



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

Tom Waldron – Global Brand President, Wrangler

Chis Waldeck – Global Brand President, Lee

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Operator

Greetings. Welcome to Kontoor Brands' fourth quarter earnings call. At this time, all participants will be in listen-only mode. A question-and-answer session will follow the formal presentation. If anyone today should require operator assistance during the conference, please press star zero from your telephone keypad. Please note this conference is being recorded. At this time, I'll turn the conference over to Eric Tracy, Senior Director of Investor Relations. Mr. Tracy, you may begin.

Eric Tracy

Thank you, operator, and welcome to Kontoor Brands' fourth quarter and fiscal 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 defined in the news release that was issued earlier this morning.

Adjusted amounts exclude the impact of restructuring and separation costs, business model changes, non-cash 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. Additionally, as a reminder, our fiscal 2020 included the benefit of a 53rd week, which fell in the fourth quarter. Joining me today—on today's call are Kontoor Brands' President and Chief Executive Officer, Scott Baxter, and Chief Financial Officer, Rustin Welton. In addition, on

today's call, we will also be joined by Tom Waldron, Global Brand President of Wrangler, and Chris Waldeck, Global Brand President of Lee. Following our prepared remarks, we will open the call for questions. We anticipate the call will last about an hour. With that, I turn it over to CEO, Scott Baxter.

Scott Baxter

Thanks, Eric, and thank you all for joining us today. On behalf of Kontoor, I hope you and your families continue to be healthy and safe. As Eric mentioned, our global brand Presidents, Tom Waldron and Chris Waldeck will be joining us for this year-end review. We believe these year-end calls provide a great opportunity to have them share insights from the past year, as well as go forward strategies for each of their respective brands. You'll hear more from each of them in a bit.

We are pleased to share our fourth quarter and full year results with you today, results that came in ahead of our expectations, driven by broad-based improving performance across the business. Let me start by thanking our colleagues around the world, as the strong fourth quarter results and momentum we are seeing into 2021 are a direct reflection of our team's tremendous efforts over the last year. Their resiliency, agility, and focus on execution during these unprecedented times has been truly inspirational. Like most companies during 2020, we experienced challenges never seen before as the impacts of COVID-19 were far reaching. However, we were nimble, and we quickly focused on supporting the safety and well-being of our associates, while also strengthening our financial and liquidity positions. And, as important, we've been flexible in evolving our strategies and, in fact, amplified many of these proactive initiatives to not only help navigate the near-term environment but also set the foundation for long-term success.

Recall at the time of the spin, we defined Horizon 1 as the first 12 to 24 months as our own independent company. During this time, our focus has centered on stabilizing and optimizing our model through restructuring and quality of sales initiatives to bolster margins while driving TSR accretive actions from our significant cash generation. Rustin will take you through more detail on these measures later, but these efforts have helped de-risk our model and were the exact right thing to do in setting the stage for healthier, sustainable, long-term growth. Even with the challenges from the pandemic, the strategies we've implemented and the investments we've been making have allowed us to end 2020 with great momentum. These strategies are clear: first, enhance and accelerate the core through share gains and expanding the marketplace within US wholesale, second, transform our D2C and digital ecosystem in driving channel expansion, third, expand geographically with a focus on China, and fourth, broaden our reach into new categories in usage occasions, emphasizing outdoor, t-shirts, and workwear.

Despite the pandemic, in support of realizing these strategic growth opportunities, we've been laser-focused on ramping investments behind key enablers. These include amplifying demand creation and marketing spend, elevating innovation platforms, including becoming an industry leader in sustainability, driving further competitive separation with our best-in-class supply chain, unlocking efficiency and productivity gains through the implementation of our global ERP and

digital infrastructure, yielding enhanced consumer insights in building data analytics capabilities, and, finally, identifying and cultivating world-class talent to create a high-performance purpose-led culture. These are the investments and strategic priorities that will fuel our transition to Horizon 2 catalyzing fundamental growth, greater cash flow optionality, and the evolution of our TSR model over time. We will provide much greater detail on this next phase at our upcoming virtual Investor Day in May, but we're really excited to share what lies ahead with all Kontoor stakeholders.

Turning to our fourth quarter results, we saw strong fundamental improvement across all areas of the business, with revenue, margins, and cash flows coming in above expectations. Overall, revenue sequentially improved in Q4, increasing 1 percent on a reported basis, compared with down 43 percent and 9 percent in the second and third quarters respectively. Importantly, we saw growth across both of our global brands and in the US, Europe, and China. The U.S. business saw continued strength in the quarter led by Wrangler in our digital business, as well as the continued development of the Lee brand in both premium and value channels. Our digital transformation continues to be a bright spot, with an evolving platform that is driving elevated consumer engagement, traffic, and AURs.

