KONTOOR™

Kontoor Brands' Third Quarter 2020 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 - EVP, Chief Financial Officer, Kontoor Brands

Operator
Thank you for joining Kontoor's Third Quarter 2020 Earnings Conference Call. As a service provider for corporate earnings conference calls, we sincerely apologize to Kontoor's management team, those of you in the investment community, and others for the inconvenience earlier today. This widespread issue was due to a technical outage with our telephone carrier systems.

At this time, all participants are in a listen only mode. A brief question and answer session will follow the formal presentation. If anyone should require operator or technical assistance during the conference, please press star, zero, on your telephone keypad. As a reminder, this convention is being recorded.

It's now my pleasure to introduce your host, Eric Tracy. Thank you, Mr. Tracy, you may begin.

Eric Tracy
Thank you, operator. Good morning, everyone, and welcome to Kontoor Brands Third Quarter 2020 Earnings Conference Call. Participants on today's call will make forward-looking statements. These statements are based on current expectations and are subject to uncertainties that could cause actual results to materially differ.

These uncertainties are detailed in documents filed with the SEC. We urge you to read our risk factors, cautionary language, and other disclosures contained in those reports. Amounts referred to on today's call will often be on an adjusted dollar basis, which we clearly define in the news release that was issued earlier this morning. Adjusted amounts exclude the impact of restructuring and separation costs, noncash impairment charges related to our Rock & Republic trademark and other adjustments.

Reconciliations of GAAP measures to adjusted amounts can be found in the supplemental financial tables included in today's news release, which is available on our website at kontoorbrands.com. These tables identify and quantify excluded items and provide management's view of why this information is useful to investors.

Unless otherwise noted, amounts referred to on this call will be in constant currency, which exclude the translation impact of changes in foreign currency exchange rates. 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' Chief Executive Officer, Scott Baxter; and Chief Financial Officer, Rustin Welton. Following our prepared remarks, we will open up the call for your 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. Good morning, everyone, and thanks for joining us. From all of us at Kontoor, I sincerely hope you and your families remain safe and healthy. We are pleased to share our third quarter results with you today, results that came in ahead of our expectation, driven by broad-based improving performance across the *Wrangler®* and *Lee®* brands, channels and geographies.

Rustin will take you through greater detail on the financials in a bit. But before that, I'd like to share my thoughts on a few key areas. First, our strategies are working, despite the impacts of COVID, as evidenced by the acceleration we are seeing across our business. I'll share some select proof points from the third quarter.

Next, I'm excited to announce the reinstatement of a dividend during the fourth quarter. I'll provide some perspective on how our improving fundamentals, coupled with strong cash generation, have given our Board of Directors confidence in making this decision. And finally, I'll offer context as to why the Kontoor model is well positioned for success going forward, with investments driving digital transformation, category extensions, and geographic expansion that will yield more sustainable and profitable growth over time.

But first, as always, our results are a direct reflection of our great employees. I want to thank our colleagues around the globe for their incredible efforts, superior execution, and continued dedication to excellence. No doubt, these are challenging and uncertain times, and we remain unwavering in our support of the health and safety of our colleagues. I know our team, no matter the environment, will continue to rise to the occasion.

Turning to our third quarter results. We are pleased to share that we saw strong fundamental improvement across almost all areas of our business, with revenue, margins, and cash flows all coming in ahead of our expectations. Rustin will take you through the margins and cash flow later in the call but let me start by providing color on how our strategic initiatives drove improving top line performance in the quarter.

Overall, revenues sequentially improved in Q3, down 9%, compared with down 42% in the second quarter. Importantly, the U.S. business saw accelerating trends during the quarter, with both the Wrangler and Lee brands delivering positive growth in Q3. In the U.S., we increased 10%, while Wrangler was up 2%.

And we are taking share broadly. According to NPD, the--both Lee and Wrangler brands saw accelerating U.S. share trends during Q3, ending the quarter with solid increases across both men's and women's denim. Both Europe and China saw sequential gains during Q3, consistent with the gradual improvement we highlighted last quarter. China will continue to be a focus for our strategic investments, given the significant white space opportunity the region presents. Including the launch of Wrangler, which remains on track for a soft opening this fall and broader launch in the spring of '21.

These broad-based improvements are a function of the strategic initiatives we've been executing since the spin. Let me touch on a few of these areas now. First, we continue to work to optimize our distribution strategy. This began with a spin, with the necessary investment in quality of sales initiatives to enhance our wholesale business through the exit of select underperforming channels, markets, and points of distribution.

These quality of sales efforts create the optimal foundation in support of more sustained, healthier top line growth in the future. Another component of our wholesale distribution strategy has been an increased focus on partnering with best-in-class retailers. Many of these partners were deemed essential and remained open during the pandemic, including Walmart, Amazon and Target, as well as select Western Specialty customers. And we believe these retailers are well positioned to continue their strong performance even assuming an uncertain environment.

The second area of strategic focus, accelerating digital, is a primary catalyst of our evolving distribution strategy. And while this is a global endeavor, our investments in our U.S. digital platforms continue to yield solid returns, with our digital wholesale and own .com in the region, up 68% and 43%, respectively. And while we remain in the early stages of transforming our own branded sites, the third quarter showed continued momentum for both brands, with global lee.com, up 27% and wrangler.com, up 38%.

We will continue to distort investments in developing our digital ecosystem as the consumer will be at the center of everything we do. We will leverage our evolving data analytics capabilities and unlock value from our new global ERP infrastructure to ensure Kontoor is a consumer-led, digital-first organization. These investments should drive not only sustained top line growth but more profitable growth as our mix improves in this accretive channel over time.

