



Kontoor Brands' Third Quarter 2019 Earnings Conference Call Transcript

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Corporate Participants:

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Scott Baxter – President & Chief Executive Officer, Board Member, Kontoor Brands

Rustin Welton – VP & Chief Financial Officer, Kontoor Brands

Operator

Greetings. Welcome to Kontoor Brands' third quarter 2019 earnings conference call. At this time, all participants will be in listen-only mode. A brief question and answer session will follow the formal presentation. If anyone today should require operator assistance during the conference, please press star, zero, from your telephone keypad. Please note this conference is being recorded.

At this time, I'll turn the conference over to Eric Tracy, Senior Director of Investor Relations. Mr. Tracy, you may begin.

Eric Tracy

Good morning everyone. And welcome to Kontoor Brands' third quarter 2019 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 Securities and Exchange Commission. We urge you to read our defined risk factors, cautionary language and other disclosures contained in those reports.

Unless otherwise stated, amounts referred to on today's call will be on an adjusted dollar basis, which we clearly define in the news release that was issued this morning. Adjusted amounts exclude the impact of restructuring and separation costs, changes in our business model, non-cash impairment charge related to our Rock & Republic trademark, and other adjustments. A reconciliation to the 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 on a constant currency basis, which excludes the translation impact to changes in foreign currency exchange rates. Constant currency amounts are intended to help investors better understand the underlying operational performance of our business, excluding the impacts of shifts in currency exchange rates over the period.



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

With that, I turn it over to CEO Scott Baxter.

Scott Baxter

Thank you, Eric. Good morning, everyone. Thanks for joining us. Today, we're pleased to share with you the progress we've made since our spinoff in May of this year. And provide an update regarding the strategic actions we're taking over the near term, which also serve as the foundation for achieving our stated annualized total shareholder return goal of 8% to 10%. The strategic initiatives we're implementing and the investments we're making from quality of sales to talent to innovation, are driving improved profitability and significant cash generation that will fuel our growth.

We remain confident in our plans and our ability to deliver on these commitments. Our resolve to successfully execute against our strategies, to drive improved growth, and enhance our brands over the long term remains focused and unwavering.

On today's call, we will cover four key areas. First, we will provide select highlights of our third quarter performance. Second, we will detail our accretive long term growth vectors across categories, channels and geographies. Third, we will dimensionalize the enablers that will help to unlock these growth drivers, including our robust innovation pipeline and evolving demand creation platforms. And fourth, we will provide a financial update through the third quarter and our outlook for the year.

With that, let's get started with the highlights of our third quarter.

U.S. revenue was down 3% in third quarter, and is flat year to date, excluding the impact of a key customer bankruptcy. We continue to expect the U.S. will be essentially flat for the year. Despite some challenges in the U.S. retail landscape, including modestly softer retail or traffic during the quarter, we are well positioned to win with the winning retailers, in our key tiers of distribution and largest market. Our focus on adding high quality distribution points for our brands further supports our domestic strategy.

International revenue was down 4% constant currency, a significant improvement from the second quarter. As we mentioned on our last call, we have new leadership across our European and Asian markets and the teams have already positively influenced results as new product introductions are selling through well in the marketplace. We're especially pleased to note, that the Lee brand revenue increased 8% constant currency in China during the third quarter, including a 10% comp store increase, good news in advance of our on schedule launch of the Wrangler brand in China in early 2020.

While we've made meaningful progress, we've also taken additional actions that influenced our near term performance. We proactively decided to further amplify some of our quality of sales initiatives. Specifically, we chose to exit points of distribution in select

channels in India that were established over the last several years, which will impact our results for the balance of the year. We will discuss these impacts a bit more, later on the call.

Moving on, we are pleased to report that our digital performance continues to excel. Our branded digital business was up 22% in the third quarter. While digital wholesale increased 21% on a constant currency in the third quarter basis, these results validate that our PSR-driven approach to investments yields superior returns.

Regarding our Wrangler brand, excluding the impact of a large customer bankruptcy, our U.S. wholesale revenue declined 3% in the third quarter. However, it's important to note that excluding the customer bankruptcy, Wrangler's U.S. wholesale performance is flat year to date, and we expect revenue to improve in the fourth quarter.

Regarding our Lee brand, excluding the impact of the customer bankruptcy, our U.S. wholesale revenue decreased 3% in the third quarter and is up 3% year to date. The Lee men's business in the U.S. remains a bright spot, up 14% during the quarter.

Of importance, gross margin was up 20 basis points to 40.9%, benefiting from favorable mix, while our quality of sales and restructuring initiatives have begun to take hold a bit ahead of plan.

For the third quarter, we delivered adjusted EBITDA of \$90 million and adjusted earnings of \$0.95 per share. And consistent with our capital allocations strategy during the third quarter, we paid our first regular quarterly cash dividend of \$0.56 per share.

Now let's review the significant progress we've made since the spin and remind everyone of how our operational model will evolve with a focus on quality of growth.

As you've heard us say before, we think our future is in two horizons. Horizon one is about optimizing the foundation for long-term, healthy, sustainable growth, and we are doing just that. Within horizon one, we're making difficult decisions that will create some near term headwinds, but they are the correct actions for both our go-forward model and our shareholders.

These qualities of sales actions include, exiting underperforming markets and points of distribution around the world while investing in and moving our business towards higher margin opportunities, rationalizing unprofitable SKUs, improving inventory management, and reducing distressed sales through right-sizing of capacity, and adjusting certain markets from direct to distributor models.

These necessary actions are helping to create the building blocks required to achieve our long-term revenue growth, margin improvement and cash generation goals, and as we look to horizon two, we remain confident that these opportunities are significant.