We saw really nice growth across the U.S. own.com business which was up 50 percent in Q4, as well as the US digital wholesale that increased 75 percent in the quarter. As we think about the US landscape, I want to be clear. We are winning in the marketplace, taking share and adding incremental business, as well. During 2020, according to NPD, we added over 200 basis points of share with our core denim and casuals business. And, importantly, these share gains are healthy, with a balance of additional units and increasing AURs. Our strategies are paying off, with quality of sales, new innovation, and design initiatives helping support the mixing of price across the business.

Turning to select international markets. Our Europe and China businesses continued sequential improvement during Q4 as expected, both inflecting positive in the quarter, with Europe increasing 7 percent and China up 11 percent on a reported basis. Given increasing lockdowns in the region, we do expect volatility in Europe will continue, but new business development wins, particularly with our Wrangler ATG line, as well as our recently announced Lee licensing collaboration with H&M, are examples that we will remain on offense, positioning Kontoor for long-term success in the region when conditions normalize.

And, certainly, China will continue to be a focus for our strategic investments given the significant white space opportunity the region represents. At the risk of stealing Chris' thunder, we are already seeing great returns on our investments in the Lee brand in the region, as our leadership position in denim was extended during 2020. And with respect to Wrangler, we've been extremely pleased with our soft launch of the brand into the marketplace during Q4. While we are in early days, we are really encouraged by the early reads, and our broader launch in the region remains on track for this spring.



I'll let Rustin take you through greater detail in a bit, but I'd be remiss if I didn't highlight Kontoor's solid financial position. We announced today the proactive early termination of the covenant relief period in our amended credit facility, a testament to our improving fundamentals and robust cash generation. Our Board of Directors also declared quarterly cash dividend of \$0.40 per share in Q4, the first quarter in which we could reinstate under the amended credit facility. And, despite the pandemic, we've been aggressively delevering our balance sheet over the past several quarters, and that continued in Q4 as we paid down an incremental 125 million in debt, taking our net leverage ratio to under three times to end 2020. Our improving fundamentals, coupled with increasing cash flow optionality, affords a powerful combination as we position the Kontoor model to transition into Horizon 2.

Before I turn it over to Tom and Chris, let me close with this. We win together. And I couldn't be prouder of our team's efforts to manage through this highly dynamic environment. We ended the year strong. And, while macro conditions remain uncertain, I am confident that we are executing on our strategic playbook, investing in key growth enablers such as demand creation, and setting the stage for an exciting next phase of the journey. That should continue to unlock great value for all contour stakeholders. Tom?

Tom Waldron

Thanks, Scott, and good day, everyone. As Scott mentioned, while the past year has brought significant challenges with impacts from the pandemic, the Wrangler brand is better positioned now than it's ever been, greatly benefiting from focused investments in people, product, and processes. And as proud as I am of our team's incredible efforts in 2020, I am even more excited about the great momentum the Wrangler brand has going into 2021 and beyond. So, I'd like to take you first through some highlights of the year and the quarter, and then I'll provide some insights on a few key areas where prioritized investments have and should continue to yield more sustained profitable growth for the brand.

Wrangler saw accelerating trends throughout the year with global revenues inflecting positive increasing 7 percent in the fourth quarter. We experienced balanced strength across the globe with both U.S. and European businesses increasing 8 percent on a reported basis in the quarter. In the US, our wholesale business has increasingly benefited from our optimized distribution strategy. Our partnerships with best-in-class retailers such as Walmart, Amazon, and Target have strengthened during the pandemic as we saw increased share gains in our core denim business throughout the year, including substantial market share outperformance during the fourth quarter as measured by NPD. These share gains are highly correlated to the strategic investments we are making across design, innovation, and demand creation. We are also seeing the increased ROI in our western and work businesses, both of which sequentially improved throughout the year, ending Q4 particularly strong.

Given that Western business is truly the most authentic expression and ethos of the Wrangler brand, this performance is really great to see. And we augmented this improving US core and elevated wholesale distribution, including Nordstrom's and Free People. These premium price

points of distribution, coupled with focused demand creation spend such as our pop-up store in Fort Worth during the Wrangler National Finals Rodeo Championship in December, provided a nice halo that cascades back to the core.

Further elevating our distribution strategy, wrangler.com continued its evolution during the past year as our US own.com increased 57 percent during the fourth quarter, driven by strong traffic and increasing AOV. And more exciting, our digital business is expected to accelerate growth in the future as investments in both front-end commerce and back-end infrastructure are helping transform our digital ecosystem from transactional to a more consumer-led seamless experience. Investments in digital demand creation across our own.com and social media platforms, as well as successful collaborations with Stranger Things and Rick and Morty, have allowed the Wrangler brand to reach new, younger consumers like never before. And while still in the early stages, digital will increasingly become our pinnacle expression, a brand-enhancing vehicle that is also margin increases. In Europe, we had a successful launch of our outdoor Wrangler ATG line in Dressmann's, which, combined with the view of retailer Cubis this spring, extends distribution of the collection to more than 700 stores across the region. Sell-throughs of ATG, now a men's and women's line, has been really solid, exceeding our expectations. Our outdoor business within the US was up 73 percent on a reported basis during the quarter.