Our third strategic focus lies within enhancing and scaling our innovation platforms. As we've discussed in the past, the investments we are making in innovation, span both product and advanced manufacturing capabilities. Our investments in design and processes, enhanced fit and fabrications, lighter and more durable materials, all support an evolving innovation pipeline that will be appropriately segmented across a variety of distribution channels with a greater emphasis on value and premium specialty.

And across channels, we know that innovation can support elevated pricing, as we've seen in the recent Wrangler by Fred Segal collection at Nordstrom, the emerging Wrangler ATG line in outdoor specialty, and the launch of our Lee MVP and legendary programs with Kohl's. In one area of innovation where advanced technologies drive both product and manufacturing is sustainability.

Last quarter, I said we needed to be louder with our great efforts behind sustainability and ESG. And this quarter, we are doing just that, publishing our inaugural sustainability report as an independent publicly traded company. This report provides great insights into our accomplishments and progress over the last 18 months. But more importantly, sets foundational goals for our organization as we aspire to be a leader on sustainability and ESG within the apparel industry.

These progressive goals connected to the three pillars of our platform, people, product and planet, include saving 10 billion liters of water by 2025. We were a first mover in this area with our development of the Indigood waterless home dyeing process, and we will look to scale this in the coming years to further reduce water use in the production process. Power 100% of our owned and operated facilities with renewable energy by 2025. Source 100% sustainable raw materials for cotton by 2025, and synthetics by 2030. And finally, we will only work with factories that support worker well-being or community development programs.

Kontoor's approach to sustainable business activities is founded on our commitment to be a purposeful business. Within that context, we've affirmed our commitment to doing business responsibly and sustainably, balancing financial success while striving to meet the needs of the communities we serve and the planet we share. We look forward to sharing progress towards achieving our sustainability and ESG goals in the quarters to come.

And the final strategic area of focus I will discuss today, is new business development. Despite the challenging environment, we have been on the offense, aggressively investing behind business development, supported by enhanced demand creation initiatives. First, let me provide an update on our Lee Master Band program that launched in over 2,000 doors with Walmart in September. Although we are still in early days, we are encouraged by the reads we are seeing in the marketplace.

The initial assortments are now largely set, and in-store point-of-sale is well under way and will be finalized over the next few weeks, which should help further catalyze sell-through. Importantly, we are using this initial launch as a solid foundation of which to build. As a reminder, the initial sell-in of the Lee program included men's and women's bottoms, primarily denim and select casual product.

The offering will scale over time to include additional categories and beneficial to our retail partners and consumers. The collection represents a compelling value at elevated prices. We are really excited about the incremental SKU and category opportunities, as well as the potential for door expansion over time. And to support these new programs, we are taking the opportunity to invest in our brands by accelerating demand creation investment in the back half of the year.

During the third quarter, this included ongoing domestic collaborations with influential brands like Alife and the recently announced partnership with AppHarvest, a leading agricultural sustainability organization. Internationally, we also introduced collaborations with local artists for a pop-up in Selfridges in London, which highlight our sustainability platform for a world that works. And in China, we launched a brand equity campaign titled Stand Tall, utilizing influencer Eddie Peng.

Turning to the Wrangler brand, new business development with Wrangler outdoor, including ATG, continues to be a highlight in our growing portfolio. Year-to-date, Wrangler outdoor has added more than 300 new doors of distribution within the U.S., primarily in outdoor specialty, demonstrating our continued wholesale diversification strategy. And internationally, the launch with Dressmanns that we highlighted last quarter is just kicking off.

We are pleased to announce today that based on its early success, the ATG line will be launching the women's collection in Cubus, a European women's fashion concept with over 300 doors. What makes this especially exciting is that this will be solely women's ATG product, highlighting the breadth of quality across genders, channels and geographies, and demonstrates how well the Wrangler outdoor platform is being received in the marketplace.

And similar to Lee, Wrangler is also taking the opportunity to accelerate demand creation investments in the back half of the year. During the quarter, we continued to scale our successful Wear with Abandon campaign, ramped our social media spend, expanded our production and photography in-house capabilities, and partnered with a new digital advertising agency. Looking ahead to Q4, our strong marketing initiatives will continue.

Ahead of December 2020 Wrangler National Rodeo finals in Arlington, Texas, we recently opened our full-price pop-up store in the heart of the Fort Worth Stockyards, an outdoor retail environment rich in Western heritage and cowboy culture. The 1,500 square foot format includes an assortment of modern, outdoor and Western collections, with laser customization technology on site. We will also introduce Wrangler collaborations with Rick and Morty on the Adult Swim channel, and we just launched our Wrangler by Fred Segal collection at Nordstrom, all continuing the brand's enhanced approach to reach younger, more diverse consumers.

So let me reiterate. Despite the pandemic, we have been aggressive in our approach to amplify many of the strategies that were implemented at the spin, allowing us to capitalize on marketplace disruption. We continue to drive new business development at a pace not seen in years. Our brands are healthy and well positioned, and we look forward to building on this momentum.

Next, I want to turn to a key topic that I know is on many of your minds, and that is the decision to reinstate a dividend. As you've seen in our release this morning, our Board of Directors reinstated and declared quarterly cash dividend payable in December of this year. Let me be clear, this is a decision our Board made with confidence.

As you all know, at the outset of the COVID pandemic, our focus quickly and prudently shifted to support liquidity and financial flexibility, including the amendment of our credit facility with the temporary suspension of a dividend for at least two quarters. And the opportunity to reevaluate during the fourth quarter. After thoughtful deliberation, our Board has declared a quarterly dividend of $0.40 per share.

