Kontoor Brands' First Quarter 2021 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

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

At this time, I'll turn the conference over to Eric Tracy, senior director, investor relations. Eric, you may now begin.

Eric Tracy
Thank you, operator, and welcome to Kontoor Brands' first quarter earnings conference call. Participants on today's call will make forward-looking statements. These statements are based on current expectations and are subject to uncertainties that could cause actual results to materially differ.

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

Amounts referred to on today's call will often be on an adjusted dollar basis, which we clearly defined in the news release that was issued earlier this morning. Adjusted amounts exclude the impact of restructuring and separation costs, business model changes, 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 excludes the translation impacts 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 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.

Scott?

Scott Baxter
Thanks, Eric, and thank you, all, for joining us. Let me state at the outset, we will intentionally keep our prepared comments a bit tighter today, as we look forward to articulating greater detail on our revolving strategies with you at our upcoming Investor Day in a few weeks on May 24th.

But today, we are really pleased to share our first-quarter results, results that continue to accelerate across nearly all areas of our business.

Our performance in the quarter demonstrates how the powerful combination of strategic investments and solid execution come together to yield improving fundamentals. And we think this quarter provides a greater example of the opportunity ahead as we are just getting started.

As always, I want to start by thanking our global team with a special call-out to those colleagues working on our ERP implementation. It is this dedication to excellence by our employees around the world that is at the core of this quarter's strong performance. And it's why I am so confident in Kontoor's future.

We have much more work to be done, and we will remain humble and focused on areas within our control, but I know our colleagues are committed to delivering on our strategic plan.

Over the last two years, we have consistently communicated the following strategy to drive more profitable and sustained growth over the longer term.

First, enhance and accelerate our core U.S. wholesale business. Second, elevate our direct connection with consumers through channel expansion, focused on evolving our B2C and digital ecosystem. Third, thoughtfully extend our reach around the globe, prioritizing opportunities within the China region. And fourth, diversify our product mix through category extensions, amplifying outdoor, workwear, and t-shirts.

And in support of these long-term growth opportunities, we have also discussed where we are distorting TSR accretive investments and enablers, including elevating and prioritizing the highest ROI demand creation platforms, scaling product and manufacturing innovation with the sustainability and ESG thread throughout, unlocking productivity through the implementation of our global ERP and digital infrastructure to generate improved data analytics and consumer insights. And, finally, developing world-class talent to build a high-performance, purpose-led, and increasingly growth-minded culture.

Let me now share some of the highlights from the first quarter that provide great proof points of how these strategies and investments are paying off.

Overall, reported revenue increased 29 percent over the first quarter last year. It is important to note that even with timing of shipments to have our regional ERP implementation, we saw a significant top-line upside to our internal expectations.

I would also point out that compared to the first quarter of 2019, we experienced 3 percent growth. And this growth would have been even greater excluding quality of sales and strategic exits we've made over this time period. So, a great sign of our business not only normalizing, but accelerating on a two-year basis.

Our U.S. business continues to see strengthening trends, with both Lee and Wrangler up compared to last year. And importantly, compared to 2019 as well, we saw strength across both the U.S. wholesale and digital channels. While fiscal stimulus has certainly contributed to increases in domestic consumer spending, our brands are absolutely benefiting from investments across marketing, product innovation, and design, all of which are allowing us to take share and drive higher AURs in the marketplace.

According to NPD, the Wrangler and Lee brands continued to see strong share gains, another quarter of outpacing the market.

It's pretty straightforward, our investments are working. Within demand creation, Wrangler introduced Georgia May Jagger as the face of its women's heritage denim collection, allowing us to reach a younger female consumer and driving significant brand heat that cascades from premium to value.

And at Lee, a heightened emphasis on social media channels, as well as collaborations with high-profile influencers, are driving gains across engagement, traffic, and conversion. If you haven't seen the recent InStyle shoot on Instagram featuring Jennifer Lopez wearing newly designed Lee products, I would encourage you to take a look. And I would add, this was organic. What an incredible statement and brand elevating moment for Lee.

We remain committed to amplifying our demand creation efforts, with a focus on the TSR bolstering areas and this includes digital. We continue to see strong returns on our investments in transforming our digital ecosystem. While Q1 experienced great growth over 2020, more impressive were U.S. digital gains relative to 2019 with own.com increasing 70 percent and digital wholesale up 132 percent.

Given the accretive nature of this channel, financially and strategically, we will continue to distort investment dollars to drive elevated and sustained growth in digital. More details to come on the building blocks for this growth at our Investor Day in a few weeks.

We also continue to invest in talent as well across global positions, including design and marketing. We are building a world-class team with an increasing focus on developing the growth-oriented organizational mindset.

In addition, over the past few months, we have also welcomed two new members to our board of directors. Today, we announced the appointment of Mark Schiller, the president and CEO of The Hain Celestial Group. And in March, we welcomed Rob Lynch, the president and CEO of Papa John's, as we further build out our team in capabilities. Both Mark and Rob will bring incredible experience and insights to our board.

Turning to our investments within innovation, our foot remains on the gas pedal. During the first quarter, we expanded one of our key sustainability platforms Indigood to include additional water savings technologies. We also recently announced a collaboration with Panda Biotech to accelerate the commercialization and scale capabilities of hemp grown in the U.S., another proof-point of our commitment to be a leader in sustainability and ensure responsible sourcing all over the globe.

Momentum in our outdoor line ATG is only increasing, taking the Wrangler brand to additional channels and extending our reach to new consumers.

