



## **Kontoor Brands' Second Quarter 2019 Earnings Conference Call Transcript**

**August 8, 2019**

### **Corporate Participants:**

Eric Tracy – Sr. Director, Investor Relations, Kontoor Brands

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

Rustin Welton – VP & Chief Financial Officer, Kontoor Brands

### **MANAGEMENT DISCUSSION SECTION**

**Operator:** Greetings. And welcome to the Kontoor Brands second quarter 2019 Earnings Conference Call. At this time all participants are in a listen only mode. A question and answer session will follow the formal presentation. If anyone should require operator assistance during the conference, please press star, zero, on your telephone keypad. As a reminder, this conference is being recorded.

It is now my pleasure to introduce your host, Eric Tracy, Senior Director of investor relations. Thank you, sir. You may begin.

**Eric Tracy:** Thank you. Good Morning, everyone. And welcome to Kontoor Brands Second Quarter 2019 Earnings Conference Call. We're pleased that you've joined us for our first ever earnings 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 differ materially.



These uncertainties are detailed in our documents regularly filed with the security and exchange commission. We urge you to read the risk factors, cautionary language, and other disclosures contained in those reports.

Amounts referred to on today's call will also 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, and other adjustments.

Reconciliations of gap measures to adjusted amounts can be found in the supplemental financial table included in today's news release, which is available on our website, [Kontoorbrands.com](http://Kontoorbrands.com). These tables identify and quantify excluded items and provided management view of why this information is usable to investors.

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 questions. We anticipate the call will last about an hour. With that, I turn it over to CEO, Scott Baxter.

**Scott Baxter:** Thank you, Eric. And good morning, everyone. This historic moment for Kontoor Brands, our shareholders, employees, and other stake holders around the world. Today represents our first earnings report after our successful spend on May 23<sup>rd</sup>.



To provide some perspective and the weeks following the spend, we've begun to unify a global brand and product architecture, announce and execute restructuring in cost saving initiatives, kick off our ERP implementation, enhance and augment our talent, and establish one global leadership team.

I thank all of our employees around the world for their passionate commitment to establish a world-class global brand in apparel company. Let me be clear, we have a lot of work to do but we couldn't be more excited to get after it and compete now, as a new independent company.

We are confident in our plans, delivering on our first-year commitment and our ability to successfully execute against our strategies to drive improved growth over time.

On today's call we will: provide select highlights of our second quarter performance, remind you of our investment thesis fueled by our disciplined approach to shareholder return, frame our business strategy, and describe how our key enablers including innovation, supply chain, and demand creation will accelerate improved growth.

With that, let's get started with highlights of our second quarter. Excluding the impact of a key customer bankruptcy, revenue in the U.S. was up 2% in both the second quarter, and the first half of 2019. Despite some challenges and the U.S. retail landscape, we are well positioned to win with winning retailers, and our key tiers of distribution, and largest market.



Now, digital wholesale continues to outperform for us, with 30% growth in the second quarter. Regarding our Wrangler Brand, international market negatively impacted our second quarter results, as we expected.

However, it's also important to note that excluding the customer bankruptcy, Wrangler's wholesale performance was up 2% in the first half of 2019 and we expect global sales to accelerate in the second half of this year, relative to the first half of this year.

With our Lee Brand, excluding the impact of the customer bankruptcy, we note that the U.S. wholesale increased 17% in the second quarter and was up 6% in the first half of 2019.

For the second quarter, we delivered adjusted ebitda of \$82 million-dollars and adjusted EPS of \$0.96 per share. In consistent with our capital allegation strategy during the second quarter, we paid down \$50 million-dollars of debt. And on July 23<sup>rd</sup>, our board of directors declared a quarterly cash dividend of \$0.56 per share.

Rustin will take you through a more in depth look at the second quarter results later in the call.

Now, I'd like to spend some time on the Kontoor Brands investment thesis. It starts with our commitment to total shareholder return. This TSR model has a number of key



underlying assumptions and commitments, with a goal of annualized long-term TSR returns of 8-10%. Our fundamental assumptions include: 1-2% annual revenue growth, 2-3% annual margin expansion, and the dividend yield of about 5%.

The deliver on our TSR commitment were focused on the following high-level business strategies. Number one, scaling our advantage and our core denim business, including innovation. Two, accelerating our positions and high value segments, distorting growth to a creative channel, including digital and international. Three, building advantage positions to reach new consumers in new and expanded channels. Four, driving an unwavering focus on margin expansion and improving capital efficiency. And five, creating a highly engaged performance driven culture with a TSR driven approach. Our team is focused on and rewarded by achieving our TSR commitments.

In support of these strategies, we are focused on three key enablers including: enhancing and further scaling innovation, strengthening a best in class global supply chain, and elevating our demand creation platform.

Let me provide some additional insight as to how we will use these enablers to operate differently as an independent publicly traded company. First, with respect to innovation, as a stand-alone company we are now positioned to more effectively to invest behind, showcase, and scale new product technologies and advanced manufacturing capabilities like never before. Within innovation we will focus on two primary areas, product and manufacturing.



Development of our product technologies is led by the Kontoor innovation team in Southern California. A second team in North Carolina focuses on supply chain enhancements. Our innovation, research, and development is intended to deliver value to consumers and position us as a global leader in the industry.