Rustin will take you through greater detail on the rationale for the level at which the dividend was reinstated, but I'll share a few high-level thoughts. First, the dividend is a foundational element of our post-spin investment theses, our total shareholder return model, and capital allocation priorities. Next, given our performance, the Board is reinstating an attractive, sustainable dividend that demonstrates confidence in the cash-generating aspects of our operating model, while providing prudent financial resilience and flexibility in a dynamic operating environment. And finally, we anticipate our improving fundamentals will drive an increasing percentage of our evolving TSR model.

While our priorities remain focused on paying down debt and paying a superior dividend, optionality will begin to emerge as we optimize our capital structure. You will hear more on this evolving capital allocation strategy in the coming quarters and at our Investor Day currently planned for this upcoming spring. Let me close with this. I am confident that Kontoor is well positioned for future success even in the face of an uncertain operating landscape.

Despite one of the most challenging consumer environments in history, we have been on offense, investing in several strategic areas that should drive competitive separation in the marketplace. The powerful combination of these strategic, proactive actions that drive fundamental improvement, coupled with our uniquely superior cash flow, positions us for more sustainable and profitable growth in the future. We are confident that the investments we are now making across digital transformation, geographic expansion, scaling innovation, demand creation and new business development will come together to yield superior returns for all of Kontoor stakeholders over time.

With that, I turn it over to Rustin.

Rustin Welton

Thank you, Scott, and good morning, everyone. As Scott mentioned, driven by our strong execution, our third quarter performance came in above our internal expectations. And clearly demonstrates that the proactive strategies we implemented since the spin are gaining traction. We drove continued sequential improvement in our brand performance, enhanced profitability, and generated significant cash, allowing for aggressive debt paydown while improving our overall liquidity position.

Scott walked you through many of the strategic actions we are taking to further these gains. So let me outline what I will cover for the balance of the call. First, I will discuss how we are enhancing profitability while continuing to invest in strategic initiatives. Next, I will walk through the progress we made in de-levering the balance sheet, putting ourselves in the best net liquidity position since the spin and enabling us to reinstate a dividend. And finally, I will close with a review of our third quarter results and provide additional perspective on our expectations for the fourth quarter and full year.

So let's get started. At the spin, we kicked off a 2-phase program that would yield $50 million in total savings. Phase one of our cost savings program included optimizing our global distribution network, exiting unprofitable and noncore channels and relocating the Lee headquarters. These projects began at the spin and are complete, yielding $25 million in savings over the back half of 2019 and throughout 2020.

As COVID began, we reexamined all of our spending and accelerated select strategic actions, including the move of the VF Outlet headquarters to North Carolina. And the strategic review of our U.S. store network is well under way and will involve additional door rationalization and reformatting of select stores. Phase two of our cost savings program was predicated on our ERP implementation, and we remain on track to realize anticipated savings, beginning in 2021.

Despite the pandemic, progress on the strategic ERP investment continues, with our first regional implementation successfully completed during our third quarter and the remaining regional implementations planned in 2021. We remain on track to deliver the balance of the projected savings. These actions came together with gross and operating margin improvement in the third quarter.

As you saw in the release this morning, we drove healthy improvements in our overall profitability, with adjusted gross margin increasing 240 basis points versus the prior year. Gross margin is a key focal point for the organization and remains an important driver of our overall TSR approach. I am pleased to say the gains were broad-based, with increases in both Wrangler and Lee and in all geographic regions.

Let's review the components in more detail. First, the aggressive actions we took to manage inventory early in the pandemic, helped us to adjust to new demand signals and avoid the creation of excess inventory. In fact, we were able to steadily improve our inventory health during Q3 and position supply to meet fourth quarter demand. These actions are driving a healthier mix of full price selling. Quality of sales actions and further supply chain initiatives also supported gross margin recapture.

Second, we continue to see the benefits from structurally accretive mix shifts we have discussed as an important part of our evolving operating model, including accelerating growth of our digital businesses. We have talked about these measures supporting an improving gross margin trajectory, and they are doing just that. I will touch on our forward expectations later in the call, but we see these benefits continuing in the fourth quarter and beyond.

As we have discussed since the spin, our owned manufacturing provides a distinct competitive advantage to adjust production as conditions warrant, while minimizing service disruptions for our partners. The pandemic has resulted in a highly dynamic environment, and we continue to actively manage the supply/demand balance. Given the abrupt onset of the pandemic, early in the quarter, we did experience select supply chain disruptions driven by lockdowns in certain countries. We worked to enhance our supply position, which has improved throughout the quarter. And we believe our current inventory levels are appropriate to respond to the marketplace, while supporting anticipated demand and new program wins.

Third, you have heard us discuss taking a prudent approach to managing cost while supporting growth platforms. Earlier in the year, we engaged the global organization to rethink processes, leverage technology and challenge discretionary expenses. We also made the difficult decision to make temporary salary and merit-based adjustments that impacted many of our colleagues.

While I am very pleased to say we were able to restore these salary adjustments during the third quarter, we also drove meaningful cost improvements in part from Phase one of the cost-saving program previously discussed, with SG&A leveraging 230 basis points. These proactive measures are leading to tangible cost structure improvements that will allow us to reinvest back into the business. We look forward to sharing more details in the quarters ahead.

Despite an incredibly challenging environment, our adjusted operating profit increased 23% to $103 million, while our adjusted operating margin increased 460 basis points to 17.6% of sales. While we continue to invest in our key long-term strategies, accelerate demand creation, and support our global growth initiatives, our third quarter results are solid proof points that the actions we are taking are positioning us for continued, sustainable long-term growth.

Now to the progress we made during the third quarter to further solidify our balance sheet and improve our liquidity position. As we've discussed since the spin, strong and consistent cash generation is foundational to our operating model. This was clearly evident during the quarter as we drove an acceleration in operating cash flow.