Elevated design within Lee is also driving increasing permission for the brand to play in premium points of distribution. And we know enhanced innovation supports pricing and the mixing up of AURs, a critical component of brand health.

By now, I'm sure most of you have heard or read of the potential emergence of a denim cycle. We think about this a bit differently, as we realize cycles by definition are finite in nature. So, we are most focused on structural change, not cyclical trends. This speaks to the very investments we are making in the brand, investments that not only allow us to participate in casualization or denim cycles, but actually drive them, to not only take share but expand the marketplace. And we are doing just that in our core and within our largest market.

And outside of the U.S., we continue to see improvement despite an uneven macro environment. Europe revenue was down 5 percent on a constant currency basis. While we expect conditions to remain difficult in Europe, the evolution of our digital platform and new business development programs should help somewhat mitigate near-term headwinds and position us for success in the region over the longer term.

And in China, our ongoing strategic investments continue to yield accelerating results, with first-quarter revenue seeing triple-digit increases in year-over-year and 20 percent constant currency growth compared with 2019. With a premium lifestyle offering, strong collaborations and partnerships with key local influencers, the Lee brand continues to build on its leading denim position in the region. And we are pleased to share that the Wrangler launch in China has been very successful, exceeding our expectations to date, building momentum throughout the quarter, and setting the foundation for scale growth over time.

Finally, let me provide an update on new business development. As we've discussed over the last several quarters, despite the challenging environment, we've remained on the offense to take our brands into new points of distribution driven by diversified incremental category extensions. Our Lee business with Walmart continues to gain momentum with increased category offerings this spring and solid visibility to the fall order book.

Turning to our Wrangler ATG line within North America, we continue to build in the core mass channel, but also expand within new channels, such as outdoor specialty and sporting goods, Scheels, a premium sporting goods retailer is a perfect example of where the ATG lines can take the Wrangler brand. Launching this spring and extending to additional stores this fall.

And finally, we are thrilled to announce today a new development in our Wrangler workwear business, where we recently won a significant new program with a key domestic retail partner. More to come on this and other exciting expansions, but this certainly represents a tremendous opportunity for the work business is a testament to how our investments support category extensions, channel diversification, and new business development wins.

Before I hand it over to Rustin, let me close with this. Over the last few years, we have strived to do what we say, deliver near-term results, while continuing to invest in the long-term, and we're doing just that. We couldn't be more excited to share greater details on our go-forward plans and evolving strategies at our Investor Day in a couple of weeks.

So, we look forward to it and hope all of you can join us. Rustin?

Rustin Welton
Thank you, Scott. And thank you all for joining us on today's call. As Scott mentioned, we will keep our remarks brief and focus largely on the quarter due to the upcoming Investor Day on May 24th.

Before the first quarter review, though, I wanted to provide an update on our recent ERP implementation in North America, as I know it is a topic of interest. In addition, I want to briefly elaborate on how our strategic investments, like technology, are yielding improving fundamentals and enhanced optionality.

As mentioned on our last earnings call, the second regional ERP implementation was scheduled in North America for early in the second quarter. I'm very pleased to report that we have successfully gone live and are executing according to plan on our transition and ramp-up activities. This is a significant accomplishment and milestone for Kontoor. And we look forward to our final regional implementation scheduled for the second half of 2021.

Technology initiatives, like ERP and digital, are excellent examples of how we remain committed to making the necessary investments to drive long-term sustainable growth and efficiency improvements. These actions are enabling execution to enhance and accelerate our core U.S. wholesale business, expand under-indexed accretive channels like Digital, enhance international penetration in key markets like China, and extend our category reach with programs like outdoor, workwear, and t-shirts.

Investments are not only leading to improved fundamentals and profitability, but also continuing to enhance optionality.

On the last earnings call in early March, we mentioned that we had already made $75 million in discretionary debt repayments in the first quarter. Given performance, we made an additional incremental debt repayment of $25 million in the quarter to bring the total to $100 million in the period.

With these additional repayments and in spite of significant headwinds from the pandemic over the past year, we have reduced net debt or long-term debt less cash by over $320 million since the first quarter of 2020, while remaining laser-focused on investing and executing to deliver sustained long-term benefits. With this progress on de-levering the balance sheet, we are excited about the enhanced optionality as we transition to Horizon 2.

Now, let's turn to our first quarter review. I will focus my comments on key highlights and encourage you to refer to this morning's release for additional detail on the quarter. Also, given the impacts COVID-19 had on prior-year results, I will provide select references to the same quarter 2019 results for additional context.

Beginning with revenue, global revenue increased 29 percent on a reported basis and was up 27 percent in constant currency compared to the same quarter last year. Revenue gains during the quarter were broad-based across segments, regions, and channels. U.S. and international wholesale, digital wholesale, and own.com all delivered strong results in the quarter.

As expected, and discussed on the fourth quarter 2020 earnings call, first-quarter revenue benefited from a shift in the timing of shipments from the second quarter to the first quarter ahead of the company's North American ERP implementation. As Scott mentioned, though, even with the timing of shipments ahead of our ERP transition, we saw significant top-line upside to our internal expectations.

Strength in the first-quarter revenue was partially offset by the impacts of the strategic actions announced at year-end to rationalize our U.S. outlet fleet and transition to a new licensed business model in India. Combined, these actions represented approximately five points of headwind in the quarter. Additionally, COVID-19 continued to negatively impact results in select channels end markets, particularly in Europe. Compared to adjusted revenue in the first quarter of 2019, global revenue increased 3 percent on a reported basis.

On a regional basis for the quarter, U.S. revenues increased 29 percent compared to the same quarter last year, driven by wholesale, new business development wins, and digital. Strategic investments in our digital capabilities continue to yield strong returns.

