumer and how we're going to control our own destiny from this moment here, going forward. I'm pretty excited about our future here. Joe, any comments about share gains and pricing?

Joe Alkire

Yeah, just a few on pricing, Bob. So pricing for us has been a tailwind, this year. There's really nothing fundamentally different compared to the prior outlook on the pricing front. As Scott said, our market share gains remain strong. Performance at POS remains strong. These brands are performing at retail.

And we were very strategic with pricing over the past couple of years. And pricing is a conversation with retailers as it always is. But it's just one factor in terms of the number of levers we have to pull on the gross margin front.

Bob Drbul

Thank you very much.

Scott Baxter

Thanks, Bob.

Operator

Thank you. The next question is coming from Brooke Roach of Goldman Sachs. Please go ahead.

Brooke Roach

Good morning, and thank you for taking our question. Scott, I wanted to follow-up on Bob's question and just get a little bit more sense of what's changing in the macro outlook that's caused you to be a little bit more cautious on the year. And it sounds like a little more caution into the first half of next year, despite the ongoing strength of your brands and the share gains.

Is there any one particular region, channel, or type of product that's causing this incremental conservatism?

Scott Baxter

So, Brooke, not cautious really at all. Still feel great about the business. From the standpoint of our POS, our POS is still strong and continues to be positive. Now, our customer might be a little bit more cautious in their ordering patterns and what have you. But let me be really clear here. This is a really interesting point.

Because our gains are so strong, share gains, our POS is so good, and our demand creation right now is hitting on all cylinders, it creates an atmosphere where you have to go ahead and order our products. So I feel really good about what's happening in our business, right now. I mean, I've been here now as the CEO for five years, and I've told the team here recently, I have never felt better than I feel, right now.

This team, this business, these brands, the product that we're creating, the decisions we're making, I feel really confident. So not from me. Joe, anything to add there?

Joe Alkire

No, I think you covered it.

Brooke Roach

Great. And then maybe a follow-up for Joe. Can you elaborate on the incremental changes in your outlook for gross margin beyond the duty charge? How much additional margin headwind are you seeing this year from inventory clearance actions? And then can you contextualize the level of transitory headwinds that are still weighing on gross margin in 4Q, where we might see some better visibility on those returning to normalized levels into 2024? Thank you.

Joe Alkire

Sure, Brooke. So for the quarter, excluding the duty charge, the gross margin was flat. That included the inventory management actions that we took. That was about 30 basis points. So excluding those, the gross margin increased, year-over-year, pretty much as we expected. And the main drivers of that were really price mix and lower transitory costs, such as air freight offset by still higher input costs, moderating as we expected versus Q2, but still higher.

So for the full year, we were at 42.5 or 42.9, when you exclude the duty charge. That's about 60 basis points off of the low end of our prior outlook, and the biggest driver of that really is the inventory actions that we took. There's a little bit of mix-related impact in there as we tightened up the revenue range, and you've got ongoing strength from U.S. wholesale.

But I think importantly for Q4, we've got about 300 basis points of expansion embedded in the outlook. Again, the drivers are really the same pricing mix, but as we've said all year, we have

input costs flipping to a tailwind in the fourth quarter, and that will really continue into next year.

Brooke Roach

Thank you so much. I will pass it on.

Operator

Thank you. The next question is coming from Will Gaertner of Wells Fargo. Please go ahead.

Will Gaertner

Hey, guys. Thanks for taking my question. So just to start off, so cash generation, you're improving your inventory significantly here.

Could you just discuss your capital allocation optionality here? I noticed you didn't have any share purchases, this quarter. Just can you maybe discuss how you're thinking about that, going forward?

Scott Baxter

Yeah, so go ahead, Joe, and then maybe I'll jump in at the end.

Joe Alkire

Yes, maybe I'll start here, Will. So on the capital allocation front, the priorities are unchanged. Organic reinvestment in the business, given the performance we have across both brands, maintaining that superior dividend, which you saw what we did this quarter, and then we've got share repurchases in M&A.

So I think near term, we're continuing to focus on working capital improvement. We're really pleased with the progress on the inventory front, and I think we're almost there on the inventory side. Leverage is in good shape.

It'll come down further next year, as we expect an increase in cash generation and gross margin recovers and our inventory normalizes, further. So we've got a lot of optionality. We're going to remain really disciplined here, but certainly an opportunity to more actively deploy capital in a TSR creative manner.

Scott Baxter

So just a quick comment. I agree with everything Joe said, obviously, right? But if you think about how we think about this as a company and how pleased we are with the position that we're in, and if you think about the industry and the world that we operate in right now, to have a balance sheet like this, to be in the position that we're in, to be able to do what we need to do to drive this business.

And I think the other thing that makes me more excited about anything, or anything that we've talked about, is the fact that we can do multiple things. We aren't tied to just one thing by any. You saw in my prepared remarks and Joe's remarks, we increased our dividend.

That was just one thing we did recently. But we have the ability to do multiple things at the same time. And I think being in that position in this day and age and the time and the environment right now really puts us at a big, big distinctive advantage, especially with these brands and how they're operating, right now.