Looking at the first nine months of the year, despite the challenges from the pandemic and ongoing investments in our IT infrastructure, we generated $130 million in cash from operations. Importantly, this strong cash generation has led to an acceleration in debt paydown while bolstering our net liquidity position. Since amending our credit facility in May, we have made $175 million in discretionary debt repayments and project at least another $100 million before year-end.

At the end of the third quarter, our net debt was $752 million, a low watermark since the spin. Additionally, we ended the quarter with $653 million in cash and available borrowings under our credit facility, marking our best liquidity position since the spin as well. So stepping back, through three quarters of 2020 and despite headwinds from the pandemic and the highly dynamic marketplace, we have meaningfully improved our capital position and see additional opportunity to further improvement in the fourth quarter.

I will touch on this again later in the call, but I encourage you to refer to the liquidity table we included in the release this morning for additional detail. Finally, as Scott mentioned, our robust cash generation has led to the reinstatement of a quarterly dividend at $0.40 per share. Let me provide additional perspective.

First, we continue to operate in a very uncertain environment and believe it is prudent to maintain financial resiliency and flexibility with the reinstatement of a dividend. Accordingly, reinstating a dividend per share of $0.40 or approximately 70% of pre-COVID levels, allows the dividend to remain a key element in creating a strong and sustainable TSR that rewards shareholders, enables for continuing debt paydown, and allows continued investment in the organic growth of the business.

Second, the Board's level of reinstatement reflects confidence in the business, and we anticipate increases over time as performance and the operating environment warrant. The timing and amount of any increase will depend on the Board's continual evaluation of the multiple factors listed in our dividend policy. As described in our filings, including, but not limited to, our financial condition, earnings, capital requirements, the terms of our outstanding indebtedness and other considerations our Board deems relevant.

And finally, these actions reflect our performance-driven TSR framework. And importantly, optionality as we position Kontoor for improving fundamentals to drive an increasing percentage of our TSR, all while supporting shareholder-friendly actions. Now let's get to our third quarter review. Global revenue decreased 9% in the third quarter compared with the same quarter in 2019.

Revenue declines during the quarter were primarily the result of impact from COVID, offset by double-digit increases in digital, new business development wins, and a timing shift of Wrangler U.S. shipments from the second to third quarter as we discussed on our last earnings call. On a regional basis for the quarter, U.S. revenues were flat, compared to the same quarter in 2019. Impacts attributable to COVID were offset by growth in digital, new business development wins and the aforementioned timing shift.

The U.S. represented 78% of our revenue in the quarter. Outside of the U.S., international revenues declined 31% in constant currency, compared with the same quarter in 2019. Despite the decline, both Europe and China improved sequentially driven by digital wholesale and improving e-commerce demand. We anticipate continued sequential improvement during Q4 in both regions.

Turning to our channels. Our revenue in our U.S. wholesale channel, which represented 67% of our revenue, increased 3%, compared with the same quarter in 2019. Increases were driven by improving trends with key wholesale partners, the benefits of new business development wins and the previously mentioned timing shift. Our non-U.S. wholesale channel, which represented 18% of our revenue, decreased 34%, compared with the same quarter in 2019 driven by impacts from COVID. We experienced sequential improvement in Q3 and anticipate continued progress during Q4.

Our branded direct-to-consumer channel, which represented 11% of our revenues, increased 2%, driven by strong gains in both Wrangler and lee.com. Our owned digital business increased 32% driven by 43% growth in the U.S. and 19% growth in China. Finally, let's turn to our brands. Global revenue of our Wrangler brand declined 6% compared with the same quarter in 2019. Wrangler U.S. revenue increased 2% in the period.

Strength in digital wholesale and growth in our Western business led to the increase, as well as the previously discussed timing shift. Additionally, we drove accelerating growth in our owned .com business, which increased 44% in the quarter. Wrangler international revenue was down 40% compared with the same period last year. COVID-related impacts continued to weigh on performance. However, we did see sequential improvement in key markets and ongoing strength with our key digital wholesale partners.

Lee brand global revenue declined 8% compared with the same quarter in 2019. Lee U.S. revenue increased 10% in the period, driven by new business development wins as well as continued strength in digital wholesale and 40% growth in owned .com. Lee international revenue was down 26% compared with the third quarter 2019. While ongoing headwind from COVID, particularly in Europe, continue to weigh on the region, we saw sequential improvement from the second quarter combined with the strength in our owned e-commerce business.

Now on to gross margin. As previously mentioned, total adjusted gross margin increased 240 basis points to 43.3%. The increase was primarily driven by the benefits of product cost as well as channel and product mix in the quarter. These increases were slightly offset by downtime in owned manufacturing. I will discuss our outlook for the fourth quarter momentarily, but we anticipate these drivers to largely continue through the balance of the year.

Adjusted SG&A decreased $28 million on a year-over-year basis to $150 million. As a percentage of revenue, SG&A decreased 230 basis points to 25.6%. Tight expense controls and benefits from restructuring actions more than offset fixed cost headwinds due to lower revenues as a result of COVID. Adjusted earnings per share were $1.33 in the third quarter, compared with $0.95 in the prior year.

Now turning to our balance sheet. Third quarter inventories decreased $113 million versus the prior year to $432 million or down 21%. The year-over-year decline reflects tight inventory controls and our strong culture for working capital management. Compared to the second quarter, inventories were essentially flat.