U.S. digital wholesale has increased 132 percent and own.com has increased 70 percent compared to the same quarter in 2019. Even with ongoing investments and promising early returns, though, we remain under-indexed and will continue to prioritize investment in this important channel moving forward.

International revenues increased 30 percent on a reported basis, and 21 percent in constant currency compared to the first quarter 2020. Improvement was driven by the strong China results on a one and two-year stack basis that Scott mentioned earlier.

Despite ongoing headwinds from COVID-19 in many markets, European reported revenue increased 4 percent over prior year, led by digital, where digital wholesale increased 98 percent and own.com increased 39 percent.

Turning to our brands, global revenue of our Wrangler brand increased 31 percent on a reported basis and 30 percent in constant currency compared to the same quarter in 2020. Wrangler U.S. revenue increased 38 percent, led by broad-based strength in our wholesale, digital, western, and workwear businesses.

The western business continued to deliver strong results with revenue increasing 54 percent in the quarter led by men's and women's bottoms. In addition, key programming initiatives and category extensions, including ATG, the female heritage collection, and expanded distribution for workwear drove strong growth.

Wrangler international revenue was flat on a reported basis and decreased 6 percent in constant currency. New business development wins with our ATG program and digital growth in Europe offset the business model change in India and ongoing COVID-related impacts.

Compared to adjusted revenue for the same quarter in 2019, global Wrangler reported revenue increased 10 percent. On a constant currency basis, Wrangler reported revenue increased 7 percent compared to the same quarter in 2019.

Lee brand global revenue increased 37 percent on a reported basis and 33 percent in constant currency compared to the first quarter of 2020. In the U.S., Lee revenue increased 28 percent driven by wholesale, including new distribution wins and continued strength in digital wholesale and own.com, which increased 73 percent and 69 percent respectively in the period. Broad-based across both genders and multiple categories led by denim and non-denim bottoms.

Lee international revenue increased 50 percent on a reported basis and 40 percent in constant currency. As previously mentioned, China, where so sequential momentum continues, led the improvement.

Compared to adjusted revenue for the same quarter in 2019, global Lee reported revenue increased 4 percent. On a constant currency basis, global Lee reported revenue increased 2 percent compared to the same quarter in 2019.

And, finally, from a channel perspective, we saw broad-based improving performance during the quarter. On a reported basis, U.S. wholesale increased 37 percent, non-U.S. wholesale grew 30 percent, and global own.com increased 62 percent compared to prior year.

Now, on to gross margin. Gross margin increased 830 basis points to 46.1 percent of revenue on a reported basis compared to the same period in the prior year. Fundamental improvement continues to be driven by favorable channel, customer, and product mix, as well as quality of sales initiatives. In addition, the period benefited from product cost enhancements, as well as lower inventory provisions and higher production volumes than prior year.

Before moving to SG&A, I want to make a couple more comments about our gross margin in future investments. As we have highlighted previously, we see opportunity for sustainable structural margin enhancements as growth in currently under-indexed accretive channels and geographies begins to materialize.

Although improvements may not always be linear on a quarter-to-quarter basis, our first-quarter gross margin performance is an excellent early proof point on how focus areas, like demand creation, digital capabilities, and quality of sales are beginning to manifest. These enhancements create oxygen in our P&L for us to reinvest back into the business, and we will continue to do so.

Finally, I realize that our prior year gross margin contains some COVID-related impacts in the period that may distort comparisons. Accordingly, to better illustrate the progress that has already been made. I wanted to highlight that our first-quarter gross margin increased 500 basis points compared to first quarter of 2019 on a net adjusted basis.

Now, on to SG&A. Adjusted SG&A increased $12 million on a year-over-year basis to $181 million. Increased demand creation and higher volume-related variable expenses were partially offset by lower bad debt expense than in the prior year.

Adjusted earnings per share was $1.43 compared to 27 cents in the same period in the prior year and compared to 96 cents in the first quarter of 2019.

Now, turning to our balance sheet. First-quarter inventories decreased $139 million versus the prior year to $350 million or down 28 percent. The year-over-year decline reflects tighter inventory controls, the reduction in the VF Outlet fleet that took place at year-end, and the business model change in India. Excluding VF Outlet in India, inventory decreased approximately 21 percent compared to the prior year.

Historically, working capital in the first quarter tends to be a use of cash as opposed to a source of cash. However, due to our performance in ERP implementation, working capital in the first quarter was a source of cash and is expected to be a use of cash in the second quarter.

We finished the first quarter with net debt of $586 million and $230 million in cash. We anticipate prudently moderating our currently elevated cash balances toward pre-COVID levels as we move through 2021.

And as we previously announced, our board of directors declared a regular quarterly cash dividend of 40 cents per share payable on June 18, 2021 to shareholders of record at the close of business on June 8, 2021.

And now, onto our outlook. Given the strength of the first quarter, we are raising our fiscal 2021 guidance for revenue, gross margin, and adjusted EPS. Although we will not provide a quarterly outlook, I will share some additional color on anticipated quarterly cadence in light of the ERP implementations.

As we shared on our fourth quarter earnings call, we anticipated some timing shifts around the implementation of our ERP. Specifically, as you would expect, we believe there were some order pattern timing shifts from the second quarter into the first quarter, somewhat tempering Q2 revenue growth rates and corresponding profitability, while aiding the first and third quarters. These timing shifts should have no impact on our full-year results.