Will Gaertner

And maybe just one follow-up. So on SG&A, you're cutting from mid-single-digit growth to low single-digit growth. Can you just discuss where you're taking costs out and maybe if there's opportunity in the next year to continue to do so?

Joe Alkire

Yeah, I'll take that. So, really no change to the investments in the strategic priorities, DTC, demand creation, and innovation. The reduction is really on the discretionary expense side, and we're just being a little bit more cautious, given our outlook on the overall environment.

Will Gaertner

Great. I'll pass it on. Thank you.

Operator

Thank you. The next question is coming from Jim Duffy of Stifel. Please go ahead.

Peter McGoldrick

Hi, this is Peter McGoldrick on for Jim. Thanks for taking our question, and welcome, Joe. First, on free cash flow, can you talk about the puts and takes of the operating cash flow guidance? I recognize this is a new guidance slide item, but with inventory managed more tightly than previously anticipated, I was curious to get a sense of the working capital items and other drivers of the \$335 million operating cash flow guide.

Joe Alkire

Yeah, so I'll take that, Peter. How are you doing? Yeah, so we've got a pretty strong fourth quarter in terms of cash generation. That's really two things, margin recovery in the business, mainly driven by gross margin, and then further unwinding of the net working capital, mainly inventory. So we've got about \$335 million for the year. I think we're somewhere around \$175 million or \$180 million in the fourth quarter, and roughly \$100 million of that will be a further reduction in overall inventory levels.

Peter McGoldrick

Okay. And one follow-up. As we zoom out and think of the long-term financial capacity of the business, can you discuss the structural gross margin potential and any updated assessment you might have of a bridge towards the prior 46% gross margin potential outlook?

Joe Alkire

Yeah, I'll start. So nothing fundamentally different, Peter. I think we still see that algorithm largely intact. You'll have the structural margin drivers in DTC and International as input costs normalize. Here, we're going to recover a lot of what we lost over the past couple of years from inflation and supply chain disruption.

And then we've got a handful of other initiatives that I talked about in my prepared remarks that are more mid- to longer-term in nature on the supply chain front that are significant. These are gross margin and networking capital related. We'll share more details on those, but those will unfold over a multi-year period, and we may start to see some of those bear fruit in the second half of next year.

Scott Baxter

And I'd reiterate what Joe said here. I think there's one really important point that we've talked a lot about as a team. We went through a spin. Obviously, everybody knows that. Then a very difficult ERP. As everyone knows, when you do an ERP, it takes up a lot of mind space for your entire organization.

Now, you've got a lot of bright people, a really talented team that are going to focus their energies on this back-end supply chain that Joe has now talked about a couple of times, and we're going to put a lot of effort and energy into that. One of the things that's great about here is that we already do it really well, and we're going to enhance that going forward. So we see opportunity there, as Joe has mentioned, and we've got a lot of people that are going to be focused on that now that we've freed up some of their time.

Peter McGoldrick

Thank you.

Operator

Thank you. The next question is coming from Paul Kearney of Barclays. Please go ahead.

Paul Kearney

Hey, good morning. Thanks for taking my question. And Joe, good to hear from you, again. First, can you talk about the margin performance by brand? It looks like Lee operating margin fell almost 350 basis points versus Wrangler down 25. What was the driver of the differential between the two? And then I have a follow-up.

Joe Alkire

Yeah, Paul, if you're looking at the reported numbers, you've got the duty charge embedded in there. So there's some noise in there related to that.

Paul Kearney

Is that primarily falling on Lee?

Joe Alkire

No, it would be both brands.

Paul Kearney

Okay. Second, I guess, as we look into next year and we think about SG&A, how should we think about SG&A growth relative to the low single digits this year, especially given the investments that you're making into the business? Thanks.

Joe Alkire

Yeah, I think we'll hold on any specific guidance for next year. But I would say just from a construct standpoint, we'll continue to look to distort investment toward the areas we talked about, DTC, demand creation and innovation, while we hold the line on discretionary expenses and look to leverage those pretty aggressively. We do continue to have opportunities to drive further efficiency in the business.

I talked about that a little bit in my prepared remarks. And we'll talk about where and how that's going to come to life in the context of our plan for next year.

Paul Kearney

All right. Thank you.

Operator

Thank you. The next question is coming from Bob Drbul of Guggenheim. Please go ahead.

Bob Drbul

I wanted to jump back in just and follow up on, I mean, the SG&A and the spend, but the demand creation, you're talking about just the brand doing as much as it's ever done sort of this current quarter, figure the Cowboys and Lainey Wilson. Can you just talk about sort of the level sort of where you are today, and as you think about that dollar spend or percentage spend, how that might proceed into next year and beyond? Thanks.

Joe Alkire

Yeah-yeah, thanks, Bob. I'll start on the numbers and Scott may want to jump in here. So, so for the quarter, as an example, we increased our demand creation spend at a double digit rate in the quarter, right. And you've seen the impact that that's had and some of the things we're doing, which we're really excited about.