We are pleased with our performance in managing inventory in this environment and believe we are well positioned to support anticipated fourth quarter and holiday demand while continuing to improve inventory levels. We finished the third quarter with $285 million in cash and debt of approximately $1 billion. As previously discussed, due to our strong performance in the third quarter and improving liquidity position, we made an additional discretionary repayment totaling $100 million on our revolver in the third quarter. Strong cash generation should support continued aggressive debt paydown during the fourth quarter of 2020.

And now on to our outlook. While the impacts from COVID, as well as macroeconomic factors remain uncertain, we are providing full year 2020 adjusted EPS guidance and offer the following perspective as you think about the balance of the year. Revenue in the fourth quarter should experience sequential improvement from the third quarter, with revenue anticipated to be flat-to-down modestly. Fourth quarter adjusted gross margin is expected to be above 2019 levels of 40.9%, reflecting continued benefits from ongoing restructuring and quality of sales initiatives, as well as higher anticipated growth in more accretive channels such as digital and improving mix within International.

Fourth quarter adjusted SG&A is expected to increase year-over-year, driven by strategic decisions to amplify investments in demand creation and D2C in support of both the fourth quarter and long term revenue. Full year 2020 adjusted EPS is anticipated to be in the range of $2.25 to $2.35 per share. And finally, strong cash generation should support continued aggressive debt paydown, expected to be at least $100 million during the fourth quarter.

In closing, I want to reiterate the confidence we have in the business and the strategies we are executing against to drive greater shareholder value. While there is still much to do and despite the challenges of the current environment, we are pleased with the progress we have made executing our long-term priorities, improving profitability, and fortifying our capital position. We look forward to sharing our progress in the coming quarters and at our Investor Day currently planned in spring of 2021.

This concludes our prepared remarks, and I will now turn the call back to our operator. Operator?

Question and Answer Session

Erinn Murphy
Great. Thanks. Good afternoon. So I guess my question is on the Lee rollout into Walmart. I'd love to hear if you could talk a bit more about how the business looked once it launched in August and into September. And then, I don't know if you could quantify how much was sell-in and what you're seeing today in sell-through. But then I think you also left the door open to talk about new categories into spring of next year and potentially even new doors. Can you just help us frame up how you're thinking about that rollout? And then I have another follow-up.

Scott Baxter
Sure. Erinn, this is Scott. From the Lee rollout perspective, we're actually really pleased. Obviously, we're winning with winners, and we're pleased with our partnership, a big expansion of our partnership with Walmart. But I think the thing that we are most pleased with is the fact that we rolled it out, it's been accepted by the consumer extremely well. Our female business has done exceptionally well. So we're really pleased with that.

I think one of the things that we've talked a lot about as a team and talked with our partner about is the accelerated pricing, too. So we're at a really good price point that we haven't been at in our collections before. So we feel really good about the fact that even at that price point, there's been really strong take out.

I think from an expansion standpoint, we wanted to get the program, that's a really big program, so we had to get it up and running. So we chose denim and casuals to start, but the program does call for expansion as we move into next year with seasonals and shorts. So we think it's got a really nice future ahead of it. And we're really pleased to date, with the rollout.

One of the things that I would mention, and I want to talk about this because we've had this question is, are we seeing any cannibalization relative to our Wrangler line? And I think the thing that I'm most pleased with that we're hearing from the team and our partner, is that we're not really seeing any cannibalization right now. And that speaks volumes to me about the consumer that's coming in and the consumer that's taking out our product there. So really pleased with where we are to date on that program. Thanks, Erinn.

Erinn Murphy
Great. Yeah, that's encouraging. And then just a follow-up on the dividend. Obviously, very good to see it reinstated this morning. It is at a lower dollar amount. So can you just share kind of how you're balancing that with debt paydown? I don't know if you can speak specifically of what you're expecting to pay down in the fourth quarter. You said it would be aggressive. And then just remind us, where do you need to be from a net debt to an EBITDA perspective before you rethink about M&A? Thank you.

Scott Baxter

Sure. Let me go ahead and start, and then I'll flip it over to Rustin, and he'll answer some of the rest of the question. But we obviously amended our credit facility. So we had a 2-quarter abatement that we had to have. And I think the thing that I'm most encouraged about is that the employees of this company. I have so much confidence in this team, and our Board of Directors have so much confidence in this team that the minute we were able to reinstate, we did.

But the reason that we did it were for strong fundamentals. So we have improving performance, improving fundamentals, really strong cash generation, which Rustin will talk a little bit about. But I would tell you, the single most important thing is taking a look at the future, thinking about our strategy, thinking about the talent that is joining this organization globally and where we're going to take this company.

We're just at the beginning of a very early journey, and a lot of good things are going to happen in the future. A lot of the things are happening now. But we have great confidence in the people. We have great confidence in the strategy. We have really good confidence in the operating model, so it gave us really strong confidence to go ahead and reinstate that quickly.

Rustin, maybe you can go through some of the details?

Rustin Welton
Yeah. Great. Good afternoon, Erinn. Just building on Scott's point, I think it really starts with confidence. And obviously, we wanted to reinstate at a healthy, attractive, sustainable dividend level. So the Board of Directors certainly considered a number of factors in determining that level, including obviously the prior dividend level, sort of peer and S&P benchmarks, future earnings estimates and the current macro environment.

And I think we're not targeting a specific payout ratio at this time, but we believe the dividend being reinstated at that $0.40 a quarter really balances kind of that Board of Directors' confidence that Scott spoke about, acknowledges the current dynamic operating environment, and puts us into a position that given increased performance and a stabilization of the operating environment, we can increase that dividend over time. Obviously, the timing and the amount of any increase will really depend upon the Board's evaluation on a number of factors. Certainly, including our financial condition, our earnings, capital requirements, levels of indebtedness, etcetera.