Let me now turn to specific 2021 guidance. Revenue is now expected to increase in the low teens range over 2020 as compared to a low double-digit range in the prior guidance, including a mid-single-digit impact from the VF Outlet actions and India business model changes.

We expect second half revenue will be modestly above the first half of the year. To be clear, we expect second quarter growth rates to modestly accelerate from the first quarter. Gross margin is now expected to increase by 230 to 270 basis points above the adjusted gross margin of 41.2 percent achieved in 2020 as compared to 150 to 200 basis points in the prior guidance.

Although second quarter margins will be adversely impacted by downtime in our production facilities for the ERP implementation, the annual increase reflects continued benefits from ongoing quality of sales initiatives, as well as higher anticipated growth in more accretive channels such as digital and international.

SG&A investments will continue to be made in brands and capabilities. Due to the strengthening revenue and gross margin outlook, we expect to amplify SG&A investments in demand creation, digital, and international expansion. These increases will be partially mitigated by ongoing tight expense controls and sustained structural cost-containment initiatives.

Adjusted EPS is now expected to be in the range of $3.70 to $3.80 per share as compared to $3.50 to $3.60 per share in the prior guidance. We expect second half earnings on $1 basis to be modestly above the first half of the year due to COVID recovery and the natural seasonality of the business.

In closing, as Scott indicated, I would just like to reiterate how our first quarter results demonstrate improving fundamentals, driven by the powerful combination of strategic investments and solid execution.

We look forward to sharing our go-forward strategies to drive greater shareholder value at our upcoming Investor Day. This concludes our prepared remarks. And I will now turn the call back to our operator. Operator?

Question and Answer Session

Jay Sole
Great. Thank you so much. I want to ask about the ERP impact and the timing of the implementation. Rustin, I think you said that the company has successfully gone live and is executing, but there's still some final regional implementations for the back half of the year.

Can you maybe just elaborate a little bit on what percentage of the ERP system has been implemented? And sort of what's the risk profile right now in terms of, you know, the business, the operational risk always associated with these kinds of things? You know, how much risk is still there? What can you tell us about that?

Rustin Welton
Sure. Good morning, Jay. Thanks for the question. In terms of the ERP impact, maybe just let me first start with where we are on the ERP implementation schedule.

You may remember, Jay, we implemented our first regional implementation in Q3 of 2020. And that was in our Asia region. And as we indicated this morning, in our prepared remarks, we just went live in North America here early in the second quarter.

So, obviously, as you know, Jay, we're predominantly a North American-based business with roughly 75 percent of our sales in North America. So, certainly, the largest region is live. And as I indicated in the remarks, we're certainly executing according to plan with our transition and ramp-up activities.

You know, as you think about the timing impact, Jay, specifically, you know, as we said on the last call, we anticipated that there would be some timing shifts in order patterns that would really help Q1 and potentially Q3, while tempering Q2 a bit more. You know, as a reminder, though, I would say that those timing shifts are expected to have no impacts on the full-year results.

So, as we think a little bit more about our Q1, you know, there were a number of puts and takes, Jay, both positive and negative that impacted the quarter, including stimulus, as Scott talked about, lockdowns in Europe, lapping the VFO in India, model changes, quality of sales initiatives, and of course, the timing shifts with the ERP.

So, several of those, including ERP, are really difficult to isolate the individual impact of those. But what I would emphasize for you, Jay, is even with the shifts, as Scott mentioned, our Q1 topline was really broad-based and significantly above expectations, really driven by the areas where you've seen us investing over the last several quarters, including U.S. wholesale, digital, and China.

And we're really seeing that some KTB-specific outperformance with really growth versus not only 2020, but also 2019, even with the drag from some of the strategic exits that we've executed. And Scott talked about the continued share gains. And that's really what we love, the momentum in the brands and the underlying business. And that's given us the confidence to raise the full-year outlook.

So, really happy about where we are on the ERP implementation. It's been a significant journey. And again, two of the three regional platforms are live now, with the third one being Europe in the back half of 2021.

Jay Sole
Got it. That's super helpful. Maybe if I can follow-up. You know, Scott, you made some interesting comments on denim, saying, you know, you didn't want to use the word cyclical, because that sort of implies an endpoint more you see structural gains.

Can you maybe elaborate on what you're seeing right now in the marketplace? You know, what you see with consumers that they're doing differently, that gives you confidence in the category, you know, really improving from where it was maybe a couple of years ago?

Scott Baxter
Yeah, I think we see a fundamental shift really. You know, we think about, you know, the talk about the denim cycle, and that's something that we'll participate in and we feel real strongly about and we're positioned extremely well. But we see this thing as a big movement, Jay. We see it as a global movement to customization and you know, when I--casualization.

So, when we think about this, we think about the fact that we can play now with the globe because of our business. You're we're restructuring where we're set up around the world. We've got a really, really nice set of initiatives that play really well into it.

So, if you think about all the work that we've done on our innovation, all the work that we're doing on our design, you've seen the product that we're producing now and how good it is globally.

And the demand creation portfolio that we put out, you know, some of the stuff that I talked about today with Georgia May Jagger and J.Lo, those things, were really helping the consumer shift into this casualization around the globe, which is really important, because we think of it as a much bigger dynamic, a much more global dynamic, and something that we'll be able to participate in for the long term. But I think the key thing for us is we believe we're the ones that are driving it.

So, we're taking share in what we're doing, which is really important for our business going forward, is we're expanding the marketplace.

So, Jay, if you were to spend time, like you do in London and New York and San Francisco globally, you're seeing that as people come back to work, they're dressing differently. The world went into, you know, a really tough situation that we're all trying to come out of now. And as people are coming out of it, they're saying to themselves in the future, I'd like to be a little bit more casual, denim is going to be my play there, and we've positioned ourselves really nicely.