To that end, let's discuss where we see the greatest long-term top line opportunities. There are three primary areas. First, category extensions, which include expanding further into tops, outerwear, and accessories across both the Lee and Wrangler brands. Second, channel evolution, which includes taking Wrangler and Lee brands to select new points of wholesale distribution and D2C, with a sharp focus on digital. And third, geographic expansion, which features moving beyond our traditional U.S.-based footprint into international markets, with a focus on China.

Now, a bit more about each of these growth drivers, providing some near term color on the third quarter, as well as some longer term perspective. Category expansions augment our strong core denim bottoms business and we will carefully extend our product offerings further into areas such as tops, outerwear, and accessories.

Let me provide a few examples. First, our outdoor program with Wrangler all-terrain gear, also known as ATG, recently launched with a major retailer and select additional points of distribution. The program affords opportunities to extend into new distribution channels such as outdoor specialty and sporting goods.

Second, while early, our tops collections for both Wrangler and Lee, created by our new design teams have sold well in upper tiers of distribution, with specialty stores and specialty dot-com. Initial reads from our tops program under the Shape Illusions platform, which I will discuss later, have been very encouraging.

And third, we remain significantly under-indexed in our t-shirt business. Just to put the relative opportunity in perspective, in the U.S. we currently sell roughly 500 pairs of jeans for every one t-shirt sold. In contrast, some competitors sell as many as five t-shirts for every one pair of jeans sold. This is an obvious and material category opportunity that we intend to capture.

Now, onto channel evolution. Within D2C, we'll focus our growth on digital, as we believe it's the most capital-efficient way to grow and effectively connect with our consumer. We're also investing behind a revolving digital ecosystem, including establishing a new global digital platform, as well as expanding with our digital wholesale partners. As evidenced by our own digital growth and digital wholesale growth in the third quarter, these investments are yielding healthy returns.

And, as related to geographic expansion, we are confident that we are establishing the right foundation on which to build long-term, durable growth. This includes exiting select underperforming markets and shifting our business models. We continued these efforts in the latest quarter with steps taken in India. Rustin will provide more insight later in the call.

While these moves may temper near term results, we are encouraged by our recent performance in our largest international markets, with our European and China and businesses improving significantly quarter over quarter. Just as with D2C, we are making

the necessary investments, including new leadership, systems and infrastructure to catalyze long-term growth.

Asia, and specifically China, will be a focal point for international expansion. Our Lee brand continues to leverage 20-plus years of business as a leading premium lifestyle brand in the region. We're pleased by our year-to-date results and we are excited about the growth opportunities for our two iconic brands.

To that end, we are on track to launch the Wrangler brand, in China, in the first quarter of 2020. Our go-to-market strategy will focus on digital, launching with a large digital partner in this brand. We're encouraged by early consumer testing associated with our global "Wear with Abandon" ad campaign, which appears to be resonating well. The global campaign goes live in the region in February and we couldn't be more excited to have our brand showcased.

It's important to note, that within branded D2C and international, we are highly under-indexed relative to our peer set, at only 10% and 26% of revenues respectively. This is really key as each of these channels represents an accretive growth opportunity relative to our historically domestic wholesale focused model.

In support of these whitespace opportunities during horizon one, we're focused on three primary enablers, including enhancing and further scaling innovation, elevating our demand creation platform, and strengthening our global supply chain advantage.

On our second quarter call, I touched on how we think about innovation, both from a product and manufacturing perspective. As a standalone company, we are now positioned to more effectively invest behind, showcase and scale new product technologies, and advanced manufacturing capabilities like never before. Let me walk you through some recent developments within innovation born out of our cognitive design science research network.

In September, we launched a new program, Shape Illusions, with one of our largest retail partners and while early, we are very encouraged by the consumer response we've seen. Starting in our Lee buyers' program, Shape Illusions is our sharper price point offering, under the broader Body Optics platform and advanced anatomy shading technology, which enhances the shaping of denim and apparel products, empowering our consumer with greater confidence in how they look and feel.

Body Optics began a few years ago in China yet was relatively confined to this region under prior ownership. Now, we have the ability to scale this innovation platform globally, and Shape Illusions is a perfect example of that, as we bring the technologies to the U.S. mass market for the first time.

Given the meaningful features and benefits of the product, Shape Illusions carries some of the more elevated price point in the denim and tops categories within the mass

channel, a positive for both Lee and our customers, and it provides a compelling value for the consumer as well.

Innovations such as Body Optics give us permission to also begin to push into higher price tiers of wholesale distribution, as well as helping to evolve our own digital ecosystem through the use of pinnacle product.

In Asia, continuous innovation of our Jade Fusion platform keeps that our leading warm weather denim offering and contributes significantly to Lee's leading market position in China. Using exotic minerals woven into the fabric, this technology actually cools denim and other lines of apparel, keeping consumers dry and comfortable in hot and humid weather. Similar to Body Optics, we look forward to extending the Jade technology suite beyond the Asian marketplace.

Whether innovation is in product design, such as Body Optics and Shape Illusions or Jade Fusion, or in revolutionary manufacturing technologies, focused on sustainability, including our waterless foam dying technology within our Indigood line, or cotton traceability within our Rooted collection, our pipeline is robust and accelerating.

Several of you were able to join us for our first ever innovation event in Los Angeles in September, and you were able to see how our innovation suite is rapidly evolving. We have only just begun to tell our innovation story, and we are excited about sharing more with you in the future, and it's not just us talking about innovation.

For the first time in these brands' histories, we are investing behind evolving our innovation platforms to scale around the world, driving competitive separation and supporting our longer term growth algorithm.