For example, the Body Optix line is an advanced anatomy shading technology, which enhances shaping of denim products. Body Optix has generated solid sell-through and brand heat for the Lee brand in China and its pioneer growth in our premium women's lines. It has recently paved the way for new women's wear lines such as 101+ and Urban Riders in this key market. Body Optix total sell in has now surpassed the 0.5 billion units mark at premium price points.

Importantly, later this year we will be extending the Body Optix platform within the U.S. marketplace, scaling its meaningful features and benefits to more consumers at a compelling value. We now have the opportunity to extend the success of the whole platform to new geographies, channels and points of distribution that would not have happened in our past.

The second program across is product and manufacturing innovation, Indigood, a brand-new innovation platform that was recently introduced into the marketplace, uses groundbreaking dyeing technology that we believe creates a significant first mover advantage within sustainability. This revolutionary dyeing process uses foam as the



carrier for the blue indigo dye instead of water. First introduced in June of this year, Indigood allows us to more effectively address the needs of the younger millennial consumer base, clearly, a focus for Kontoor now as an independent company.

The technology uses no water, generates zero wastewater, uses 60% less energy and produces 60% less waste. Indigood will help us save up to 5.5 billion liters of water by 2020. We develop the technology with our network of innovation partners and are the first to bring it to global markets via the Wrangler ICONS collection with our Lee brand soon to join the platform.

From a supply chain and manufacturing perspective, Kontoor Brands uses sustainable technology and breakthrough innovation to address consumer needs to minimize our risk exposure and improve our operating efficiency all while demonstrating our commitment to good corporate citizenship. We are and will remain committed to responsible sourcing and sustainability initiatives.

In addition to responsible sourcing, our supply chain affords us distinct competitive advantages. The scaled, vertically integrated production capabilities developed over the years in our supply chain are arguably among the best in the world in the denim category. Specialized manufacturing innovations, including lasering technology, which we engineered in-house several years ago, and custom-made production equipment utilized



in our internal manufacturing are perfect examples of supply chain technologies and processes born in our denim business.

Our supply chain is a key competitive advantage for several reasons. First, scale, as one of the world's largest denim manufacturers, our capital investments in developing the most scaled, vertically integrated production architecture create a competitive advantage.

Next, speed, with more than a third of our current own production strategically placed in the Western Hemisphere, we can bring product to market for retailers in the U.S. within a matter of days, significantly faster than branded or private label producers that source in Asia. And quality, the quality of the goods we produce reflects the quality of our manufacturing processes in emerging best practices.

Our supply chain presence around the world continues to evolve as evidenced by our recent closure of three manufacturing facilities in Mexico, to more effectively right size capacity. More than 50% of this reduction was associated with products manufactured for the former company that will no longer be produced. It's essential that we remain nimble in operating a supply chain that is in line with today and tomorrow's demand.

With the topic of our global supply chain comes to discussion about the current and anticipated trade and tariff environment, so let me address this as I'm sure you all have questions on the subject. Today, we have very limited tariff exposures in China with less than 1.5% of our global production for exports to the U.S.





We do have some sizable production presence in Mexico, which as we stated, is a distinct competitive advantage given its scale and speed to market and we're optimistic that the pending USMCA trade agreement with Mexico and Canada will ultimately be approved.

However, as the trade environment continues to evolve, be assured that we have developed a multitude of strategic alternatives to implement if necessary.

We appreciate that the concerns around tariffs are not just based on our production in China, but also the potential negative impacts on global consumer spending. We recognize the most recent tariffs proposed act as an incremental tax on the U.S. consumer and many retailers will look to pass on higher costs in the form of higher prices.

Let me be clear, we will be very strategic regarding pricing, with a comprehensive assessment of the elasticity helping guide our decisions. This is a dynamic landscape that requires a dynamic approach and we are skilled at delivering, giving our leading supply chain expertise.

And while our supply chain is currently well positioned, we continue to seek ways to drive further competitive advantage.

To that end, we began a top to bottom review of our global supply chain approach, an initiative that we are confident will yield additional process and production efficiencies to leverage and enhance our performance.

The final key enabler, and it's an important one, is our evolving demand creation platform. This is an area where we see significant opportunities to catalyze Kontoor growth. First, we will elevate and sharpen the focus of our spend, doing so in a way that is prioritized through our TSR lens. We'll direct our demand creation dollars to areas where we see the most sustainable, healthy long-term growth. We will expand our marketing through designer and artist collaborations, engagements with both macro and micro influencers, and we will use social media to more effectively connect with consumers.

Here are a few highlights. We hired a new advertising agency for Wrangler, and we will do the same for Lee, both with a strengthened global approach. We have collaborated with Lil Nas X in his global chart topic song, Old Town Road, launching our Wrangler collection with amplified product placement through digital channels.

We have recently introduced Capsule collections for both Wrangler and Lee, which have provided strong sell-through with key customers in higher tier channels of distribution. And we're very excited about an upcoming Wrangler brand event where we will unveil our new ad campaign, more to come on this in the coming weeks.

So, what's the outcome? We will allocate incremental spend to high growth areas such as defending our core, digital and international expansion, and we will continue to shift our current demand creation spend to higher ROI areas, where we see the most opportunity to solidify and grow our position.