Operator
Thank you. Our next question is coming from the line of Erinn Murphy with Piper Sandler. Please proceed with your question.

Erinn Murphy
Great, thanks. Good morning. I was hoping, Scott, you could talk a little bit more about the Tmall launch of the Wrangler brand. You said it exceeded expectations.

How do you see that scaling in the region over time? And then, just curious, China bigger picture for both brands, what's the promotional landscape been like versus the pre-pandemic? And then I have a quick follow-up question.

Scott Baxter
Sure, sure, no problem. So, from the Tmall standpoint in the Wrangler launch, you know, we feel really good about the launch. You know, we set all of our internal expectations. You know, it's a higher profile over there.

I think the thing that's really important for us, and we've talked a little bit about this, is we have such a head-start with our Lee brand. We've been in the marketplace for a really long time. We know the consumer. We know the market. We know the customers. So, we really know how to operate with a really senior team, you know, so, we've got a terrific team on the ground there.

So, bringing our brand Wrangler to that marketplace was a real benefit for us having that kind of expertise.

So, we've seen and hit the metrics that we've established for ourselves. But I think the most important thing was that our team was very strategic and smart in how we launched this first from a digital standpoint. And now, we'll go to a physical omni-channel presence going forward, which you're going to hear a lot more about as we come up to our Investor Day on May 24th. But we're really pleased with how the consumer is thinking about and reacting to the Wrangler brand in China right now.

And then, from a broader perspective, you know, you heard my comments and Rustin's comments about how the business is doing in China. We're really pleased with the brand and how it's doing right now, pleased with the team. And we see a lot of opportunities still in that marketplace, I mean, significant opportunity going forward.

You know, I liken this to the very early stages. You know, if it was a scale of one to 10, I liken this to a--you know, we're at, like, a two right now with all kinds of potential and opportunity ahead of us. So, we're pretty pleased with where we are.

And again, you know, we're going to spend some time and we're going to unpack that for you at Investor Day going forward. But thanks for the question. Thanks for joining us today, Erinn.

Erinn Murphy
Perfect. And then, I guess, a follow-up for Rustin on just the shaping of the year. And I hear you on the timing shift of ERP. But looking at kind of how you spoke to Q2, you know, the implicit back half guidance is very--well, it seems conservative to us. It really doesn't give you guys a lot of credit for growth or just very modest growth in the back half to get to your low teens topline.

So, can you just maybe help us think through some of the drivers there just--or if we're missing anything? Maybe it's kind of coming out of the India business model change, but again, very different kind of second half versus first-half growth rates.

Rustin Welton
Sure. Thanks, Erinn. Good morning. Thanks for the question. You know, obviously, one of the things is the comp. You know, as you think about 2020 and certainly strengthening, you know, as you move through the back half of 2020, relative to the front-half, you certainly saw our results. So, you know, that's part of it, but maybe let me step through kind of the full-year impact on both profitability and earnings.

So, you know, again, really strong momentum here in, Q1 and going into Q2. You know, as we talked a little bit about that, that ERP go-live will cause some timing shifts, kind of benefiting Q1 as well as Q3, while tempering, you know, Q2 a bit more.

And just as a reminder, you know, Q2 is our lowest volume quarter. And so, as you would expect, we will have a bit more pronounced impact on profitability, particularly as we continue to invest behind strategic initiatives and demand creation to support that topline not just in '20--the back half of 2021, Erinn, but in 2022 and beyond.

You know, and finally, you know, as we've stated, you know, we will be--we do expect to be modestly higher in the back half of EPS on a dollar basis in the second half of the year. You know, the other thing I would sort of highlight, Erinn, is that, obviously, there is a lot of macro uncertainty as Scott and I both referenced in our discussion earlier, whether that's, you know, continued lockdowns in Europe, certainly supply chain disruptions.

So, you know, we certainly want to be prudently conservative and feel like we've taken those into consideration, but really want to make sure that we're emphasizing those investments to support the long-term topline as well in the back half.

So, hopefully, that helps a little bit more with the shaping in the year and how we're seeing it play out.

Operator
Thank you. Our next question will be coming from the line of Adrienne Yih with Barclays. Please proceed with your question.

Adrienne Yih
Good morning. Let me add my congratulations. You know, this is a--the second quarter in a row where we're really starting to see that Horizon 2 play out. So, well done there.

Scott Baxter
Thanks, Adrienne.

Adrienne Yih
I was wondering if you--you're welcome. I was wondering if you can talk about, you know, the China Wrangler launch, what you're seeing there, how strong--I mean, China seems to be a hotbed of positive news in terms of the strength of the recovery.

And then on the other side, you know, we have had inbound (PH) questions about, you know, denim-based retailers having exposure. And, you know, I know, this is a kind of political subject, but, you know, to the extent that do you have exposure? How do you know that you have--if you were to have cotton, you know, perhaps, that is exposed to that Xinjiang region?

And if you can talk a little bit about risk--you know, any risk reward aspect from China upside versus any exposure? Thank you very much.

Scott Baxter
Good morning, Adrienne. How are you? Thanks for joining us today. It's Scott. I'll start with the--

Adrienne Yih
--Hey, Scott--

Scott Baxter
--China question for--nice to hear your voice. I'll start with the China Wrangler question. You know, we've talked a lot about it on the prepared remarks, but it's an opportunity to kind of talk more about it now. So, I appreciate it.