The second key enabler lies in evolving our demand creation efforts, doing so in a way that is prioritized through our TSR lens. Let me walk you through a few specific demand creation highlights from the third quarter.

First, as I mentioned earlier, in the U.S. we launched our new Wrangler global advertising campaign "Wear with Abandon" an elevated expression from prior campaigns that remains tethered to its western brand ethos while pushing to new heights of diversity, ambition, and creativity. And this campaign will soon have global reach. It will support Wrangler's launch in the Chinese market this coming spring.

Second, in September, we began a collaboration with Fred Segal, kicking off a six-week Wrangler pop-up store in the specialty retailer's Sunset Boulevard location in Los Angeles. Using our archives as motivation, our new design team developed a capsule-collections, spanning decades of the brand's history. While showcasing that when design and innovation are elevated, we have permission to play in upper tiers of distribution. Importantly, we will extend the pop-up store to a permanent assortment with Fred Segal in the coming months, a testament to the collaborative effort across our evolving design and marketing teams.

Third, we also recently introduced an anniversary collaboration with Alife, with a co-branded capsule-collection that celebrates 20 years and 130 years of history for the Alife and Lee brands respectively. The capsule incorporates these iconic heritage styles with contemporary updates by Alife.

And Fourth, we are excited to announce the collaboration with Nordstrom NYC and the Wrangler brand, with an activation event that kicks off tomorrow in Manhattan. Our fashion forward Wrangler Heritage collection draws from our past, and with modern styling, pays tribute to our authentic western legacy that's synonymous with our name. The event this weekend will also showcase our customization laser technology to personalize product. This technology allows us, or in the future our retail partners, to elevate the consumer experience through both customized design and heightened convenience.

So, how does this all come together? Our evolving innovation and demand creation platforms, when combined with our world-class supply chain, will act as key enablers in support of accelerating long-term growth fueled in three key areas: category, channel, and geographic expansion. It reflects on the changing faces of the Wrangler and Lee brands around the globe. It's a differentiator for us.

The global retail landscape is dynamic, and we have much work to do, but we're confident that we will not only deliver on our near term commitments, but also develop a long-term operational model that rewards our shareholders, customers, and our employees.

With that, I turn it over to Rustin.

Rustin Welton

Thank you, Scott. And good morning, everyone. During our prior conference call, we outlined details associated with our restructuring and cost savings initiatives. As a follow-up, I'll update you on our progress, including our global ERP implementation, before turning to our third quarter financial results.

As a reminder, we announced a restructuring and cost savings program that is expected to yield more than \$50 million dollars in annual savings upon completion by the end of 2021. All actions in the first phase have been announced and executed, and we are beginning to see the benefits in our financial results.

Key projects included but were not limited to, exiting unprofitable markets in select international locations, streamlining and right-sizing our supply chain operations, including closing three owned manufacturing facilities in Mexico, and consolidating and relocating select facilities and operations, including moving the Lee business from Kansas to our global headquarters in North Carolina. Our program is on track and the benefits will continue to accrue to our financial results over the next several quarters and beyond.

In addition to the restructuring actions, we are also laser focused on quality, quality of our sales and quality of the operational model we are building for the future. Establishing the highest quality foundation is paramount for our long-term sustained success and aligns with our TSR approach in evolving our business. Let's look at our quality of sales actions in more detail.

Last quarter, we mentioned that we had exited our direct operations in Turkey, and shifted to a licensed model in Chile, Russia and Israel. We have entered a new distributor relationship in Chile and plan to announce additional relationships in the near future.

This quarter, we continued analyzing all aspects of our operations with fresh eyes and new personnel and made decisions to exit additional unprofitable points of distribution. In India after considerable analysis, we began rationalizing unprofitable points of distribution in select channels. These strategic actions drove an approximate \$8 million dollar unfavorable adjusted EBITDA impact in the third quarter, due primarily to lower sales and margin, increased inventory reserves, and higher than planned bad debt reserves.

We anticipate an estimated \$8 million dollar impact in the fourth quarter as well. However, as we have said before, we are committed to taking the actions necessary to establish a sustainable platform for the long-term health and growth potential of the business, understanding that India remains an important market for us.

And in the U.S., we exited a selected retailer as well as non-core programs that were inconsistent with our go-forward strategy.

Finally, moving forward, each brand remains focused on rationalizing unprofitable SKUs, improving our inventory management, and reducing distressed sales through the right-sizing of capacity. We are anticipating an estimated \$75 million dollar inventory reduction in the fourth quarter, with further improvement expected in 2020.

With regard to our global ERP program, we remain on track. As a reminder, this program is a critical enabler in establishing a global platform for us to operate our global brand model in the most efficient manner possible.

We have completed the validation phase and are proceeding into the development and testing phases for our first scheduled regional go-live in mid-2020. We will complete the program in 2021 with the final two regional deployments.

Now, let's get to our review of the third quarter and our outlook. Unless otherwise stated, results will be on an adjusted basis. We believe these adjusted results most accurately reflect our business on a standalone continuing operations basis.

Our global revenue decreased 5% in constant currency in the third quarter, compared with adjusted revenues for the same quarter in 2018. The revenue decline was primarily driven by two factors. First, quality of sales initiatives contributed three points to the

decline, reflecting actions taken to exit an underperforming country and other global points of distribution, including select channels in India.

And second, the impact of a major U.S. retailer bankruptcy in the fourth quarter of 2018, represented two points of the decline. As you'd expect, we will continue to see some revenue headwinds from these actions until their anniversary dates.

On a regional basis for the quarter, U.S. revenues were down 6%, in line with our expectations. The U.S. customer bankruptcy, as mentioned earlier, represented approximately half of this decline. It's important to note that our U.S. business was flat year to date if we exclude the bankruptcy with U.S. wholesale up 1% year to date. The U.S. represented 72% of our revenue in the quarter.