In summary, we will leverage our three key enablers, evolving innovation, supply chain excellence and demand creation platforms, to stabilize the core business over the near-term while accelerating our growth across categories, channels, and geographies for the long-term.

With that, I turn it over to Rustin.

**Rustin Welton:** Thank you, Scott. Beyond our successful spin-off and standing up a new independent company, our global teams have completed a number of key strategic actions that set the foundation for our future success.

Prior to the spin, we announced a restructuring and cost savings program that will yield more than \$50 million in annual savings upon completion by the end of 2021. We will complete the first phase by the end of 2020, with an expectation that it produces \$20 million to \$25 million in annualized savings.

We've just begun to achieve some of these savings, and we expect that savings will accelerate during the second half of 2019. Actions are already being taken in all regions of the world to simplify, stabilize, and strengthen the company's global results, while delivering improved profitability.



I want to highlight some of the details to illustrate the depth and breadth of the actions already announced and taken, including exiting and profitable markets in select international locations. Specifically, in Europe and South America. Streamlining and right-sizing our supply chain operations, including closing three owned manufacturing facilities in Mexico, exiting our internal trucking fleet, and eliminating a shift at one of our domestic distribution centers.

Consolidating and relocating select facilities and operations. Including relocating the Lee business from Kansas to North Carolina and closing our Canadian headquarters office. Redesigning the commercial organizations in the U.S. and Asia and initiating the implementation of our new global ERP system.

Some of these actions create near-term headwinds, including the market exits and changes associated with right-sizing operations. But be assured that all will strengthen our long-term performance and improve our quality of sales.

The second phase of this cost savings work is anticipated to begin in late 2020 or early 2021 and is expected to generate an additional \$25 million to \$30 million-dollars in annualized savings as we further leverage global processes and systems to generate improved efficiencies.

Now let's get to our review of the second quarter and our outlook. Unless otherwise stated, results will be on an adjusted basis. Keep in mind that adjusted amounts exclude

the impact of restructuring and separation costs, changes in our business model, and other adjustments.

The changes in our business model that have been adjusted include the exit of Argentina, production for our former company, and the exit of the internal trucking fleet. We believe these adjusted results most accurately reflect our business on a standalone continuing operations basis.

Our global revenue decreased 6% in the second quarter of 2019 compared with adjusted revenues for the same quarter in 2018. The revenue decline was primarily driven by three factors.

First, the impact of a major U.S. retailer bankruptcy in Q4 2018 represented two points of the decline. Second, actions to exit, and underperforming country in Europe, and to change additional business models in select markets contributed another two points to the decline. And third, foreign currency headwinds negatively impacted revenue by about a point in the quarter.

The additional business model changes include exiting our direct operations in Turkey and shifting from a direct to distributor or licensed model in Chile, Russia, and Israel. Obviously, we will continue to see some revenue headwinds from these actions up until their anniversary dates. All top line headwinds outlined here were factored into our 2019 outlook in three-year financial roadmap.

On a regional basis for the quarter, U.S. revenues were down 1%. Excluding the impact of the customer bankruptcy, our U.S. business would have been up 2%. We had shifts in timing of shipments that affected both Wrangler and Lee's, U.S. business in the quarter, but our U.S. business was flat in the front half or up 2% if we exclude the bankruptcy. The U.S. represented 80% of our revenue in the quarter.

International revenues were down 23%, driven by the following three factors. First, the planned exits and the business model changes represented about seven points of the decline. Second, shifts and timing of shipments in Europe, impacted second quarter revenue by an additional six points. And third, we continue to see softness in India, including the negative impacts of demonetization, which contributed three points to the decline.

Excluding these three factors, our international business would have been down 9% or 4% excluding the impacts of foreign currency.

Our international operations are clearly an area of great focus. As an independent company, we now have the opportunity to more effectively globalize our businesses. Choosing the healthiest markets in which to operate, scaling innovation historically confined to specific geographic regions, investing behind global demand creation platforms, and placing the right leadership and talent that supports our growth efforts. This is the first opportunity we have had to get after this in a meaningful way.

To that end, we've installed a new General Manager, finance lead, and other key leaders in both Europe and Asia to fuel improved outcomes. We continue to see significant white space to grow globally.

International represented only 20% of our revenues in the quarter, well below our branded apparel peer set. China in particular remains a key pillar 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.

And we remain on track to launch the Wrangler brand in China in the first quarter of 2020, with our go-to-market strategy focused on digital. We will continue to assess global market conditions using our focused TSR lens to help determine where we choose to invest.

Turning to our channels. Kontoor's reported revenue in our U.S wholesale channel, which represented 68% of our revenues in the quarter, was down 2% in the quarter as reported, but up 2% excluding the customer bankruptcy. U.S. digital wholesale increased 30% in the second quarter. A reflection we believe of longstanding partnerships with leading digital wholesale platforms. Due primarily to proactive strategic actions, I mentioned before our non-U.S. wholesale channel, which represented 16% of our revenues in the quarter was down 25%.

Our branded direct-to-consumer channel, which represented 11% of our revenues in the quarter, was down slightly, with U.S. digital strength offset by weakness in European brick-and-mortar operations.