You know, it was a big decision for us to go there, but it was a very easy decision that we made early on in our strategy, our portfolio there with Lee, the business that we had built, the leadership team that we have in place, and the experience that we have in the marketplace over a very, very long period of time. And quite frankly, the success that we've had there, it was an easy decision for us. It was just a timing standpoint, when will we go ahead after the spin and make the decision to move.

So, since the decision to move, and it was delayed during the pandemic as you know a little bit, we've been really pleased. We've been pleased with how the consumer has taken the product. We've been pleased with the demand creation and how the consumer is absorbing the demand creation. What I mean by that is that the consumer really gets the story, and they get the brand, and I think that's the really important part.

And then we can capitalize on the infrastructure that we already have in place, which is really important. And now, you know, we're kind of phasing into kind of our second kind of thought process and strategy around how do we go ahead and start to really grow the brand there, and that we launched, as you know, digitally first and now we've gone to an omni-channel thought process in how we go head to wholesale and how we have our own physical stores, too, in the marketplace. So, it's a really good position for us to be in.

As far as exposure, you know, as you know, we don't buy cotton. As you know, it's a fabric, you know, that we buy. And for us, you know, we do a really nice job. One of the things that we pride ourselves on is our supply chain here at Kontoor Brands, very well established.

One of the great parts about our spin was that our supply chain had been established from a world-class supply chain, long-term supply chain. So, this wasn't new to us, and we brought a lot of talent over.

So, they've done a really nice job with making sure that working with our suppliers around the globe, that we are buying the right type of, you know, fabric for our products. So, right now, we feel very well positioned in how we are positioned in that situation currently.

Adrienne Yih
Okay, fantastic. That's super helpful. Scott, I know we've touched on the denim cycle, but I guess, I actually am more curious whether you think there's a, you know, fashion shift component to it. So, we understand that there's a, you know, transference of athleisure, perhaps, to perhaps denim, which is sort of more broad-based. But on top of that, you know, can you talk about a fashion component of it, maybe change in silhouette, et cetera?

And then for, Rustin, really want to get a little bit more color on AUC progress. I know that you have had continued AUC progress in the face of rising input pricing pressure. So, a little help there would be great. Thank you.

Scott Baxter
Yeah, for sure. So, I'm thrilled you asked that question, because you're the first person that's picked up on that component and that piece of it. And let me tell you why that's really important and why I'm really impressed with the question. Because you're thinking about it in terms of the fact that we're expanding the marketplace. And that's exactly what we're thinking about.

We have spent a ton of energy, time, and money in our innovation, and also in our design. And that innovation and design is bringing our product to a more premium level, which is really good, because that just creates incredible brand heat throughout the entire portfolio.

But what we're going to see throughout this casualization, and I mentioned this a little bit earlier, and this is why it's important, big cities, major metro markets around the globe, from London to New York, to San Francisco, to Paris, to Munich, they move into a casualization process. Those people that come back into not just the workplace but coming back into social environments, concerts, you know, things like that, they are going to want to dress with a little higher design fashion element from a denim standpoint.

So, we are playing right into that extending marketplace. That's why I said earlier that this--you know, the cycle is great, and we're going to participate in it, no question, but we're going to expand the entire marketplace. That's where the real win is very long-term, and that's that component.

So, great question, glad you asked it, because it's a really important part, and it helps us because it's really been part of the strategy of how we've been investing.

Now, from an ATG standpoint, you know, we have been really pleased with ATG. I think the thing that's really important for us for ATG is it's been very easy for us to take the Wrangler line into the outdoor world because it's really just an extension of who that Wrangler consumer is.

And we've gotten really good traction, as you know, especially around the globe. So, Cubus and Dressmann, you know, female and male stores in the European marketplace, and then, of course, really, really good distribution here in the United States.

But I think the thing that's happening now for us that's really important is we are now starting to see folks like Scheels. And you know, Scheels, an incredibly, you know, strong outdoor retailer, sporting goods retailer in the middle--you know, mid-central part of the United States, you know, bringing our product on. I think that's bringing real validation to the product and, you know, placing it right there next to our competition.

And we really like when they do that because what happens for us, if the consumer comes in and they see a couple of things and it's very, very obvious for them quickly, one, they see an incredibly high-quality product, they see it as a very, very good price, and they also have a trusted brand.

So, you add that--those components, those 3 things, great brand, great product, and great price, the takeout is there, the consumer reception is really good. And we see really good things on the horizon.

And we look forward to talking to you more about our ATG line coming up on May 24th. But thank you for the questions. I appreciate it.

Rustin Welton
And Adrienne, it's Rustin. I'll go ahead and talk a little bit about rising input costs. So, you know, certainly, as we've spoken about previously, we're not immune to the macro-economic challenges that are happening in the marketplace, whether that's, you know, port congestion, higher freight rates, labor shortages.

You know, we're certainly actively monitoring all of the input costs. And we've considered that in the updated outlook that we provided this morning where we raised our gross margins from the previous guide of 150 to 200 basis points versus adjusted margin from last year up to 230 to 270 basis points.

And, you know, just a couple of points to highlight. I mean, it was our third consecutive quarter of triple digit gross margin increases. In that first quarter, you know, as I mentioned on my remarks, we did see 500 basis points improvement above our Q1 '19 on an adjusted basis.

So, you know, the investments, I think, are a big key here, Adrienne, as we think about, you know, our model moving forward. And we've talked about this quite a bit here this morning, whether that's in demand creation, innovation, digital, et cetera.