International revenues were down 8%, improving from down 23% in the second quarter, primarily driven by three factors. First, planned exits and business model changes represented about four points of the decline. Second, our proactive actions in India drove about three points of the decline. And third, shifts in timing of shipments in Europe, which we discussed last quarter, favorably impacted third quarter revenue by two points.

Excluding these factors, our international business would have been down 2%, or up 1% excluding the impact of foreign currency.

Our international operations remain an area of great focus. We're investing behind people, infrastructure, and global demand creation platforms. And we're very encouraged by how our new leadership teams across Europe and Asia were able to effect change so quickly, as evidenced by our improving third quarter results across the international business.

That said, work remains to establish the foundation on which to grow, including choosing the healthiest markets in which to operate, scaling innovation that was previously confined to limited geographic regions, and investing behind global demand creation platforms that support our growth efforts.

We are clearly under-indexed in our international businesses, representing only about a quarter of total revenues. We can now get after this in a meaningful way, and we are doing just that.

As Scott mentioned, China remains a key area of focus in our international expansion strategy. Lee continues to maintain a strong leading position in China with substantial expansion opportunities in both incremental retail distribution, as well as further development of the digital platform. We are very encouraged by Lee's third quarter results in China, growing 8% constant currency including a 10% brick and mortar comp.

We remain very confident in the long-term accretive opportunities this region affords our international expansion story. We will continue to assess economic conditions in all other markets using our focused TSR lens to help determine where we choose to invest.

Turning to our channels, revenue in our U.S. wholesale channel, which represented 60% of our revenues in the quarter, was down 6%. The U.S. customer bankruptcy, the exit of less profitable points of distribution, and quality of sales initiatives contributed to this decline. U.S. digital wholesale increased 27% in the third quarter, a reflection of longstanding partnerships with leading digital wholesale platforms, and the investments we've made into this important area.

Due primarily to proactive strategic actions mentioned before, our non-U.S. wholesale channel, which represented 25% of our revenues in the quarter, was down 8% or down 5% in constant currency. Our branded direct to consumer channel, which represented 10% of our revenues in the quarter, was flat or up 1% in constant currency.

Broad-based strength in Asia, as well as U.S. and European digital, was offset by weakness in European brick and mortar operations due in part to select store closures. Our U.S.-owned digital business was up 16% in the quarter.

We are seeing positive results from our investments in the U.S. platform, an area that has been prioritized. We will apply these learnings to further enhance our digital platforms globally. The implementation of our global ERP system will be a significant enabler in developing our digital ecosystem. Given the accretive, under-indexed nature of this channel, we will continue to distort investments to grow in this area.

Now, let's turn to our brands. Global revenue of our Wrangler brand declined 6% or 5% in constant currency. Wrangler U.S. revenue declined 4%, driven by the previously mentioned customer bankruptcy, reduced sales of lower margin lines of business, and quality of sales initiatives. The U.S. business is flat year to date.

Wrangler international revenue was down 11% and 8% constant currency, driven by the actions taken in India, a market exit and business model changes in Europe, and training shifts in Europe. We expect Wrangler global sales to improve in the fourth quarter of the year, driven primarily by improvement in our U.S. business.

Lee brand global revenue declined 7% or 6% in constant currency. Lee U.S. revenue decreased 9%, negatively impacted from the previously mentioned customer bankruptcy and reduced sales of lower margin lines of business. Excluding the bankruptcy, the U.S. business would have been down 3% in the second quarter and up 2% year-to-date.

Due to continued reduction of sales of lower margin lines of business, we anticipate Lee's U.S. results will moderate in the fourth quarter of 2019. Lee international revenue was down 6% or 2% constant currency, primarily driven by a market exit and business model, changes in Europe, and actions taken in India.

As we mentioned on our second quarter call, we have recently made changes in our China digital commerce platform, it's staffing and our strategies. We are encouraged by how these adjustments have been able to positively impact near term results, including digital growth in China of more than 40% in the quarter. We are well positioned with the

Lee brand in China with significant growth opportunities, both in further penetrating existing regions while also expanding further into lower tier cities.

Now, onto gross margin. Total adjusted gross margin increased approximately 20 basis points to 40.9%, due primarily to the impacts of quality of sales initiatives, restructuring, and favorable channel mix, which more than offset the negative impact of strategic actions taken in India, as well as pressure from foreign currency.

As we've previously mentioned, the customer bankruptcy and related capacity adjustments, have caused near term manufacturing inefficiencies as we move through elevated inventory levels. As the capacity adjustments are fully achieved and we clear additional distressed goods, gross margins have improved, and we expect great progress in inventory, which is expected to be at our below prior year levels by year end, or an approximate \$75 million dollar reduction from the third to fourth quarter.

As anticipated, we've seen year-over-year comparison improvements in gross margin in each of the past three quarters. While favorable mix from restructuring and strategic quality of sales actions will benefit gross margin, unfavorable mix in India will temper underlying strength during the fourth quarter. Longer term, structurally accretive mix shifts to higher margin channels, such as digital and international, will fuel further gross margin expansion.

Adjusted SG&A as a percent of sales increased 80 basis points to 27.9%. The year-over-year increase was driven primarily by higher demand creation, higher bad debt expense in India, and fixed cost deleverage due to revenue declines. These increases were partially offset by tight expense control and restructuring benefits.

We also recorded a non-cash \$33 million dollar impairment charge related to our intangible asset trademark of the Rock & Republic brand during the quarter, based primarily on anticipated revenue reductions given changes to the composition of our distribution going forward.