Our owned.com U.S. digital business was up 15% 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 in further enhancing our digital platforms globally. Given the accretive, under index nature of this channel, we will continue to distort investments to grow in this area.

Now let's turn to our brands. Global Wrangler brand revenue declined 8%. Wrangler U.S. revenue declined 3%, due to the previously mentioned timing shifts and customer bankruptcy. Excluding these impacts, the U.S. business was up modestly in the second quarter and up 2% in the first half of 2019.

Wrangler international revenue was down 30% during the quarter, driven by the strategic exit and business model changes as well as timing shifts in Europe. Also, the continued effects of demonetization in India negatively impacted our Wrangler results.

FX negatively impacted Wrangler international by 3%. It is important to note, that we anticipate Wrangler global sales will accelerate in the second half of this year, driven primarily by continued strength in the U.S. market.



Global Lee revenue declined 5% during the quarter, with a 7% increase in the U.S. region that was more than offset by declines in Europe and to a lesser extent in Asia. Lee, U.S. revenue increased 7%, benefiting from the previously mentioned timing shifts, somewhat offset by the customer bankruptcy.

Excluding the benefit of timing shifts, and negative impact of the bankruptcy, the U.S. business would have been up 1% in the quarter and up 5% in the first half of 2019. We anticipate Lee's U.S. results will moderate in the second half of 2019.

Lee international revenue was down 20% during the quarter, driven by the strategic exit and planned business model changes, as well as timing shifts in Europe. Also, the continued effects of demonetization in India and softer European demand impacted our Lee results. Lee international decreased 15% excluding FX.

Changes have been made recently in our China digital commerce platform, staffing, and strategies. And our recent early results from these changes have been encouraging. 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 Tier 3, Tier 4 and Tier 5 cities. It's important to note, that in the front half of this year, China was up low single digits in constant currency.



Now onto our gross margin. Total adjusted gross margin declined approximately 110 basis points to 40%, due primarily to channel mix as well as product cost increases. FX negatively impacted gross margin by about 20 basis points.

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 distress goods, gross margins will begin to stabilize and improve. We expect great progress in inventory with levels at year end, at or below the prior year.

Our second quarter, year-over-year gross margin reduction improved from first quarter. And we are confident the comparative performance will further strengthen in the second half, as restructuring efforts begin to take hold. Benefits of quality of sales initiatives and skew rationalization materialize, and channel mix improves. 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 decreased 40 basis points to 27.7%, compared with 28.1% last year. The year-over-year improvements were driven primarily by tight expense control.

Adjusted operating profit was \$74 million or 12.3% of sales down 9 million from the prior year.



Adjusted EBITDA was \$82 million or 13.6% of sales in the quarter, compared with \$91 million in the second quarter of 2018.

Net interest expense was approximately \$6 million, and our effective tax rate was 19.8%. We delivered adjusted EPS of \$0.96 in the second quarter.

Turning to our balance sheet, inventories as expected were elevated as we ended the quarter up 9% compared with the same period last year, primarily due to inventory built in anticipation of the plants closed. Again, at year end, inventory levels are expected to improve and be relatively flat to below prior year.

We have a significant opportunity to improve working capital efficiency, with up to \$100 million from enhancing our cash conversion cycle across inventories, receivables and payables. We are all over this, you will hear more about these efforts in the coming quarters.

Significant free cash flow generation supports our robust capital allocation strategy, which is focused for the next two years on paying our superior dividend and deleveraging our balance sheet.

On July 23, our Board of Directors declared a regular quarterly cash dividend of \$0.56 per share. In addition, during the second quarter we paid down \$50 million-dollars of debt.

And now onto our outlook. This morning, our earnings release reaffirmed our 2019 full year outlook. We are confident that we will deliver on our first-year targets as an independent company.

I'll offer some additional insights. Revenue is expected to exceed \$2.5 billion, reflecting a mid-single digit decline compared with full year 2018 adjusted revenue. The benefits of strategic initiatives to improve revenues in the second half of the year and beyond are beginning to be realized. Second half revenue should improve relative to first half, with the fourth quarter benefiting the most from strategic actions, and the Q4 2018 customer bankruptcy comparison.

Adjusted EBITDA is expected to range between \$340 million and \$360 million-dollars, reflecting a mid-single digit to low-double digit decline compared with full year of 2018 adjusted EBITDA.

We expect to see improved second half performance as benefits from restructuring and cost savings begin to take hold. As planned, inventory levels are anticipated to remain elevated during the third quarter of the year, due to the inventory built during the second quarter in anticipation of the plant's close. We expect second half adjusted EBITDA to be more weighted to the fourth quarter.

As previously stated, year-over-year gross margin reductions should improve in the



second half of the year. Capital expenditures are expected to range between \$55 million and \$65 million-dollars, including approximately \$30 million to \$40 million-dollars to support the design and implementation of a global enterprise resource planning system.

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

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

## **QUESTION AND ANSWER SECTION**

**Operator:** Thank you. Ladies and gentlemen, at this time we will be conducting the question and answer session.

If you would like to ask a question, please press star, one, on your telephone keypad. The confirmation tone will indicate that 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.

Our first question comes from the line of Bob Drbul with Guggenheim Securities. Please proceed with your question.