And that proactive kind of margin improvement opportunities where we've been investing in is really driving favorable channel and geographic mix. And certainly, you've seen us focused on quality of sales. That innovation in design is also going to help support pricing and mixing up of AURs.

So, you know, that's what's giving us confidence from a margin perspective. You know, and certainly, as we always do, we always talk about our supply chain as a differentiator. And that diversified supply chain where approximately one-third of our global production is internally manufactured in this hemisphere and approximately two-thirds are sourced from over 225 facilities in over 20 countries really provides us the flexibility to diversify where possible and minimize some of those inflationary pressures.

So, hopefully, that provides a little more color on how we're thinking about not just average unit costs, but also pricing and mixing up of AURs. Thanks, Adrienne.

Operator
Thank you. Our next question will be coming from the line of Bob Drbul with Guggenheim Securities. Please proceed with your questions.

Robert Drbul
Good morning, Scott. Good morning. I guess a couple of quick questions for me. Can you talk a little bit about, you know, new business development wins that you're seeing? I think, first.

And, I guess, can you comment a little more around--you know, as you look at the digital ecosystem evolution, you know, where you think you are, and how that's developing? And I'd be remiss not to ask about the J.Lo campaign.

So, I don't know, if you could just give us an idea on demand creation, sort of, you know, where you see it, especially with these gross margin gains and the ability to reinvest, you know, where you are with the J.Lo campaign and the Georgia May Jagger campaign, that'll be pretty helpful for us. Thanks.

Scott Baxter
Sure about that. That's no problem. Thanks for the questions. Really appreciate it.

From the new business development standpoint, I think the thing that I'm most pleased with is that we, since the very beginning, have decided that these brands were under-invested and under-penetrated and under distributed. And we had a pretty big whitespace globally, and we've attacked that.

But I think the thing that's probably the most important, you know, piece of it is that we just see a ton more opportunity going forward with the brand.

So, you know, when we, you know, had our success, you know, with our launch of Walmart, and, you know, we've seen really, really nice results, especially since we got all our POS up, feel really good about that launch, you know, that really got us going. And then, you know, you see the things that we've done with ATG, you know, and this is a global point of view, right?

You know, so, the things that we've done with Dressmann, the things that we've done with Cubus, and then, obviously, the things that we're going to talk about in our upcoming meeting. So, you know, we're also going to spend time with you, we're going to take you through this in a pretty significant way, you know, on Investor Day, but, you know, there's much more to come.

And then, I look at, like, things like Scheels, right? And I think about how do we structure and how do we have new business development that really elevates the brand and puts us on the next pedestal so that we can get to the next level? And a win like that gets ATG to the next level because it's such an important customer, it's such an important consumer.

And people see that at the right place and you're seeing our products, you know, positioned really correctly, it just brings, you know, additional brand heat. So, really pleased with it.

From a digital standpoint, you know, that's a really big win for us. You know, if you think about, you know, the work that we've done from the ERP standpoint, and all the work that, you know, Rustin and Joe and the team has done on that, it's just been exemplary, and can't thank the team enough.

But, you know, I likened earlier, when I said on a scale of 10, you know, we were at a two and I talked about some of the other stuff. We're just at the very beginning of the digital piece and we're seeing really accelerated results, as you've heard today in our response.

Our consumer is finding us online. They're finding us with our digital partners. They're finding us on our own digital.com. We're creating much better platforms for them to go ahead and book with us and shop with us.

You know, we think that we have easy products. You know, most consumers know their pant size, most consumers know their shirt size and the accessories that we sell. So, we're easy--you know, an easy sale from that standpoint.

But I think the key, Bob, is that, when you go to our sites now versus two years ago, you're just seeing a much better product from both Wrangler and Lee, and I think that's really a huge win.

And then what you're seeing is people are being driven there because of the incredible demand creation programs that we're creating. You know, the heat that we get from J.Lo being on the cover of InStyle magazine, all organic, which is terrific. You know, the campaign with Georgia May Jagger, you know, for our women's line, you know, with Wrangler has just been--it's been off the charts successful. We've been really pleased with it.

I think it really has to do with the talent. You know, I would go as far as to say it's the talent that was hired and promoted in the organization. So, the demand creation teams at both Wrangler and Lee, they're just--you know, they're terrific and the work that they're doing is really terrific. And, you know, we're creating brand heat in the company in a pretty significant way. So, really pleased.

And I think, Bob, if I can finish with this, it's how it all flows together, right? You've got new business development, you've got our digital component, you've got our demand creation, you've got our innovation, and you've got all of that coming together, all of it at infancy stages, and it's really creating an exciting opportunity for Kontoor.

We're just at the beginning of that and you're starting to see. We've climbed into Horizon 2 in a really, really nice way. We've landed the plane, and now it's time for Horizon 2 to take off. Thanks, Bob.

Operator
Thank you. Our next question is from the line of Sam Poser with Susquehanna. Please proceed with your question.

Sam Poser
Thank you for taking my questions. I've got a couple. One, just on your supply chain. I mean, what--you're not getting--what percent of your supply chain is coming--is all from the North America and not being impacted by the ports right now?

Rustin Welton
Yeah. So, Sam, it's Rustin. Good morning. You know, as we talked a little bit about, you know, our global production roughly, a third is in this hemisphere that is really serving this hemisphere. And certainly, you know, our plants in Central America, you know, are really servicing this hemisphere.

Again, two-thirds of our production is source, and certainly serves not just the U.S., but Asia and Europe as well. And certainly, you know, obviously, Sam, you know U.S. is about 75 percent of our business. So, we have a pretty fair portion that is coming through with our own internal manufactured product in this hemisphere. And certainly, that's helping us mitigate some of the broader supply chain challenges that you're hearing from others in the peer set.