So we're not going to get into the timing of that, but we see that opportunity for expansion over time. You mentioned a little bit about how we're thinking about balancing aggressive debt paydown. Certainly, very proud of the fact that over the past two quarters, we've made discretionary debt repayments of $175 million. I think that speaks to the strength of our operating model, particularly in this environment.

And as we indicated in the script and on the release this morning, we anticipate an additional debt repayment of at least $100 million in the fourth quarter. You also ask a little bit about reaching our optimal capital structure. At the time of the spin, we said that we were targeting a gross leverage ratio less than 3 times, Erin. Certainly, we're getting after the debt paydown. Our capital allocation priorities for Horizon one here remain the same. That aggressive debt paydown and certainly paying that superior dividend that was just reinstated with confidence this morning. So we'll continue to evaluate that as we work our way through 2021, but really focused on the fundamentals of the business and paying down the debt.

Scott Baxter
And Erinn, one last thing. Thank you, Rustin. One last thing is we'll spend some time on this in our upcoming Investor Day in the spring, which we're really looking forward to everyone joining. I think it's going to be a great day where we can really share with you what we're thinking and how we're thinking about this business long term. So thank you, Erinn.

Erinn Murphy
Great. Thank you.

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

Alexandra Walvis
Good afternoon. Thanks so much for taking our questions, here. My first question, you noted your intention to amplify investments in demand creation and digital in the fourth quarter. Can you elaborate a little bit more on that? What investments are you making? And are those a pull-forward on previous investment plans? Or are they new opportunities that you're taking advantage of?

Scott Baxter
So, how are you Alex? It's Scott. I'll go ahead and start, and Rustin and I will take that together. So we have a lot going on in the fourth quarter. But I would tell you, a lot of that just is future build, too. So I don't like to think of things as a short-term perspective. I'd like to think of how we're going to build these brands over a very long period of time.

And we've done some really nice things from a new business development standpoint, as you know, with Dressmanns and Walmart and Cubus and more in the hopper to come in the future. And we've got to go ahead and support those programs going forward. So we're going to go ahead and do that. We're supporting these really cool collabs that we're doing with the likes of Fred Segal and Alife around the globe, which we're really excited about.

And one of the things that we talked a lot about at the very beginning, and you probably remember this all too well, Alex, is we talked about these two brands that haven't been invested in, in a long time. And we talked a lot about the fact that we love these brands. They're great brands, incredible history and that with a little bit of investment, with a little bit of strategy, with a lot of marketing, we can really make something special out of these. And I think the team, we owe a debt of gratitude to our incredible team and our marketing teams and our global teams, on how we're bringing these brands back to life in a really significant way.

So as I think about the opportunity that we have to invest back in these brands, I think about the casualization that's happening around the globe and how that plays right into our strategy. I think about our all-terrain gear, our outdoor line that's expanding and growing rapidly, and we talked a little bit about the new business development today. And I think about the investments, the really smart investments we're making in digital and how they're paying off and how we're starting to build a really capable digital team.

And you can see that really starting to come together in our ERP system that will be coming on board next year and how those two things will come together in a really, really elegant way. So building these brands, investing back into these brands, getting them to an optimal level so that we can feel comfortable within the marketplace that we're spending the right amount of money against these brands. I would say the really important thing is that we do it the right way. We get a nice return for these, and we grow as the business grows.

Rustin?

Rustin Welton
Yep. Thanks, Scott, and good afternoon Alex. Just a couple of points to build and maybe further dimensionalize Scott's comments. We spend, Scott and I do, a significant amount of time talking about, obviously, this dynamic operating environment that we find ourselves in. And we really believe that strong trusted brands that offer consumers compelling value that is really enabled by an agile supply chain will win in this environment.

And Scott talked a little bit about our belief on our brands. We believe we have two of the most iconic brands in the world, with over 200 years of trusted history amongst consumers. We have a diversified, world-class supply chain. We're sourcing or operating from over 275 factories in 20 countries, that has enabled us to continue to supply the market. And really believe we offer a quality product at compelling value in all of the channels of distribution that we have. And so the decision to sort of distort demand creation and D2C investment during this fourth quarter is important, as Scott said, to support a lot of the strategic initiatives that we've launched but really to set us up for long-term growth on the top line and acceleration, not just through holiday, but in 2021 and beyond.

Alexandra Walvis
Great. That's super clear. And then my second question was on inventory, down over 20% in the quarter. Can you share expectations for how you expect that to grow going forward? And

any comments on the health of inventory, both on your own balance sheet and in the channel, would be super interesting, too?

Scott Baxter
Yes. Thanks, Alex. I'll start and then flip it over to Rustin for some detail. But we feel like we're in a really good position. I would tell you, in my time here, of 10 years with this business, we've never come out of the fall and the seasonal period as clean as we have. So really have a lot of confidence in that, we feel really good about that.

And then the way that we're going ahead and matching our supply and demand model going forward. And I think one of the things that's a great advantage right now is our world-class manufacturing capabilities. I think that just has really played really well in the environment that we're in right now. So we feel like we're in a really good place.

And I think one of the things that's really, really important here is you have to create product that people want to buy. And our teams and our product teams are doing a great job of designing and making products that people want to be seen in. So I can't thank them enough. Our Board can't thank them enough and I'm just super proud of what we've done here in a short period of time and what our teams have done.

Rustin?

Rustin Welton
Yeah. I think Scott did a great job, Alex, of dimensionalizing that for you. I'll just give you a little bit around the figures. So we were down 21% in the quarter. That was about $113 million year-over-year, down to $432 million. That was relatively flat with where we ended Q2.