**Bob Drbul:** Hi, guys. Good morning. I've got a question for Scott.

**Scott Baxter:** Good morning, Bob.

**Rustin Welton:** Good morning, Bob.

**Bob Drbul:** Good morning. Scott, can you just talk to, I guess, the transition post to spin-off? I think the culture, what you're creating-- You know, from the business standpoint?

**Scott Baxter:** Yeah. Well, thanks, Bob. Appreciate you joining the call with us today. We're thrilled about being an independent company. Putting our people in a position to compete, our folks want to do really well. They're thrilled about the opportunity to go ahead and focus on these two big global brands, which our folks have wanted to do that for a long time. We played a very strategic role in the past and now we get to be independent and we get to see how we do. And the scoreboard is out there every single day, which I think is the most important thing for our folks.

But, Bob, there are a couple of things that from my perspective as the CEO that I think are really important. And as we start, and obviously, you know we just spun on May 23, everything that we're doing is new. And I have been really encouraged by the intelligence



and the work ethic and how we've gotten after all the things that we need to; it's actually exceeded my expectations from a team standpoint and the things that our folks have done.

I've also been extremely encouraged by the fact that we moved a very significant business from Kansas, and it had been there 130 years. And we've been able to integrate that culture with our Wrangler culture here now to have a Kontoor culture and it's going very well. And one of the reasons it's gone well is we were able to bring the right talent from Kansas City and the right type of leadership. And those folks are now working really well together throughout our business.

And I think just as importantly, and Bob, I know you know this, but we've had to hire quite a few people to go ahead and stand up the company here. And we've brought in some incredible talent and they've just really worked well with the rest of our folks. But I think the key is that as our current talent looked around and we brought in this really good new talent, it's lifted us as a company.

And having that compass from a TSR standpoint and really focused on that, and then also talking to our folks constantly, in our town halls and in our communications about, hey, this is going to be a performance-driven culture. We're going to go ahead and focus strictly on these two big brands and our other business, really focused on the two big billion-dollar brands. I'm really encouraged by what I've seen. And more than anything, Bob, I'm encouraged about the future.

**Bob Drbul:** Great. Thanks, Scott. And, Rustin, I just have a question for you. On the inventory, up 9%, and you've given some commentary around that, but can you just help us sort of walk through the next several months and quarters and how you really think about that in the back half?

**Rustin Welton:** Yeah, yeah. Thanks, Bob. Good morning. Thanks for joining us. Great question. As we talked at the beginning of this spin process, Bob, we mentioned that we were sort of ending 2018 in a little bit of an elevated inventory position due to the customer bankruptcy. And obviously, that has grown here in Q2, as you indicated, up 9%. And that was really built strategically in anticipation of these closures of these facilities that were announced in June.

So, as we think about sort of the shaping in the back half, Bob, Q3 historically is our highest quarter of the year from an inventory perspective in advance of holiday shipments. So, we will see--we are anticipating to see inventories grow. We expect to remain elevated over prior year levels at the end of Q3. But we do expect to see a significant decline in the fourth quarter to be at or below the prior year levels.

As we've discussed, cash flow is really a critical component for us as an organization and a critical piece of how we are structured from a TSR perspective. So, we are laser-focused on that and I think you'll see a progressive improvement as we move through the year until the end of the year.



**Bob Drbul:** Great. Thank you very much. Good luck with everything.

**Rustin Welton:** Yes.

**Scott Baxter:** Thanks for joining today, Bob.

**Operator:** thank you. The next question is coming from the line of Erinn Murphy with Piper Jaffray. Please proceed with your question.

**Erinn Murphy:** Great, thank you, and good morning. I guess I had a couple of questions. First, maybe thinking here about the North American landscape, could you talk about kind of how sell-out trends looked with your top four accounts versus maybe the balance of the U.S. wholesale business?

And then just as you think about the second half, how are you feeling about kind of trends at retail? How are the order books shaping up? There has been some of your peers that have been a little bit more skeptical or there's a level of uncertainty into the back half. So just curious on your confidence, particularly here in the North American market. And then I have a follow-up.

**Scott Baxter:** So, Erinn, I'll start. This is Scott and then Rustin will join me here as we move along. But we feel pretty good; from a POS standpoint we're able to track that with

certain customers and we get that data. Our POS is good. The reason our POS is good is we've done a really nice job as a company of flowing some consistent innovation into the marketplace.

And we think about innovation as trying to hit singles and doubles, home run is very elusive in innovation. And how we think about it is how do we go ahead and stage that innovation so that we keep the consumer engaged with our product, wanting to come back, and we also look at it like, from a partnership standpoint. We are very happy with our current wholesale partners.

So, we think about it as winning with the winning retailers. And we really like how we're positioned relative to the channels that we participate in. We have 30 plus year long-term relationships with some of these folks. And we take that very seriously and we work real hard to make sure and win every day on their space. And all of that's embedded in our long-term outlook as we move forward.

But I will tell you this and we spend a lot of time talking about inventory and we spent a lot of time talking about our customers. We really like where we're coming out of the summer season. We really like how we're positioned to going into fall.

I know you know this, but we are a little bit of an at-one business. So, we don't worry as much about the pre-book situation because our business is very strong from an at-one

standpoint and that's also how it plays into our real strong supply chain advantage that we have.