Sam Poser
Thanks. And then, secondly, you're increasing your marketing spend, and that sounds like it's pretty much focused on digital. In doing that--and how much of that digital marketing do you think helped the first quarter? And how are you thinking about that within your guidance for the back half? And I have no more questions.

Rustin Welton
Yeah, it's a great question, Sam. I mean, I know when you look at this business, you know we've been traditionally under-indexed. As you think about demand creation as a percent of revenue, sub 5 percent of our revenue has been spent historically on advertising.

So, you know, we've talked since the spin about really wanting to invest back behind these brands. You certainly saw us start to do that a little bit more when we amplified in the fourth quarter some of the demand creation. Certainly, drove strong results around holiday and into the first quarter today with the results.

And we certainly see an opportunity to continue to invest there. And we're going to drive that. Digital, as Scott mentioned, is really a critical piece, but it's not exclusively digital. It's really talking about the brands and you're seeing really strong momentum, obviously, with both brands gaining share in the marketplace.

And really, all of that is fueled and funded, as you know, Sam, by that gross margin expansion. That's what creates the oxygen, gives us the ability to invest back into the brands, while improving operating margins as well. And that's the secret sauce from our side.

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

Jim Duffy
Thanks. Good morning. Hi, Scott. Hi, Rustin. Hi, Eric.

Rustin Welton
Hey, Jim.

Scott Baxter
Hi, Jim. How are you doing?

Jim Duffy
Well, thank you. I wanted to start talking on the gross margin. Really super progress, really strong margin in the first quarter. Rustin, it sounds like some give back in the second quarter.

I'm trying to think as we look towards the second half of the year, is there any reason that that first quarter gross margin wouldn't be sustainable?

Is there some absorption of fixed cost deleverage from 2Q manufacturing? Or what are some of the other things which would pressure the gross margin relative to what you were able to deliver in the first quarter?

Rustin Welton
Yeah. It's a great question. Thanks, Jim. Appreciate it.

First quarter was really a milestone for us, as you know. We've had three consecutive quarters now with triple-digit margin improvement. You know, north of 46 percent was our strongest quarter to date in Q1 by nearly 300 basis points.

So, yeah, a number of drivers structurally really driving that, as we talked a little bit about, you know, that favorable channel mix, you know, quality of sales initiatives you've seen us undertake, as well as product cost enhancements we continue to focus on. And then, certainly, that first quarter also benefited by some customer and product mix, lower inventory provisions versus prior year, and certainly, higher production volumes versus prior year, which were impacted by COVID.

So, you know, that gross margin expansion remains a critical focal point for us, Jim, and really enables us to invest back into the brands while improving the operating margins, as we talked about. You know, as we think about this unfolding into the balance of the year, you know, certainly as we go into the second quarter, you know, there will be some margin impact, ERP implementation activities with the cutover.

So, you know, we said that the gross margin expansion wouldn't be linear on a quarter-to-quarter basis. And then, as you think about the back half of the year, you know, as we've talked about on the call here, Jim, you know, certainly a lot of uncertainty is still out there with supply chain issues. And we are just being prudently conservative as we're thinking about the balance of the year, and making sure that, you know, we're dialing in the margin appropriately.

But obviously, we feel good about what we're seeing to raise that guidance on the gross margin, again, from that 150 to 200 basis points improvement up to the 230 to 270 we talked about this morning.

Jim Duffy
Okay, great. And then, Rustin, I wanted to ask about EBIT margin and flow through. The guidance implies EBIT margin back above pre-spin levels. I understand you're reinvesting some of marketing. Can you talk about what the demand creation budget that's implied in that guidance is?

You mentioned, you know, wanting to get it above the 5 percent level. Where would you see it this year?

And then, related to EBIT margin, you know, strong upside in the first quarter. I'm wondering for investors, is there any sort of framework to think about, like, when you have upside how much of that gets passed through to investors versus reinvested in the business? You know, is it two-thirds/one-third, one-third/two-thirds? Anything you can say on that would be helpful.

Rustin Welton
Yeah, certainly, we'll go into the SG&A and our thoughts on how to invest and demand creation a little bit more at Investor Day here in a couple of weeks, Jim. But maybe just a couple of points to highlight on your questions.

You know, you've heard us talk from the very beginning about earning our way into these investments, and you're seeing that materialized with that expansion on the gross margin side. And again, really creating that oxygen to reinvest back into the business.

You saw us start to do that a little heavier in the fourth quarter of last year. And we're going to continue that this year. I won't get into specifically targets around, you know, advertising as a percent of revenue this year.

But, again, we really like the momentum on the brands, and really investing behind the brands. You know, they've been under indexed or under invested in historically. And that's a key part of our thesis here at Kontoor is the ability to really invest back behind these brands and drive growth.

And certainly, you'll see a lot more about that on the Investor Day here in a couple of weeks. But appreciate the question, Jim. Thanks.

Operator
Thank you. At this time, we've reached end of our question-and-answer session. And I'll turn the call over to Scott Baxter for closing remarks.

Scott Baxter
I wanted to thank all of you for joining us today and certainly appreciate the engagement and the support of our company and the great questions that we had today from the community. So, thank you very much.

And I also wanted to make sure that all of you can join us on May 24th for our Investor Day. We'd love to have you all there. Look forward to a great day together.

And thank you again for your participation today. Have a wonderful day, everyone. Thanks.

Operator
Thank you, everyone. This will conclude today's conference. You may disconnect your lines at this time. Thank you for your participation.