So just to sort of highlight and reiterate maybe what we talked about on the last call, as of Q2, we were down about $105 million in inventory year-on-year. And really $80 million of that came in the back half of last year as we were working down inventory with the balance, $25 million, coming in the second quarter. So again, inventory is flat Q2 to Q3, feel like we're in a great position as Scott talked about and just really happy with the quality of the inventory that we have on hand. So thanks, Alex.

Alexandra Walvis
Thank you, and all the best.

Operator
Thank you. Our next question comes from Robert Drbul with Guggenheim Securities, LLC. Please proceed with your question.

Robert Drbul

Hi guys, good afternoon. Just a couple of questions from me. I think first for Scott. Can you talk a little bit about the denim category, maybe across channels, in terms of what you're seeing in sort of the trends throughout the different price points, etcetera, and maybe even globally? And then the second question for Rustin. Can you talk, I think you talked about gross margin being sustainable into the fourth quarter, can you just talk about into '21, and where you see gross margins over the next two years from where we are today? Thanks.

Rustin Welton
Sure.

Scott Baxter
Yeah, Bob, I'll take the first one, and then Rustin will take the gross margin. Really love the category that we're in. We love this business. I think the category is just absolutely terrific right now. There's a casualization that's happening globally, and we're sitting right in the sweet spot of it. And I think one of the things that's been exceptional for our business and our strategy is, if you know this business, and you've been around it for a while, Bob, we have actually played in a narrow range from a category standpoint for a long time.

And now that we've ventured out in our own as a publicly traded company, one of the things that we talked about was playing in a higher range and making sure that we were taking care of all consumers. So for us, whether it's our business in Asia or some of the business that we've built here in the United States recently, with Nordstrom's and some other folks, playing in those higher channels, in the new Walmart Lee business at a higher price point, it really gives us a distinct advantage to play in multiple channels and to be a bigger player in the category itself. So from a casualization standpoint, from a global standpoint, and from just how we're building and thinking about our segmentation, I am really pleased where we are.

Rustin Welton
Great. And Bob, I'll take the second part here on your gross margin question. Obviously, really pleased with our gross margin in the third quarter, up 240 basis points. Strongest margin we've seen since the spin. And as we talked about in the prepared remarks, we really see those drivers around product cost improvements, channel mix and product mix largely continuing in the fourth quarter. Again, expect that to finish above prior year levels.

As we start to think about 2021, you've heard us, Bob, talk quite a bit since the spin about how sequencing matters. And the first thing that we really did coming out of the spin was get after margin expansion. And certainly got after the cost save program and the quality of sales initiatives to really recapture some of the margins that have been lost in this business pre-spin.

So that gross margin expansion remains a critical focal point for the organization, because it really enables us to invest into our brands while enhancing the operating margin. And I'm not going to provide specific guidance on the '21 gross margin today. But I will tell you that gross margin expansion will remain a critical strategic imperative for us as we move forward. It really is the oxygen we breathe into the P&L that allows us to make a lot of the strategic investments that Scott's talked about while improving the operating margin.

So thanks for the question, Bob.

Robert Drbul
Thanks you, sir.

Scott Baxter
Thanks, Bob.

Operator
Thank you. Our next question comes from Adrienne Yih with Barclays. Please proceed with your question.

Adrienne Yih
Great. Thank you very much. Good afternoon. Scott and Rustin, I think this quarter really reminds us of what a strong business you run. You're obviously a low to mid-teen margin business after the spin, and that's one of the better ones in the space. So I guess when I look at the 17.6%, this is my question. We haven't seen anybody in the midst of COVID expand margins, let alone expand them by 460 basis points. And so it seems like this is a step-function change that Horizon 1 has moved to Horizon 2, certainly next quarter when you start to see that sales growth.

And so I guess I'm asking for some longer-term guidance, and maybe that's going to come on the LRP on the Analyst Day. But this business seems very different, much more profitable. And I'm wondering if there's a one-time nature to 3Q, or you don't want to put the cart before the horse, and maybe there's some happy medium as you are on that path to Horizon 2? Thank you very much. Sorry for the long--

Rustin Welton
--yeah. Adrienne, hey, good afternoon, it's Rustin. I'll go ahead and take that. So certainly, proud of our Q3 results here. I'd be remiss if I didn't begin with stating that we're obviously in a very dynamic operating environment. And really pleased with the sequential top line growth in the third quarter. We see that continuing into the fourth. Obviously, the gross margin expansion, driven in part by sort of the distorted growth in digital, is a welcome sign for us.

And I talked a little bit in some of the prepared remarks that the SG&A, we did take some actions in the middle of the quarter to reinstate some of the actions we had taken at the height of the pandemic in terms of temporary salary reductions, etcetera. So you'll have kind of the impact of that moving forward now that we're back to sort of normal operating levels. But I think, you asked the question about the 17.6% and sort of how we think about it moving forward.

Certainly, a high watermark at the 17.6%. And we talk quite a bit about wanting to distort demand creation and D2C investments. And again, that's to solidify that fourth quarter top line, but really talking about starting to inflect in 2021 and beyond. So as we think about sort of capital allocation, Horizon 1, Horizon 2, we're really focused on what we can control, and that is improving the fundamentals of the business.

So again, two priorities here in Horizon 1, that aggressive debt pay down that will continue here in the fourth quarter, reestablishing sort of a superior dividend, obviously, an important element. And then just really being able to organically reinvest into our brands and our business. We feel like we put ourselves in a healthy financial situation with the best net debt and liquidity position we're in, since the spin here at this quarter.

And our priorities will continue over the near term. So certainly, next year, as we get into the Investor Day that is currently planned in the spring, we'll talk a little bit more about how we see that capital allocation evolving as we move into Horizon 2. But we really like the fact that we should see increased optionality to drive further TSR-bolstering actions in the future, as we continue to improve the fundamentals. And that's really where the focal point is, in this dynamic environment we're operating in.