Let me unpack ATG and, more broadly, our focus on outdoor a bit more. This category is a great representation of how investments in innovation that play to a growing macro consumer trend fueled incremental growth across categories and extended distribution into new channels. We know the category is accelerating as more people want to be outdoors, and we are leaning into this trend and building high-performance product at a great value. This serves to not only diversify and augment our core denim business but affords the opportunities to open new channel distribution, particularly in the outdoor specialty and sporting goods. We look forward to giving more specifics on the outdoor strategy at our upcoming Investor Day, but Wrangler Outdoor has tremendous growth opportunities ahead.

And last but not certainly least, let me discuss our launch of Wrangler brand in China. As you know, given the pandemic, we chose to begin to see product into the market last year with a soft launch on T-Mall and, while early, the findings are extremely encouraging. Across all KPI metrics, the rollout is exceeding our expectations. We are on track to more broadly launch in the region this spring supported by enhanced marketing initiatives and live streaming events with high-value influencers. As we've stated previously, we will be measured in our approach to scaling in the China market, but, needless to say, the team couldn't be more excited to build on early momentum. And similar to outdoor, I'm eager to share even more details on our longer-term strategy at our Investor Day.

I want to reiterate our confidence in Wrangler's position as we begin 2021 and, importantly, thank the entire global team for their collaborative efforts over the last year. Combined with the increasing strategic investment that we have been making since the spin, we are confident that actions we are taking will fuel future accelerated growth for the Wrangler brand, growth that will

be more sustainable and profitable over the long term. With that, I'll turn it over to Chris to take you through Lee.

Chris Waldeck

Thank you, Tom. Let me also convey my appreciation to all of you for joining us today. Similar to Tom, I'm thrilled with what the Lee brand accomplished in 2020, and I'm even more excited as we turn the page into 2021. These achievements over the last year were significant and my sincere thanks to the team for not just weathering the storm with the great execution on our strategies, including brand elevating initiatives, material new business development wins, and, perhaps most important, delivering substantial profitability gains for the business.

First, I will walk you through some of the key takeaways from 2020 and the fourth quarter, and then I will hit on the many exciting opportunities that lie ahead for Lee. As most of you know, since the spin, one of our points of focus has been in repositioning Lee for healthy long-term growth, and the COVID pandemic has only validated our strategy. Given Lee's historic exposure to more challenged points of distribution within the US and select international markets, one of the biggest investments we've made has been within our quality of sales initiatives. During last year, we accelerated these quality of sales measures, which impacted near-term topline but will support sustained TSR accretive growth. This is a game-changing cultural shift relative to how the Lee business was historically run. A great proof point, this was the brand's seventh consecutive quarter of adjusted gross margin expansion in our largest market.

While we have prioritized profitability in brand's health, let me be clear. We have remained on offense. Investments in innovation and design, demand creation, and new business development are delivering significant opportunities across categories, channels, and geographies. Overall, revenue increased 1 percent on a reported basis in the fourth quarter. Revenue in the US was relatively flat on a reported basis, with a focus on quality of sales, while we achieved sequential improvement in our China and Europe business, which increased 11 percent and 5 percent respectively during the quarter on a reported basis. Diving further into the US business, while more temporary nonstrategic headwinds impacted the quarter, we are really encouraged by the gains within structural areas of the business. According to NPD, during the fourth quarter the Lee brand realized strong share gains across both men's and women's categories in the US.

Let me now turn to new program wins. Consistent with our TSR lens, we continue to develop new distribution opportunities, with a focus on select premium and value channels. As you know, we launched the Lee Master brand with Walmart in Q3, and I'm excited to share that its in-store point-of-sale became fully set. We saw a strong correlation with sell-through, and these trends have only accelerated as we start the New Year, a testament to how our investments in demand creation are paying off. This is just the beginning, as we look to expand the program into new categories and doors over time. Additionally, we entered premium points of distribution such as Anthropology, Nordstrom, and Free People. When we invest in design, innovation, and demand creation, the Lee brand has increasing permission to play in these elevated channels.