Adjusted operating profit was \$83 million dollars or 13% of sales, down 11% from the year prior. Adjusted EBITDA was \$90 million dollars or 14.1% of sales, compared with \$100 million dollars in the third quarter of 2018. As mentioned previously, the actions we took in India drove an approximate \$8 million dollar adjusted EBITDA impact in the quarter.

Net interest expense was approximately \$15 million dollars, and our adjusted effective tax rate was 19.9% due in part to the Rock & Republic impairment. We delivered adjusted earnings per share of \$0.95 in the third quarter. The actions we took in India drove an approximate \$0.09 unfavorable impact in the quarter.

Now, turning to our balance sheet. Inventories, as expected, were slightly elevated as we ended the quarter, up 1% compared with the same period last year, primarily due to inventory built in anticipation of the plant's close.

The second quarter year-on-year comp was an increase of 9%, so we're making progress here. Again, we are on track to achieving our expectation that at year-end, inventory levels should be relatively flat to below prior year.

Next, cash flow. Significant free cash flow generation supports our robust capital allocation strategy, which is focused for the next 12 to 18 months, on paying our superior dividend and deleveraging our balance sheet. During the third quarter, we paid our first quarterly cash dividend of \$0.56 per share.

And now, onto our outlook. As discussed earlier, the actions we took in India drove an estimated \$8 million dollar negative impact to adjusted EBITDA in the third quarter. And we are expecting a similar impact in the fourth quarter, for a total second half impact of \$16 million dollars. Based upon the magnitude of these actions, we have sharpened our full-year adjusted EBITDA outlook to be in the lower half of our previously announced range of \$340 million dollars to \$360 million dollars.

Revenue expectations are unchanged and should exceed \$2.5 billion, reflecting a mid-single digit decline compared with full year 2018 adjusted revenue. The benefits of actions taken to improve revenues in the second half of the year and beyond are beginning to be realized. The fourth quarter will also be less impacted by the fourth quarter 2018 customer bankruptcy comparison.

Capital expenditures are unchanged and expected to range between \$55 million dollars and \$65 million dollars, including approximately \$30 million dollars to \$40 million dollars to support the design and implementation of the ERP system.

Other full year assumptions are unchanged and include an effective tax rate of approximately 24%, and interest expense should be approximately \$40 million dollars in 2019, or \$60 million dollars on an annualized basis.

Before we move onto Q&A, I offer this summary of our message today.

First, our restructuring and cost savings initiatives are on track and the benefits are beginning to be realized, as evidenced by steady gross margin improvements during the past three quarters. Second, as we've stated since our spin, our first 12 to 18 months will be focused on setting the foundation for healthy, sustainable, long-term growth, including the implementation of quality of sales initiatives. And finally, while our operating model is evolving, strong cash flow generation is visible, supporting our robust capital allocation strategy that is focused on paying a best-in-class superior dividend and aggressively de-levering the balance sheet.

With that, it's time to turn the call back to the Operator for the question and answer discussion. Operator?

Operator

Thank you. We'll now be conducting the question and answer session. If you'd like to ask a question today, please press star, one, from your telephone keypad, and the confirmation tone will indicate your line is in the question que. You may press star, two, if you would like to remove your question from the que.

For participants using speaker equipment, it may be necessary to pick up your handset before pressing the star keys.

One moment please, while we pull for questions.

Thank you. The first question today is coming from the line of Bob Drbul with Guggenheim Securities. Please proceed with your questions.

Bob Drbul

Hey, guys. Good morning. The first question that I have is Wrangler U.S., can you just talk a little bit about what you're seeing in terms of your anticipation for the brand to improve in the fourth quarter, maybe just a little more color on the performance there?

Scott Baxter

Yes, hey Bob, it's Scott. How are you? Thanks for joining us today.

Bob Drbul

Hi Scott.

Scott Baxter

I'll go ahead and kick that off. You know, Bob, we're really encouraged we're going to work through this large customer bankruptcy, which will really mitigate itself in the fourth quarter, which will be very helpful.

In addition to that, we've got some really good, exciting new product in the pipeline. We have this-- I mentioned it in my script, the all-terrain gear, the ATG, which has gained broader distribution and is checking really well. We're thrilled with our new campaign.

You know, our campaigns from the past have been kind of focused on specific channels, but we've opened up the lens on this campaign and we're talking to a broader range of consumers, which has been really important. So, we've gotten what I would call very positive feedback from our partners and consumers around the globe, so real happy about that.

But then I think about how proud I am of the team with some of the partners and the co-labs that we're doing. We have some really exceptional people that want to partner with us. I talked about Fred Segal, I talked about Nordstrom. I think it just really shows how the brand is gaining significant heat.

But I will tell you. You know, those are some really good things, but I will tell you, Bob, the single most important thing, which we have not dimensionalized, or talked a lot about but I think it's really important that I bring this up here today, is the Wrangler brand is under-distributed. And it has been under-distributed for a long time. It played a very specific role in our past ownership and that was important, and it did exactly what it needed to do.

But now, as we look at this business and I look at what we need to do with that brand in the U.S. and globally, and for instance we both know that it's not even in China, we've got an opportunity to go ahead and pick and choose really high quality wholesale partners going forward, and I want you and everyone to know that our team is doing that work right now.

So, I think we're very advantaged, because even though we have been under-distributed, we now have chance and the choice to make really good decisions for our brand going forward, and we have walked and talked the line about high quality. This is a great global brand that belongs in the discussion with the world's greatest brands. And we are going to do that going forward, and that work is being done by our Wrangler team right now.

So, more to come on that, Bob, in the future.

Bob Drbul

Got it. Thanks, Scott. And I guess, just-- On India, can you just give us a little bit more color on the distribution exits you made in India, Q3 to Q4? Maybe elaborate a little bit more exactly what the factors were, and partners were, etcetera, the doors. Thanks.