Adrienne Yih
Great. And then, Scott, if I may. Would you comment, give us some more details on China, what you've been seeing there, the improvement and in the Wrangler launch? Thanks very much.

Scott Baxter
Sure, Adrienne. We've been seeing nice fundamental improvement in China that we've been talking about here now for a couple of quarters. So we'd like to think that, that's going to continue with the consumer there. They are getting back to what we would call closer to normal.

The Wrangler launch is happening in a soft way, receding the market right now as we speak. And then when the operating environment is at what we would call normalization, in the spring, which we hope it will be, I have no reason to believe that it won't, we'll do a full launch. And then that way, we can do collaborations and programs and marketing and things that we can do with people and have groups together, and just be more inclusive and have a better launch timing relative to what we want to do with the brand. So small and seeding now and then the full program this spring. Thanks, Adrienne.

Adrienne Yih
Great. Thank you very much.

Scott Baxter
You bet.

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

Sam Poser
Thanks for taking my question, gentleman. This is sort of an all-over-the-place question. But it sounds to me like through COVID and the launch at Walmart with Lee, it sounds to me like your brands are getting better defined. And despite the fact that sales in total have been tough this year, has this pandemic sort of allowed you to slow things down and better define your businesses for arguably more robust growth going forward than it might have been otherwise?

Scott Baxter
Yeah, Sam. This is Scott. I'll take that. It's allowed us to go ahead and segment our brands. So if you think about what we've done with both the Lee and the Wrangler brand, globally, we've really segmented them. I think one of the benefits of the spin-off and one of the things that we talked about, was the fact that the brands have stayed in a lane.

And now these brands, we've talked a lot about the history of these brands. These brands have permission to go to other places as our competitors have. And what we're seeing is with some marketing, some really good product and bringing them to other channels, the consumers love these brands. So that's what gives us really good optimism about the future of our model, Sam.

Sam Poser
And just to clarify the question, I want to say to you that you might have tried to grow maybe a little bit more aggressively had there not been the crisis. And because of the crisis, you were arguably able to be more methodical about it to make the brand even stronger than they may have been without the crisis. That's what I'm getting at. I understand your answer, but a slightly different question.

Scott Baxter
No, completely understand. We certainly have taken advantage of the dislocation in the marketplace. And one of the things that we've tried to do is treat these brands in a really good way, in a real strategic way on how we look at them going forward. I think one of the things, Sam, that's really important about your question and about our business is we are taking a very long-term view of bringing these brands back to the forefront. So agree with what you're saying.

Rustin Welton
Yeah. And I would also add, Sam, Scott's talked for several quarters now just about the criticality and new business development for us, and really gaining those wins. And we've also talked about how it's going to take time. And if you think back to the beginning of the year, pre-COVID, we talked about an acceleration in the back half. And really, it was some of these wins,

whether it's a Dressmann's, at Lee at Walmart, at Cubus that Scott's talked about now, really getting after sort of placing these brands in a segmented way, as Scott talked about, in new points of distribution.

Operator
Thank you. Our final question comes from Jim Duffy with Stifel. Please proceed with your question.

Scott Baxter
Hi, Jim.

Peter McGoldrick
Hi. This is actually Peter McGoldrick on for Jim. Thanks for taking my question. It seems like you're really seeing the ball on revenue, which is stabilizing. Gross margins are working for you, which could sustain into future years. Recently, this is a low-teens operating margin business on an even lower gross margin. Can this return to low teens plus operating margin in the near term, net the DTC investments and reversal of salary reductions?

I know there's some seasonality that we're looking at very near term, but we're guiding mid-teens in for the second half. And then just as a follow-up, I was curious on demand creation. How should we think about that? Is that a pull-forward, given the strength in the third quarter? Or is there an emergent opportunity that might not have existed previously?

Rustin Welton
Yeah. It's Rustin. I'll go ahead and take those. As we think about, sort of the P&L, I'll go back to the comment I made coming out of the spin. We really focused on cost savings and quality of sales because it really all starts with gross margin enhancement, and that was important for us. We sequenced that at the start of the spin. And we really think about that as creating oxygen for the P&L.

So as that gross margin expands, it's going to allow us the ability to invest back into the brands as you're certainly seeing here in the fourth quarter via demand creation and D2C, while also improving the operating margins. So we see an opportunity to do both over time with that gross margin expansion. And that's why it's such a focal point for us as an organization.

As we think about the fourth quarter demand creation, I'll go back to my comments a little bit ago, where particularly in this environment, you really need strong trusted brands. And certainly, we feel good about our distribution and winning with the winning retailers. And to Scott's point earlier, we really want to support some of these new business development wins.

And it's really an opportunity for us to do that, not just in holiday and in support of the fourth quarter. But again, moving forward, we're under-indexed as Scott talked about in demand creation a little bit earlier in the call, and really see an opportunity to continue to expand that over time. And certainly get behind the brands to drive a stronger top line growth, as well. So thanks for the questions.

Scott Baxter
So folks, I wanted to quickly say thank you for your flexibility today. We apologize for the inconvenience we caused everyone, but really appreciate you jumping back on the call, having that flexibility and being patient with us. Also wanted to thank you for the support of our company. It's much appreciated and wish all of you a happy and healthy rest of the year and holiday season.

And again, we'll look forward to spending some quality time with you next year in our Investor Day, and we'll talk to you some time in between. But thanks, again, everyone, and appreciate the flexibility today. Have a great day.

Operator
Ladies and gentlemen, this concludes today's web conference. You may now disconnect your lines at this time. Thank you for your participation and have a great day.