To further highlight new business development wins during the fourth quarter, we announced a significant new licensing collaboration with H&M, with focus on iconic legendary looks bolstered by the brand sustainability platform for a world that works. This partnership brings the Lee brand into over 1,000 doors across 61 countries, reaching a new and younger consumer. Additional powerful collaborations with Keith Haring, AppHarvest, and Alife provide perspective that we are clearly investing in elevated demand creation platforms that will continue to transform the Lee brand. We're only scratching the surface on our long-term opportunity. Rest assured our pipeline is robust. I'm eager to share more detail at the Investor Day in a few months. Another important element at Lee's evolution is our increasing efforts on transforming our digital platforms. Globally, on a reported basis, our lee.com business increased 28 percent in the fourth quarter, while digital wholesale increased 32 percent. We will continue to start investment in digital capabilities to drive further brand, elevation, and our closer connection with our consumer.

Finally, let me touch on our business in China. As I mentioned, we saw solid growth in the region during the quarter but more importantly, as Scott discussed, we believe the Lee brand extended its overall leading denim share position in the quarter, outpacing the overall market and our next closest competitor. And the momentum continues as we start the year. China will remain a focus for strategic investment, with a spotlight on highly successful partnerships with key influencers such as Eddie Peng and our Stand Tall campaign. This campaign generated 340 million views on our social media platforms during the quarter. Our investment in these demand creation efforts are expected to support further share increases in existing channels and measured expansion into Tier 4 and 5 cities and further diversification of our digital platforms. There will be more to come on the building blocks of our growth plans for this region at the upcoming Investor Day.

Let me summarize by thanking my colleagues throughout the Lee team for the amazing work done over the past year. In the face of incredibly difficult macro conditions, we didn't just persevere. We were able to deliver outstanding profitability improvements and market share gains, all while keeping our foot on the gas pedal driving new incremental growth aligned with our TSR accretive principles. The future is bright for the Lee brand, and we really look forward to sharing this transformation with all KTB stakeholders. Rustin?

Rustin Welton

Thank you, Chris, and good day, everyone. Hopefully, it's come through loud and clear with the team's remarks so far, but let me reiterate. Despite a highly dynamic environment, solid execution of strategic initiatives is yielding improving fundamentals as evidenced by our fourth quarter results. We have consistently stated that sequencing of our story matters, with the focus in the first few years post-spin on the optimization of the model. And even with the global pandemic, I am proud to say, we have done just that. I am confident we are entering 2021 as a stronger, more profitable company.

For the balance of the call, I will touch on a few key areas. First, I will discuss how the actions we've taken over the last 12 months have fundamentally improved our operating model and positions Kontoor for success going forward. Next, I will speak to how enhanced profitability

supports investments to catalyze an accelerating top line. And finally, I will close with highlights of our fourth quarter results and outlook for fiscal 2021. As we've discussed since the spin, our core focus during Horizon 1 is making the strategic investments in business model changes that will set the foundation for longer term sustainable TSR accretive growth. This included quality of sales initiatives, global ERP and digital investments, efficiency and cost savings efforts, and deleveraging the balance sheet. Together, these actions have driven meaningful improvement in our underlying fundamentals.

Let's discuss a few of these items in more detail, starting with our IT investments. Progress on the strategic ERP implementation continues as planned. Following our successful go live in Asia during the third quarter, we remain on track for the remaining regional implementations in 2021. As you would expect, there will be some timing shifts on quarterly cadence associated with the rollout across the U.S. region in early Q2. We continue to see meaningful efficiency opportunities that will drive tangible improvements to our cost structure and reduce non-strategic spend, providing fuel for investments in areas like demand creation, digital, and international.

We also amplified actions in the fourth quarter to optimize our distribution, including strategic initiatives within our U.S. outlet in India businesses. Recall, over the past three quarters, we discussed the strategic evaluation of our VF Outlet operations in the United States. We have now completed this work and taken appropriate action. Before detailing the actions, let's level set where we were. Entering 2020, we operated approximately 80 doors in our US retail fleet, of which over 80 percent were branded VF Outlet. Slightly under half of the sales in these stores were dilutive, non-Kontoor branded goods, with the balance primarily being distressed Lee and Wrangler product.

Following our strategic review, we opted to close 38 VF Outlet doors and convert approximately 15 doors to our Lee, Wrangler formats. Over 75 percent of the door closures were lease expirations that were not renewed, and we will continue to evaluate and optimize the fleet as leases expire. Importantly, these actions will, first, provide an improved consumer experience with greater in-store presentation for Lee and Wrangler products, second, support overall profitability, including accretion to our operating margins in the first year, third, right-size the fleet and establish a healthier foundation for our evolving B2C strategy, something you will hear more about at our upcoming Investor Day. And finally, this allows us to brand all stores Lee and Wrangler.