Scott Baxter

Yeah. Sure. You know what, Bob? I'll start and then Rustin will pick it up from there.

But before we jump into India, I just want to remind everyone that as we've talked about horizon one and we've spent a lot of time outlining our horizon one and horizon two initiatives. And one of the things that I want all of our investors and shareholders to know, that we're very serious about our playbook and that we are really doing a good job as a team as far as making sure that we are playing and doing what we said we would do with our outside community, and making sure that we're hitting those milestones.

One of the important things is we said we would make sure we were a high quality company with high quality sales. So we have a new team there, really thrilled with our new Asian leadership team, and in conjunction with our leadership team here, at headquarters, made the decision that that's a channel that's just not representative of where we want the Wrangler brand to be long-term, and I'm proud of the courage that the team made to go ahead and walk the talk there.

So, we made the decision to exit and it is going to impact our Q3 results, as Rustin outlined in his script, and it's also going to impact our Q4 results, but once we get past that the Wrangler brand has a chance to thrive and grow in the Indian marketplace in the right channels.

I'm going to let Rustin go ahead and dimensionalize a few points for you.

But thanks again, Bob, nice to hear from you.

Rustin Welton

Yeah. Good morning, Bob. Just to add onto Scott's comments, as you'll recall, we've seen some demonetization impact affecting the broader market, and we've cited that for the past several quarters. So, as we were projecting our outlook for the year, we certainly were taking into consideration the softness that we had seen in that market.

To Scott's point, we're seeing it in a couple of select channels. It is not in all channels within India. We actually have some very robust channels in India as well. But we started to take a fresh set of look at the points of distribution and there were two channels, again, that were particularly challenged. They tend to be smaller retail operations, Bob, and so we took action to, sort of, amplify our quality of sales there. And that's the right decision for the long-term profitability in that market, which we see great potential for.

And, despite taking those actions, it certainly creates a short term headwind for us, but we're still delivering within the range of EBITDA that we had previously discussed, in spite of these actions. And so, optimizing the foundation, as Scott talked about, is critically important for our long-term success, and you'll see that bear through in the profitability in the future.

Operator

Thank you. (CROSSTALK) Thank you. Our next question comes from the line of Erin Murphy with Piper Jaffray. Please proceed with your questions.

Erin Murphy

Great. Thanks, good morning. I guess I had a follow-up, just on Bob's question, just to clarify on India. I guess, why-- On the pressure, I should say. Why would this not continue into the beginning of 2020? Are you syncing with another distributor as you reposition in the market? I guess, trying to understand just the magnitude that's hitting in the third and fourth quarter, and is it something that disappears in the beginning of next year as you reposition in the market? Just trying to understand the math for the next four quarters.

Rustin Welton

Yeah. Erin, it's Rustin. Good morning. I'll go ahead and start and if Scott wants to add anything, he's certainly welcome to here.

But we looked at these particular retailers again in some of these channels, and some of them are more challenged than others. And so, in the third quarter we made some decisions to exit some of those. We're continuing to look at some of those retailers and anticipate some decisions in the fourth quarter as well, which is why we cited that we would see some pressure in the fourth quarter.

But we're very interested in moving quickly through this and getting this behind us, so as we think about 2020, obviously I'm not going to provide specific guidance as it relates to India, but we're confident that we will see improved profitability in 2020, by putting these decisions behind us quickly.

Erin Murphy

(CROSSTALK) Yeah. Sorry. Keep going.

Scott Baxter

Nope. I think Rustin captured that well.

Erin Murphy

Okay. Are you signing up with a new distributor to reposition in maybe a more elevated way in the country? Just trying to understand-- Because you cited, (CROSSTALK) I think Scott, that you were very confident in the region longer term.

Rustin Welton

Yeah. So, Erin, I think about a couple of things there as it relates to the market. I mean, a lot of these points of distribution that we're exiting are very small retailers. It's a very fragmented market, we have lots of points of distribution within India. So, we're taking a look at those and making sure that we're only remaining in those healthy ones that we see long-term potential with.

In terms of the market, we're also looking at, sort of, the digital side because we see great opportunity. We've seen nice growth on the digital piece, and similar to what we're doing globally, we're going to invest behind the digital opportunities that are within India.

Erin Murphy

Got it, okay. And then, I guess, that dovetails well with my second question, just broadly on direct to consumer digital, I think was up 21% in the third quarter. Can you just share a little bit more about the platforms that are driving this?

And then I guess the second part as it relates to direct to consumer, I know it's not necessarily a strategic piece of your business, but can you share what you saw in the quarter in outlets just in terms of traffic and conversion here in North America? Thank you.

Rustin Welton

Maybe I'll start with the digital, and then I'll let Scott speak a little bit to the brick and mortar and the outlet side of the business and what we're seeing, Erin.

From a digital perspective, we're particularly happy because it is really broad-based growth that we've seen, so it's in the U.S., it's in Europe, and clearly, we spoke about the China performance was up over 40%. But really solid growth across the board, and again that's where we're emphasizing our direct to consumer focus is on digital. We just think that's the most capital efficient way to reach that consumer, and that's where our focus is as we think about D2C.

But with that, I'll turn it over to Scott and maybe some comments on outlet.

Scott Baxter

Yeah, Erin, as you are aware and you know, it's a very small part of our business. It has been for a long time. And a good part of our business, but a small part of our business. We're continuing to assess our footprint as we go forward in that business.

And then, I think the key point here is, and we talked about it in both our scripts, is we're distorting our investment to a digital standpoint. We just believe that there's bigger and better opportunities, much more accretive, and we've got a nice flywheel going there, and our investments are paying off.