So as we look at our business going forward in the U.S. marketplace; a real strong relationship base, winning with the winning wholesalers in specific channels, and also, and we touched a little bit on this in our prepared remarks, moving to different channels and geographies and segments that are going to be really helpful in creating some brand heat for our products and our brands going forward.

**Rustin Welton:** Yes. Erinn, it's Rustin. Good morning. I would just add a couple of things to Scott's comments. We're really encouraged about sort of the front half performance in our U.S. business as we talked about. Excluding the customer bankruptcy, we were up 2% in a quarter and 2% in the front half and we really seen that strength across both brands and across multiple sort of categories. So, it's not just been denim long bottoms, but we've seen strong performance from both brands, and that's really encouraging as we start to think about our go-forward strategy.

As you're well aware, our long-term TSR outlook calls for us to be up 1% to 2% on top line. 80% of our business in the second quarter was in the U.S. And again, excluding that bankruptcy we were up 2%. And so, combined with some of the things that Scott talked about with the brand heat, we're really encouraged as we start to move forward throughout the balance of this year and into 2020.

**Erinn Murphy:** Got it. Okay, that's helpful. And then maybe just internationally, there were a lot of moving parts there. So, I think, let's cut through that noise, that seems like the underlying trend is down 4% constant currency. Can you just maybe share a little bit more? What regions outperform that trend? Which ones are still underperforming? And then what is your expectation in the second half just for the international business? Thank you.

**Rustin Welton:** Yeah. Erinn, it's Rustin. So, let me maybe dimensionalize a little bit more and provide a little more color on the international results in the quarter. We haven't sort of provided some of the historical information, but when we look at 2018, 2018 in Q2 was the only quarter we saw growth in our international business, and we were up 1%. If you look at the balance of the quarters in 2018, we were down mid- to high-single digits. So, we were up against the tough comp to begin with.

Secondly, I would say that there's really three factors that are driving that performance. The first were the planned exits and business model changes. And again, that was contributed about seven points to the decline, or about \$11 million. We also had some timing shifts in Europe with some products, spring and summer that are shipped early in Q1. So, we saw a benefit in the first quarter from that. And then we also had some fall winters shipments that shifted out to Q3. That affected us by about six points, or about \$10 million.

And then we've seen the continued sort of softness in India. Again, it contributed about three points to the decline or about \$5 million-dollars. If you exclude those three factors as you indicated, we were down about 9% on reported, about 4% constant currency.

In terms of the regions that were really driving that, the European region was the most affected by those, given sort of the planned exits, again, the exit of Turkey and the model changes in Russia and Israel, as well as the timing shifts. And to a lesser extent, we saw softness in Asia driven by India.

**Scott Baxter:** And, Erinn, this is Scott. Just a real quick comment. The benefit of us being a new spin-off and acting as a startup is, we kind of got a chance to press the reset button in those international markets. And we've gone ahead and hired two new presidents that we're really excited about, not only the fact that they're really experienced and also very experienced in those geographies, which was really important to us going forward. And the fact that now we're going to globally operate those businesses reporting to Tom and Chris on a global basis, I like our positioning going forward here.

**Erinn Murphy:** Great. Thank you, gentleman, and all the best.

**Rustin Welton:** Thanks, Erinn.

**Scott Baxter:** Thanks, Erinn.

**Operator:** Thank you. Our next question comes from Jim Duffy with Stifel. Please proceed with your question.

**Jim Duffy:** Thank you. Good morning, guys. A lot of moving parts.

**Rustin Welton:** Good morning, Jim.

**Scott Baxter:** Good morning, Jim.

**Jim Duffy:** Good evidence of progress. Clearly you guys are really getting after it. I wanted to start on Wrangler in the U.S. Can you guys speak to what's behind the expectations for acceleration for the U.S. Wrangler wholesale business? Is it simply just the anniversary of the bankruptcy or do you have visibility to incremental shelf space or distribution?

**Scott Baxter:** Well, Jim, I actually think it's quite a few things. A couple of years ago we started the process of going ahead and repositioning Wrangler for the long-term. You know, Wrangler had been really powerful in both the mass and Western channels but had a lot of permission to go ahead and expand out of those channels and we started that process. And Wrangler has since spent a lot of time moving up market with capsules and collections and collaborations, which have all been very successful and have all generated some additional brand heat.

And then in addition to that, Wrangler has done a very nice job of bringing innovation to the marketplace, and that has been a real key differentiator for us as far as moving forward. We really like how the brand is gaining momentum. And if you step back and Rustin did a really nice job of articulating how you pull those certain pieces out, like the bankruptcy and what have you, that you can start to really see the building of the Wrangler brand.

And for us, I think one of the big things that's going to be a very big strategic change for us is we have a new ad campaign. But more than just a new global ad campaign, Jim, is we have a new ad agency. We had an ad agency before that was domestically focused. We now have an ad agency that has a global focus and a global partnership with us.

So, bringing all those components together and at the end of the day, Jim, building really great product that our consumers really like is really putting us in a position that we really like that we will build on from that point.

**Jim Duffy:** That's great. And Scott, maybe you don't want to steal the thunder, but is there anything you can say about the new strategic direction for the ad campaign? It's different in focus that we should look for, maybe?