And in India, we began rationalizing select points of distribution prior to COVID and took action recently to proactively revise our approach to better position our brands in the changing marketplace. Accordingly, we are entering a partnership to convert the business to a licensing model. This will provide a number of distinct benefits for our brands in the region, including an enhanced consumer experience, aided by greater investment in our brands, omni-channel capabilities for the first time in the market across both digital and brick-and-mortar stores, and a more sustainable and profitable business model, with accretion to our operating margin expected in the first year. The impact of these strategic actions are included in our full year

outlook that I will cover shortly. And at this time, we do not foresee any additional business model changes in any of our major commercial markets.

Another critical area of focus has been our steadfast commitment to delevering the balance sheet and improving our overall capital position. This remains an essential element as we transition from Horizon 1 to Horizon 2 in 2021, unlocking greater optionality. Based on another quarter of strong cash generation, we made \$125 million in discretionary debt repayments in Q4 while improving our overall net debt position to 665 million, and debt reduction remains a focus in 2021. In fact, we have repaid an additional \$75 million thus far in the first quarter. As Scott discussed, based on our improving fundamentals, we announced the early termination of the covenant relief period in the amended credit facility. This action will help reduce interest expense in 2021 and has been contemplated in our outlook I will provide shortly.

Next, let me touch on the progress we have made improving overall profitability. Adjusted gross margin increased 230 basis points during the fourth quarter. The increase continues to be supported by the structural drivers we discussed last quarter, and it is really important to note that we are in the early innings of these gross margin improvements, as structural enhancements remain ahead. The combination of quality of sales actions, supply chain initiatives, mix shifts to both digital and international, and leveraging our own manufacturing base will result in sustainably higher gross margins over time. This allows us to pivot from Horizon 1 to Horizon 2 this year on offense, providing increased fuel to invest behind the key enablers that will create a virtuous cycle of growth. As our outlook implies, you can expect to see us amplify our demand creation, enhance innovation, and further distort investments into accretive channels such as digital and China, all leading to a more sustained top line algorithm. We will discuss in more detail during our upcoming Investor Day.

Now, let's get to our fourth quarter review. I encourage you to refer to this morning's release for additional detail, as I will focus my comments on key highlights. Global revenue increased 1 percent on a reported basis and was flat in constant currency compared to the same quarter in 2019. Revenue gains during the quarter were primarily the result of strength in U.S. wholesale, digital wholesale, and own.com, partially offset by impacts from COVID, as well as the previously mentioned VF Outlet actions. On a regional basis for the quarter, U.S. revenues increased 1 percent compared to the same quarter in 2019. International revenues increased 4 percent on a reported basis, driven by continued sequential improvement in China and Europe, partially offset by ongoing impacts from COVID and the business model change in India. On a constant currency basis, international revenues were flat.

Turning to our brands. Global revenue of our Wrangler brand increased 7 percent on a reported and constant currency basis compared to the same quarter in 2019. Wrangler U.S. revenue increased 8 percent, led by strength in our digital wholesale, ATG, Western, and workwear businesses. Additionally, our U.S. owned.com business increased 57 percent, and U.S. digital wholesale increased 87 percent. Wrangler International revenue increased 5 percent on a reported basis and 1 percent in constant currency. COVID related impacts, particularly in Europe,

weighed on performance. However, this was more than offset by new program wins, including the launch of ATG at Dressmann's and strength in digital wholesale.

Lee brand global revenue increased 1 percent on a reported basis and was flat in constant currency. Lee U.S. revenue was flat, driven by new business development wins, as well as continued strength in digital wholesale and 36 percent growth in owned.com. These increases were primarily offset by COVID related headwinds. Lee International revenue increased 3 percent on a reported basis, driven by China growth of 11 percent. On a constant currency basis, Lee International revenue was flat. Ongoing headwinds from COVID, particularly in Europe, continued to weigh on results. And finally, from a channel perspective, we saw broad-based improving performance during the quarter. On a reported basis, U.S. wholesale increased 4 percent, European wholesale grew 15 percent, and global owned.com increased 37 percent compared to the same quarter in 2019.

Now on to gross margin. As I mentioned earlier, adjusted gross margin increased 230 basis points to 43.2 percent. We see ongoing gross margin tailwinds continuing in 2021, which I will touch on momentarily. Adjusted SG&A increased \$5 million on a year-over-year basis to 187 million. As we indicated last quarter, we distorted spending in demand creation, which was up 16 percent compared to the prior year. Growth in SG&A was also driven by investments in the business in support of our digital initiatives. Adjusted earnings per share was \$1.23 in the fourth quarter compared to \$0.97 in the prior year.

Now turning to our balance sheet. Fourth quarter inventories decreased \$117 million versus the prior year to 341 million, or down 26 percent. The year-over-year decline reflects tight inventory controls, as well as the VF Outlet actions mentioned earlier. We finished the fourth quarter with \$248 million in cash and net debt of \$665 million, our best net debt and liquidity position since the spin.