Thank you, Erin.

Operator

Our next question comes from the line of Sam Poser with Susquehanna. Please proceed with your questions.

Sam Poser

Good morning, I have a few. Thank you, for taking my questions. I guess number one, you talked about the Wrangler business in the U.S. and you talked about a retailer closure, plus the bankruptcy. So, if you net-net everything, like the bankruptcy plus this, whoever this closure was, and then add the new customers in, how do we think about the foundation of the Wrangler U.S. business right now?

Rustin Welton

Yeah. So, maybe I'll make some opening comments, Sam, and then I'll let Scott weigh in on the future of the business here.

As we think about Wrangler and the actions that took place in the quarter, we were in the U.S. down about 4%, again as we indicated on the prepared remarks. Approximately half of that was due to the bankruptcy. We also took the opportunity, as we're doing, whether it be India or any market around the world, to really take a look at making sure that we have the right emphasis on quality of sales.

So, to your point, we did exit a particular retailer, and a couple of special made programs that were not strategic for us moving forward. We're going to continue to do that, whether that's the Wrangler U.S. business or Lee, and make sure that we're setting that solid foundation moving forward.

So, with that, maybe turn it over to Scott, about where he sees the opportunity for the Wrangler business domestically.

Scott Baxter

Yeah. Sam, I'm really pleased with where we're positioning ourselves with Wrangler. I talked about it before, Wrangler is one of the great apparel/brands in the world. And the way that we're positioning the business going forward, and the opening points of distribution that we can gain, and all the folks that we've partnered with, we're becoming a really significant lifestyle brand that is creating incredible heat, and also expanding our distribution.

A great example of that is you win with product, right? So, we rolled out our all-terrain gear last year. It did really well, checked really well with the big wholesaler that we rolled it out with, and it's gained new points of distribution for us, outside of what you would classify as traditional Wrangler channels of distribution.

So, you couple that with a really smart, intelligent advertising campaign that's capturing new consumers, and we think those two together and as we think about cleaning up some things that we need to clean up, which happens in a spinoff, it's just typical of how it works, we're putting ourselves in a really nice position going forward.

Sam Poser

So, let me just follow up there. So, if you think about-- Well first of all, are you seeing a trend in western coming? Number two, did you get benefit from Lil Nas' song about Wrangler?

And then I have another question about India and the question of, when are you going to start guiding EPS instead of EBITDA.

Scott Baxter

All right, so Sam, why don't I start with western. Yes, we do really like where the western trend is heading. Obviously, everybody knows that's where our brand history is, but our team has done a really nice job of opening up that lens from using our brand history in a really positive way.

What's happening right now in western, is fairly simple but also really good. The retailers in the western space are very healthy. And so, not only that, you've got a healthy, resilient

western consumer, so you couple those two things together and you've got really nice traffic, you've got people buying high AURs.

And then you've got this Americana, both apparel and music, on trend in that category, so that all plays into it.

And then what our team has done, our team-- Again, I go back to the design team that we have in Wrangler, the sales team that we have in Wrangler, and placing our retro into this western moment. And this retro product that we've come out with for both men and women, has done exceptionally well, but here's the key from a retro standpoint. It's done really well both in metro and traditional western markets, Sam, and that tells us that, one, it's strong, and it also tells us that, two, the brand is getting noticed more than it has before.

Rustin Welton

Sam, I'll take your second question as it relates to guiding on EPS. Clearly when we did the spin, as you will recall, even our first meeting back in April, there were a lot of things that were unknowns at that point, including frankly even the share count and distribution ratios that would take place at the spin. That's why we guided on EBITDA here in 2019.

We will be providing more specific guidance for the 2020 period on our Q4 earnings call.

Scott Baxter

Thank you, Sam.

Operator

Our next question is coming from the line of Jim Duffy with Stifel. Please proceed with your questions.

Jim Duffy

Thank you. Good morning. (CROSSTALK) First question is on the gross margin. Encouraging to see the progress there, I presume a reflection of improved quality of sales. Can you guys just comment on your confidence and opportunities for further gross margin improvement as we look into 2020?

Rustin Welton

Yeah. Thanks Jim, it's Rustin. I'll start there and take that one.

Yeah. We're proud to see three consecutive quarters of sequential improvement here from a gross margin perspective, in terms of year-on-year comparisons. So, our gross margin in the first quarter was 260 basis points below the adjusted 2018 number. Second quarter, we were 110 basis points below, but we improved 150 basis points from the first quarter. And then obviously this quarter, you saw us inflect positive versus prior year at 20 basis points. And that's really a 90 basis point improvement from the second quarter.

So, we're pleased with the ongoing progress here. We believe that this is a significant opportunity for us to recapture gross margin, and that's why we're really focused on some of the restructuring and cost savings initiatives.

And then, longer term, as we've talked a little bit about, we really like being able to get those structural benefits as we start to grow and distort growth in those accretive categories, like digital and like international, that will provide that structural framework for us to expand gross margins over time.

Jim Duffy

Great. And then, next question, can you give more details on the discontinuation of the Rock & Republic license? I'm hoping you can talk about the run rate impact of that.

Rustin Welton

Yeah. Yeah, it's Rustin, again. I'll go ahead and take that.

With Rock & Republic, as you know we've had an exclusive, domestic wholesale distribution and licensing agreement. During the quarter, we determined that that would not continue in 2020, which created a triggering event and a non-cash impairment charge in the quarter that you saw.

As we think about the Rock & Republic brand, it's a fantastic brand that has considerable equity with both genders. And this really creates an opportunity for us to really broaden the distributions and reach on the brand, both domestically and internationally. So, we're excited about that opportunity.