That's something we'll continue to do, over time. So I would expect demand creation as a percent total to continue to increase, and we'll look to grow that investment at a rate slightly above our overall revenue growth.

Scott Baxter

And Bob, I'm going to jump in here because I really want to, because I would be remiss if I didn't give a big shout out to Holly and Bridget, globally, from Wrangler and Lee, the two folks that lead our demand creation platforms across the globe for our brands. And my point of view is that you can spend any amount of money you want, but if you don't spend it intelligently, it really doesn't matter. And we used to spend a lot of money and not get a lot of return from that investment.

And like anything in life, you want to increase that investment return. In our teams, and those leaders have done an outstanding job. And I won't go through all the things that we talked about like the Lainey Wilson, the Cowboys and all their, collabs and everything again.

But it's a real tribute to how the teams are thinking about our brands, how we're culturally right in the center of everything that's going on around the globe. And every day, I'm astounded when I hear about the things that we're working on.

And I shared this one other time, we used to make outbound calls for people to partner with us. We get a lot of calls that come in now, everybody wants to partner with us. So it's a really fun position to be in, and we're really driving forward. And I think that we're doing some things that I think, people would think about us from the standpoint of our size as a company and our spend.

I think people would think that we're much larger than we are and spend a lot more than we do because we're having such an impact on the things that we're doing, culturally. And you can see it, the brands are really, really, benefiting from it, greatly. So, I just wanted to make sure that that was stated. So thanks, Bob.

Will Gaertner

Thanks, Scott.

Operator

Thank you. The next question is a follow-up coming from Mauricio Serna of UBS. Please go ahead.

Mauricio Serna

Great. Thanks for taking the follow up. I just want to follow-up on two things. First, on DTC, maybe you could talk a little bit more about the momentum you're seeing there on the own dotcom business. How much actually does that represent of your sales at the point? And then another follow up on inventory.

Do you have any exposure to the PFAs chemicals? Just wondering if that increases any risk on the inventory age as some retailers with a national footprint would likely try to reduce that exposure starting the spring of '24, as other brands have commented recently. Just wondering how that could affect your approach to discounting, too. Thank you.

Scott Baxter

Yes, so let me start with the dotcom. And yeah, we're really pleased with our dotcom business, right now. I think the thing that I'm most pleased with from the standpoint of certainly the growth, but we put a lot of investment behind our dotcom and we're actually seeing the benefit of that, now.

We built out a team. We've done some really good advertising and marketing within their capabilities. And now you're marrying our new ERP system that we've put in globally, and you're matching that up and marrying that up to our dotcom business.

And the teams are working really exceptionally well together, and we see a pretty bright future. So I guess I want to make sure everyone knows that we're still focused on that digital aspect. It's super important to us.

It's still front and center, of course, going forward and really like what Chris and team are doing there. So, so really pleased. And on the other one, let us get back to you and we'll look into that. We'll make sure that we have the exactly correct information. So we'll get back to you, Mauricio.

Mauricio Serna

Thank you.

Scott Baxter

Thanks. You bet. Thank you.

Operator

Thank you. The next question is coming from Will Gaertner of Wells Fargo. Please go ahead with your follow up.

Will Gaertner

Hey, guys, thanks for let me come back in here. Just a question on the US wholesale. You have a big, you're lapping a big number next quarter. Just how are you thinking about that, as far as growth in the next quarter as you're lapping this sort of big spike, last year?

Scott Baxter

Yeah, I think, Will, the most important thing is the freshness of your product, making sure that you're enhancing your core product at all times, which we've done, making sure you've heard us talk a lot about our category extension.

So we've done a really nice job in our T-shirt business, done a really nice job in our, for instance, our ATG business, our Wrangler for Angler business. So all of those ancillary lines and also categories are helping us grow that business.

We're gaining real estate because of our strong POS. We're gaining share because of our strong POS. And then you enhance that with all the demand creation that I talked about. We feel really confident in the next quarter and we really like our big customers. They're terrific partners. We've been with them for a long time. We work really well together. They're winning in the marketplace. And I think that's a pretty powerful combination.

And I will say this once again, our inventory is in a really good spot. So, from an inventory standpoint, with our customers, we've got A plus inventory heading over there. And that's what we're focused on, going forward. I like what I'm seeing quite a bit.

Operator

Thank you. At this time, I'd like to turn it back over to Scott for closing comments.

Scott Baxter

Well, thank you, everyone. Really appreciate all the thoughtful questions today and look forward to spending time with you again next quarter. Wanted to wish all of you a happy, healthy, and safe holiday season. And thanks for your interest and care about our company.

We are working really hard to make sure that we're doing all the right things. And we've got a terrific team here. And I'm glad you have a lot of confidence in us. And I know I have a lot of confidence in our team going forward. And we'll look forward to sharing more with you in the future. So thanks, everyone.

Operator

Ladies and gentlemen, thank you for your participation. This concludes today's event. You may disconnect your lines or walk off the webcast at this time and enjoy the rest of your day.