And now on to our outlook. As you know, prior to COVID, our practice was to provide guidance on an annual basis, and we are moving back to that approach for our fiscal 2021 outlook. However, given macroeconomic uncertainty associated with the pandemic, I will share some perspective on quarterly cadence. Similar to our Q4 review, I refer to our release this morning for more detail, and I will focus my comments on key items. First, revenue is expected to increase in the low double-digit range over 2020 levels, including a mid-single-digit impact from the strategic actions with VF Outlet in India discussed earlier. Adjusted gross margin is expected to increase 150 to 200 basis points driven by the previously discussed structural benefits to the model. Adjusted EPS is expected to be in the range of \$3.50 to \$3.60, including the accretive impacts of actions taken with the VF Outlet in India businesses.

As it relates to quarterly color, I'll share a few additional points. As you know, during Q4, we amplified demand creation that enhanced holiday 2020 and continues to yield consumer demand benefits into early 2021. This top line strength, combined with anticipated significant margin improvement compared to the first quarter of 2020, is driving strong first quarter momentum.

As I mentioned previously, our U.S. ERP go live is planned for early in the second quarter. And, as you would expect, we anticipate some order pattern timing shifts around the transition, somewhat tempering Q2 revenue growth rates and corresponding profitability while aiding the first and third quarters.

Finally, from an EPS perspective, we expect second half earnings on a dollar basis to be modestly above the first half of the year due to COVID recovery and the natural seasonality of the business. And lastly, I would like to remind everyone of our Investor Day scheduled for Monday, May 24th, which will be held virtually. We look forward to sharing more on many of the topics we discuss today, as well as our go-forward strategies for driving greater shareholder value. This concludes our prepared remarks, and I will now turn the call back to our operator. Operator?

Question and Answer Session

Adrienne Yih

Yes. Good morning, and let me congratulate you. We have made it to Horizon 2. We're growing sales. So, congratulations. I know it's a hard lift. So, I guess I—Rustin, my question is going to be for you. The prepared remarks were great in the detail. We've been hearing disruption on kind of port congestion, et cetera, and I know that your DCs are primarily on the East Coast. So, I'm just wondering if you could talk to us about the inventory being down 26 percent. You seem very comfortable with that. Obviously, I'm assuming that most of the stuff is coming to you on the East Coast. So, if you can talk to us a little bit about that. Tom, if you can talk to us about the Wrangler launch in China, specifically the brand positioning, the brand awareness, and then kind of the digital aspect of that? And then finally, for Chris, if you can talk to us, also, about the investments in Lee product design and development and what that has borne out in 2020? Thank you so much. Scott, I'm giving you a rest today.

Scott Baxter

Thanks, Adrienne.

Rustin Welton

Thanks, Adrienne. It's Rustin. Good morning. Appreciate the questions. I will answer your questions around port congestion and inventory and then turn it over to Tom about the Wrangler launch in China. Certainly, as we think about port congestions, we're not immune to the challenges that are taking place in the operating environment, whether that's port congestions, higher freight rates, or labor shortages. And rest assured, we're aggressively working to minimize those impacts, including intentional port diversification. As you're well aware, Adrienne, certainly select ports, primarily on the West Coast with L.A. and Long Beach, are more impacted than other ports. And as you talked a little bit about, we really believe our diversified supply chain affords benefits for us as we manage through this time.

With approximately a third of our production in this hemisphere and two-thirds of our source production coming from 225 facilities in over 20 countries around the world, we can be a little

more creative, I'll say, in navigating some of the challenges. Our outlook has considered kind of prolonged headwinds through the better part of 2021 based on some of these measures, but we're continuing to work our way through that. As it relates to inventory, you talked a little bit about being down 26 percent in the fourth quarter. You know this has been a focal point for us since the spin. In the second quarter we were down 20 percent. The third quarter, we were down 21. We're down 26 in the fourth quarter, but that also takes into consideration the model changes that we've made at VFO.

So, if you exclude the VF outlet (inaudible) and really the discontinuation of the third-party goods, we're down more like 20 percent, which is really in line with prior quarters. We continue to manage this. We feel good about the quality of the inventory heading into '21. It's clean. And we really believe the levels are appropriate given the uncertainty but also support the momentum we're seeing in '21. We continue to work closer than ever with our customers to align those supply and demand signals to maximize the in-stocks and certainly leveraging that diversified supply chain that I talked about earlier to minimize those important logistics disruptions. So, that's a little bit around inventory. And with that, I'll turn it over to Tom to talk about Wrangler in China.

Tom Waldron

Hi, Adrienne. Really excited about the soft launch in China. It went very well. It exceeded all our KPI expectations. We will have a more robustful launch on track for this spring when the consumer environment will be healthier. We will be measured, test, and learn through this initiative, but what I'm really excited about is the team on the ground. They've been driving the China brand for well over 20 years. They understand how to emotionally connect with the Chinese consumer, and, certainly, they couldn't be more excited about the Wrangler brand going after—you talked about the brand positioning. It's younger. It's male/female fashion-oriented. So, really excited about this initiative.