Just for perspective in terms of dimensionalizing the impact, Rock & Republic is less than 1% of our global revenue and EBITDA today. So, it's a very small piece of our business.

Scott Baxter

Thank you, Jim.

Operator

Thank you. We have time for one additional question today, which will be coming from the line of Alexandra Walvis for Goldman Sachs. Please proceed with your question.

Brooke Roach

Hi there, thanks so much for taking the question. This is Brooke Roach on for Alex.

My question is on cost saving initiatives, and in particular, your own manufacturing footprint. Could you help us frame the right-sizing of your manufacturing footprint in the context of the additional quality of sales initiatives that you have, both in the U.S. and globally?

Is your manufacturing base now optimized for the business you expect to have post-these initiatives? Thank you.

Rustin Welton

Yeah, Brooke, it's Rustin. Good morning. Thanks for joining us. I'll go ahead and take that one.

As we think about the restructuring activities that took place, we did announce three plant closures in Mexico, in June, that took place. And as you may recall, at the time over 50% of the production that was taking place in those facilities, was going away as part of the spin. So, that really is what drove that action in those particular facilities, and allowed us to right-size capacity in light of the customer bankruptcy as well, that took place in the U.S.

As we think about moving forward and the right footprint associated with manufacturing, I would tell you that we're constantly looking at that. We perform make-versus-buy analysis on each product that we produce and determine the optimal location, whether that be sourced or manufactured in our own manufacturing facilities. So, we're constantly looking at that impact.

In terms of your question about dimensionalizing that impact on margin, I would say that the combination of the restructuring, quality of sales, and some of the favorable mix that we saw, probably drove close to a 50 basis point improvement in margins in the third quarter. And then, you had some headwinds there as it related to India and FX, that I talked about a little bit on the call.

Scott Baxter

In closing, thanks for joining us this morning. As a wrap-up, today we reaffirmed a few key points that you've heard from us since day one. We're making great progress and we will deliver on our year one financial commitments. We're sharply focused on a TSR approach to business. We will drive improving margins and sustainable long term growth. We will maintain a strong dividend policy, supported by a healthy balance sheet. Strong cash flow generation, and thoughtful deployment of cash. And we have meaningful category, channel and geographic growth opportunities, prioritizing our investments through the lens of our TSR model.

With that, we look forward to our fourth quarter call, and reporting on the progress we've made at Kontoor Brands. Thank you.

Operator

Thank you. Thank you. This concludes today's conference. You may disconnect your lines at this time. We thank you for your participation.



About Kontoor Brands

Kontoor Brands, Inc. (NYSE:KTB) is a global lifestyle apparel company, with a portfolio led by two of the world's most iconic consumer brands: Wrangler® and Lee®. Kontoor designs, manufactures and distributes superior high-quality products that look good and fit right, giving people around the world the freedom and confidence to express themselves. Kontoor Brands is a purpose-led organization focused on leveraging its global platform, strategic sourcing model and best-in-class supply chain to drive brand growth and deliver long-term value for its stakeholders.

Forward-Looking Statements

Certain statements included in this release and attachments are "forward-looking statements" within the meaning of the federal securities laws. Forward-looking statements are made based on our expectations and beliefs concerning future events impacting Kontoor Brands and therefore involve several risks and uncertainties. You can identify these statements by the fact that they use words such as "will," "anticipate," "estimate," "expect," "should," and "may" and other words and terms of similar meaning or use of future dates. We caution that forward-looking statements are not guarantees and that actual results could differ materially from those expressed or implied in the forward-looking statements. Potential risks and uncertainties that could cause the actual results of operations or financial condition of Kontoor to differ materially from those expressed or implied by forward-looking statements in this release include, but are not limited to: risks associated with Kontoor Brands' spin-off from VF Corporation, including the risk of disruption to Kontoor's business in connection with the spin-off and that Kontoor could lose revenue as a result of such disruption; the risk that Kontoor does not realize all of the expected benefits of the spin-off; the risk that the spin-off will not be tax-free for U.S. federal income tax purposes; and the risk that there will be a loss of synergies from separating the businesses that could negatively impact the balance sheet, profit margins or earnings of Kontoor. Other risks for Kontoor include foreign currency fluctuations; the level of consumer demand for apparel; disruption to distribution systems; reliance on a small number of large customers; the financial strength of customers; fluctuations in the price, availability and quality of raw materials and contracted products; disruption and volatility in the global capital and credit markets; response to changing fashion trends, evolving consumer preferences and changing patterns of consumer behavior, intense competition from online retailers, manufacturing and product innovation; increasing pressure on margins; ability to implement its business strategy; ability to grow its international and direct-to-consumer businesses; Kontoor's and its vendors' ability to maintain the strength and security of information technology systems; the risk that Kontoor's facilities and systems and those of third-party service providers may be vulnerable to and unable to anticipate or detect data security breaches and data or financial loss; ability to properly collect, use, manage and secure consumer and employee data; stability of manufacturing facilities and foreign suppliers; continued use by suppliers of ethical business practices; ability to accurately forecast demand for products; continuity of members of management; ability to protect trademarks and other intellectual property rights; possible goodwill and other asset impairment; maintenance by licensees and distributors of the value of Kontoor's brands; ability to execute and integrate acquisitions; changes in tax laws and liabilities; legal, regulatory, political and economic risks; the risk of economic uncertainty associated with the pending exit of the United Kingdom from the European Union ("Brexit") or any other similar referendums that may be held; and adverse or unexpected weather conditions. More information on potential factors that could affect Kontoor's financial results is included from time to time in Kontoor's public reports filed with the SEC and Kontoor Brands' Registration Statement on Form 10 also filed with the SEC.