**Scott Baxter:** Jim, I would think that you should look for us to be more diverse, for us to be more global, and for us to be more adventurous, I would leave it that.

**Jim Duffy:** Fair enough. And then last one for me. I just want to get a sense for where we are, as a baseline for the international business. Do you guys now have in place the business models you want for both brands in international markets, and then related to that, when does all that become a normalized compare?

**Rustin Welton:** Yeah. I would say, Jim. It's Rustin. I'll take the front side of that. We're continuing to evaluate, as I would say, and we will always evaluate not just the international landscape but all of our landscapes to improve our quality of sales.

We're going to do that through the TSR lens. As we think about the steps that we've taken, Scott just talked a little bit about the new leadership teams that we've put in place in those international regions. We're really excited about the teams, and the fresh perspective that they can bring to that. And we're going to cut kind of constantly, look and evaluate at all the markets to figure out what's the most effective way for us to go to market.

I think the thing that, you've seen as demonstrate already, Jim and our short time period here is, we will make the right decisions through that TSR lens. And if that means, exiting markets as we did in Turkey or shifting the business model, we will do that when required. But we feel good about the foundation we've built in the international side and we're encouraged to start growing that because we see a huge white space opportunity there.

**Jim Duffy:** Great. That's all I have. Thanks.



**Scott Baxter:** Thank you, Jim. Thanks for joining today.

**Operator:** Thank you. Our next question comes from Sam Poser with Susquehanna. Please proceed with your question.

**Sam Poser:** Thank you for taking the--

**Scott Baxter:** Hi, Sam.

**Sam Poser:** Hi, how are you? Congratulations on your first quarter, or first second quarter, I guess. Anyway, can you give-- I think you answered the question, but I just want to clarify. Could you sort of give us what the wholesale equivalent sales would have been or the increase or decrease including wholesale equivalent sales against Russia and Israel, I guess? That would be the two that you switched to distributors.

**Scott Baxter:** Yeah. Yes. On the international side, Sam, we exited Turkey. We switched Russia in Israel to a distributor model as well as Chile. So, as you think about those international results, that contributed about 7% of the decline in the international market in the quarter or about \$11 million-dollars.

**Sam Poser:** Okay. Thank you. And then, can you give us an update on the global ERP, sort of where you are, where you were, where you are now? And sort of how we should-

- the timing and how we should think about it rolling out over the next, I guess 18 months or so?

**Rustin Welton:** Yeah. Sam. It's Rustin. I'll take that one. As we mentioned in the prepared remarks, we've kicked off the program. It's gotten off to an aggressive start. Maybe just to sort of frame up again what we're looking at in terms of investments in time periods. We're looking at \$80 million to \$90 million-dollars in capital over the next two to three years, including \$30 million to \$40 million-dollars in capital expenditures in 2019.

So, as we think about the ERP, we're really looking to aggressively deploy this but also manage the risk of the implementation. And to do that, we think there's three critical pieces that help us manage that risk.

The first is resources. We brought a number of internal Kontoor employees on board, who have significant global ERP implementation experience. And then we've paired that with experienced systems integrators to bring that expertise.

And I think as you know, Sam, and you've seen with multiple implementations, the quality of the individuals running the implementation directly correlate with the success of the implementation.

The second is, I think that the out-of-the-box solution mentality we're approaching this with. And that's really looking at modifying our processes to fit the system and not modifying the system to fit our processes. I think that's really important as a new publicly

traded company standing up and establishing global processes to really utilize the best practices that are part of the system.

The third I would say is you will see us deploy a staged go-live process. The first go-live from a timing perspective will be next year, followed by two in 2021.

So in closing on the ERP, Sam, I would just remind you that it's really a key enabler of how we're going to run the business globally moving forward and really unlocking that additional \$25 million and \$30 million-dollars of cost savings that we really see as the second part of our restructuring program.

**Sam Poser:** Okay. Great. And then lastly, I mean, can you, one of the-- I guess concerns from some investors have been sort of the safety of the dividends. Can you give us some-- I guess probation and details as to what the confidence in the \$2.24 annual payout and why investors I guess should or should not be concerned, like I would assume should not because of your sticking with it.

**Scott Baxter:** I think you're-- Sam, this is Scott. And you're absolutely right. You should assume not. They should feel very good about it. We just announced our first quarterly dividend. I think the single most important thing is this is philosophically how we wanted to start and spin this company from the very beginning. And we've been very, very upfront with the fact that our dividend strategy is one of the single most important things that we will do as a company going forward and that we are in income and dividend play from a

company standpoint, and we're very proud of that. And you can see the financials that we have and how we will continue to deliver and improve on those going forward.

**Rustin Welton:** Yes. I would just add to that, Sam. Our focus-- the most critical piece of our TSR, the largest component again is declaring that are paying that kind of mid-single digit dividend yield.

We've targeted that 60% payout, cash flow and our focus on cash flow is critically important for us as an organization. Our incentives as a management team are aligned with the shareholders on delivering that cash flow. And so, we absolutely continue to plan to declare that quarterly dividend moving forward.

**Operator:** Thank you. Our next question comes from the line of Heather Balsky with Bank of America. Please proceed with your question.