Chris Waldeck

Adrienne, it's Chris.

Adrienne Yih

Hey, Chris.

Chris Waldeck

You're right. It's really all about product and delivering that consumer low cost product. And we have made significant investments on the Lee side and the Wrangler side around product design, innovation, and, when we look at this, we talk internally about style crafted with purpose. And when we think about that as that elevated styling, leveraging innovation, so we can deliver the consumer exceptional fit, comfort, quality but again, at that style push that they truly need. So, we're excited about the investments we've made. We're seeing that come through in our sell-through right now. If it's at Walmart, if it's the—our partnership with H&M and the share that

we're gaining over in China. So, we're excited about these investments. More to come with that as we get into it, though. Thank you for the question.

Operator

Thank you. Our next question is from the line of Bob Drbul with Guggenheim Securities.

Bob Drbul

Good morning. Just got a couple of questions. The first one is, can you elaborate a little bit more just on the Wrangler strength and the Lee deceleration in the US, really sort of how you think that's playing out and sort of where we are going in next few quarters with both of those brands, specifically here in the US? And then the second question is, Rustin, if you could spend maybe—as you look at the year, the gross margin expectations are pretty healthy. I was just wondering if you might be able to just walk us through a little bit more quarterly expectations throughout the year. That would be helpful. Thanks.

Scott Baxter

Hey, Bob. How are you? It's Scott. I'll go ahead and start, and then Tom and Chris will help me out. But we're really pleased with the arc of the Wrangler and Lee brands. As you know, for many years, under-invested in, but I think what you're seeing now in the marketplace is just the investment in the brand and the consumer response. One of the most significant pieces of that is that we're building and designing really good products. So, our consumer is loving what we're doing. And now you're seeing us go ahead and get to a better position financially, which we've talked a lot about, and we talked a lot about capital allocation, and we talked a lot about investing back in these brands at the appropriate levels, because they've been under-invested in.

And what we're seeing is we're seeing an acceptance in the broad global marketplace relative to the brands around categories, channels, geographies, and both brands are able to go up and down the value scale. So, we really like what we're seeing. And I'll tell you one of the things that I think you can measure, which is really important—and I think Tom and Chris both have a comment—is that we're fielding a lot of incoming calls about people that want to do collaborations with our brands and with our people because they're seeing, in the marketplace, the strength of these two brands globally. Tom? Chris?

Tom Waldron

Yeah. Thanks. Super excited about the momentum. Wrangler is hitting on all cylinders right now. It's a combination of really great product fueled by design and innovation and then really great storytelling. We mentioned Rick and Morty. We mentioned Stranger Things, making sure that we're connecting with younger consumers. And that's just pulling through from a consumer demand standpoint. And as Scott mentioned, we're able to invest behind the brand like we never had before. So, really excited about Wrangler's trajectory. I'll hand off to Chris.

Chris Waldeck

Hey, Bob. It's Chris. Horizon 1 for Lee was really all about focusing on a cultural shift, and I talked about that in our remarks. And we really brought that to life and focused on TSR accretive growth for the Lee brand. And we've set ourselves up nicely for that. We're starting to see that come through, seven consecutive quarters of sequential margin expansion in our biggest market. So, we feel good about how we're positioned. And, as Scott said, our investment behind design and innovation are starting to really come through for us. So, we're excited about what the future holds and look forward to talking to you more during our Investor Day.

Rustin Welton

And, Bob, it's Rustin. Good morning. Thanks for joining. Let me provide a little more kind of shaping around the quarters. I know that's certainly top of mind as you're looking to build your model for the year. Although, I won't provide specific quarterly guidance given the macroeconomic uncertainty, let me just give a little bit of additional color as you're thinking about it. So, as we mentioned in our prepared remarks, we really see strong top line momentum coming into the first quarter supported by that amplified demand creation investments we made during Q4. Actually, we would anticipate Q2 growth rates to accelerate sequentially. Certainly, the Q2 of 2019 was most impacted by COVID, as you're well aware, and we would expect those Q2 growth rate again actually ahead of the Q1 growth rates.

We would, however, just remind you, Bob, as you're thinking about this that Q2 is typically our lowest volume quarter. And with the U.S. ERP plan in the second quarter, that certainly will have some implications, as well, as we talked about. So, we really view kind of the top line growth rate as a bit more balanced both on a one year and two year stack basis. And so, that is kind of how we're thinking about the top line. As we think about gross margin, certainly, we're pleased with the progress we've seen over the last two quarters. Gross margins have topped 43 percent both in Q3 and Q4, up 230 and 240 basis points. So, we're pleased with the progress we've seen. Again, confidence in talking about that expansion of 150 to 200 basis points off of that 41.2 percent we delivered on an adjusted basis in 2020.