**Heather Balsky:** Hi. Thank you for taking my question. I have two-fold. One, if you could talk about your strategy for Lee going forward, how you're going to accelerate growth at that brand, especially in the U.S.? And two, if you could just-- I guess in the back of the question on the dividend, just some color on how we should think of cash flow this year and going forward? What's the low-hanging fruit? Thank you.

**Scott Baxter:** You bet. Thanks for joining call today, Heather. This is Scott. I'll take the Lee's strategic question. We feel really good about where we are in Lee. We have a playbook. We did this with Wrangler over the last couple of years and we learned a lot.

So, I guess the most important thing is, are we doing everything the same? No. We're taking those learnings and we're going to build on those. And I would tell you that the key building blocks are the things that we've done already, and actions are really important here, right?

So, we moved the global headquarters here to North Carolina. We're unlocking all those synergies and all the value of these teams working together now to create something really powerful going forward.

Wrangler got that start. And of course, they were here. But bringing these two big powerful brands together has got some really big opportunity ahead of it. We just are now about to announce a new global ad agency. And again, we've used domestic agencies before and here's part of the issue. We were regionally run in three of the different big regions around the world. But now we're pulling together a global product architecture. This Lee global team is led by one person, Chris Waldeck. And we were primarily regionally based and so think about things like product and we came up with new innovations like Body Optix for instance.

We would launch that innovation, it would stay regionally focused, but now we're launching innovations with certain parts of the world and then we're expanding them

globally. And Body Optix, as I mentioned in my prepared remarks is a great example about bringing an innovation that we had very much-- very high level of success with in Asia and bringing that here now to the U.S. And then we're also cleaning up our distribution points and we're pointing towards digital. So those are some of the key building blocks that you'll see out to Lee going forward.

**Rustin Welton:** And Heather, It's Rustin. I'll take the second part as it to cash flow. Good morning. Thanks for joining.

In terms of cash flow, let me provide a little bit of context around shaping first as you think about the back half, as well as kind of where we see the greatest opportunities moving forward.

So, as we think about the shaping, we talked a little bit in our prepared remarks about ebitda and how we expect that to really strengthen as we move into Q4, largely due to revenue and performance improving. And really that's not comping the customer bankruptcy as well. Some of the strategic actions we've taken to improve our outcomes moving forward.

As you think about inventories, we've talked a little bit about that. We anticipate those will continue to be elevated in the third quarter until the end of the year. We do expect Q4 to see some significant working capital improvements driven by inventory.

I would say, that we see a significant opportunity as it relates to cash conversion moving forward. And that's not just on the inventory side, but clearly inventory is a big focus.

We're also focused on improving the receivables and the payables side, and that cash conversion cycle, as I talked about in the prepared remarks, we see up to a \$100 million-dollar opportunity and we are going to be aggressively get after that and that is already underway.

Operator: Thank you. Our next question comes from Alex Walvis with Goldman Sachs. Please proceed with your question.

**Alex Walvis:** Good morning. Thanks so much for taking the question. I wonder if we could start with sourcing exposure. You gave us your exposure to China, which is helpful. I wonder if you could perhaps give us a size of-- sense of the magnitude of other markets, ranking them in terms of importance and then talk a little bit about where you're sourcing has moved and how it's evolved over the last few years?

**Rustin Welton:** Yeah. Alex, its Rustin. I'll go ahead and take that one. As we think about sort of sourcing, we did in prepared remarks, talk a little bit about China. We do have a very limited exposure to China, at less than 1.5% of our FOB, is our exposure to China.



As we think about where we source, we tend to source from Asia. And a lot of our product does come from markets such as Bangladesh. And we've been aggressively looking at different areas where we can source for some time.

So, the movement and the reduction of exposure in China is not a result of the tariffs. It's something that we have aggressively been looking at expanding sourcing opportunities in new markets over time, and we'll continue do that as we move forward.

**Operator:** Thank you. We have reached the end of our question-and-answer session. So, I'd like to turn the floor back over to Mr. Baxter for any additional concluding comments.

**Scott Baxter:** So, folks, just a quick comment to say thank you. Thanks for the support of our company. And thank you for taking the time with us today and asked such thoughtful questions and giving us a chance to talk a little bit about something that we're real proud of and that's Kontoor Brands and our spin-off.

There are few key points that you've heard from us since day one when we came out a year ago. And you'll continue to hear that today, and you'll continue to hear them as we moved forward. We are sharply focused on our total shareholder approach to our business. And I know that you heard that throughout the day-to-day, know that we're going to stay focused on that. We're going to continue to drive on margins, and we're focused on long-term sustainable growth, really high-quality growth as we move forward.





And again, back to Sam's question, we're going to maintain that strong dividend policy and we're going to support that with a really healthy balance sheet, strong cash flow, and we're going to be very thoughtful about how we utilize our cash and our capital going forward. We have meaningful category and channel and geographic growth opportunities, and we're prioritizing all of these opportunities through our TSR lens in our model. We've made great progress and we are committed to delivering on our year one financial commitments.

We're certainly looking forward to the next call. Have a great day, everybody. And again, from all of us here at Kontoor Brands. Thank you very much.

**Operator:** Ladies and gentlemen, this does conclude today's teleconference. Again, we thank you for your participation and you may disconnect your lines at this time.

END

#### ***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*<sup>®</sup> and *Lee*<sup>®</sup>. 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.