So, as you think a little bit about the cadence of profitability, Bob, and earnings, again, I would expect strong momentum into Q1. And as you would expect, the ERP go live is going to cause some timing shifts, helping Q1 even more, as well as Q3, while tempering Q2 a bit more, again, on our lowest volume quarter. So, as we said, too, in the prepared remarks, given the typical seasonality and some of these timing shifts, we would expect EPS on a dollar basis to be modestly higher in the second half of the year. So, hopefully that provides a little more color, Bob, as you're thinking about constructing the models. Thanks for the question.

Operator

The next question is from the line of Erinn Murphy with Piper Sandler. Please proceed with your questions.

Erinn Murphy

Great. Thanks. Good morning. I guess a first question is just on the Lee and H&M partnership. I was curious if you could speak to if the shelf space gains you're capturing right now, is that temporary? Is it more permanent? And then just bigger picture, Scott, for you as you think about being a leader in sustainability, can you talk about how you're prioritizing some of your consumer facing efforts, whether it's the recycled denim partnership with H&M, waterless dying, sustainability—or sustainably sourced cotton, et cetera? Just curious on that.

Scott Baxter

You know what? Why don't I go ahead and start, and I'll handle the sustainability piece. Thanks for the questions, Erinn. And then I turn it over to Chris, but we're really proud of our efforts in sustainability. We published year two of our company, so early on in our history our first ever sustainability report early on. So, I'd encourage everyone to go out on our website and take a look at that. I think it's a really, really good piece, but we are focused on three pillars: the next people, product, and planet. And those are the key pillars that we're going to focus on going forward, and we're going to be—we have stated we're very serious about that, being a leader in sustainability going forward. So, I can give you a couple of examples from a product standpoint or a planet standpoint. We've got a goal by the year 2025 to save 10 billion liters of water and also a goal by 2025 to have all of our operating facilities using renewable energy. But we take (inaudible) components in all pieces of the value chain within sustainability very serious. So, look for more from us. You mentioned our foam dying process is, a very important part of our water savings initiative, but there will be much more going forward. Thanks for the question. Chris?

Chris Waldeck

Hey, Erinn. It's Chris. It's interesting about the H&M partnership, and you talked about sustainability. So, it's really all based around sustainability and Lee's platform for a world that works. And your question about is this a one-time thing with H&M, this is a collaboration. So, by definition, it is one-time from that standpoint. But what I will say is that, we really had a great partnership with H&M, and we're really encouraged by that. Our teams albeit had to do everything virtually because of COVID really got along well. So, I think there's high likelihood that there will be additional partnerships between Kontoor Brands if it's Lee and/or Wrangler but then also with other vertical retailers as we think about the different opportunities out there.

Operator

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

Sam Poser

Williams Trading, but thank you. Just a quick one on the impact of India, where that comes from, and did any of that impact the fourth quarter, or is that going to flow through? I mean, I would assume that it's going to impact Lee more than your—well, India is going to impact Lee, but can you give us sort of—can you spell it out and flow it for us a little bit?

Rustin Welton

Yeah, Sam. It's Rustin. Good morning. I'll go ahead and take that. Appreciate the question. Certainly, as we think about the India market, we do have both brands there. It is Wrangler and Lee. And as we talked about sort of on our outlook for 2021, we said a low double-digit top line growth for Kontoor, including a mid-single-digit impact from both the VFO actions that we took this morning, as well as India, Sam. So, while I won't get into sort of the specific impacts of each of those, I will sort of emphasize for you that we do expect both to be accretive for us from a margin perspective in that first year. And importantly, we're really confident these are the right things to do from a brand perspective and is really aligned to our TSR focused approach. So, hopefully that helps understand things. In terms of the Q4 impact, as we talked about, we'll be transitioning to that new model in the first quarter. So, certainly, there were some Q4 impact associated with those actions in advance of moving from a direct to a license model.

Sam Poser

Alright. So, let me reask the question. With—in absolute revenue dollars, can you give us—or as a percent of that 5 percent, how much is coming out of the VF Outlets, and how much of it is coming out of India? Can you give us some idea in dollar terms?

Rustin Welton

Sam, we're not going to--.

Sam Poser

I understand the profitability situation. I'm just trying to be able to run the model—to be able just to break it out properly. Or how much of the revenue are you eliminating from VF Outlet with the store closures? I assume those stores that you're closing weren't great stores to begin with.

Rustin Welton

Yeah. What I would say, Sam, again, we won't break it out, but it is collectively a mid-single-digit impact from both VFO and India. The VFO piece certainly has two components to it. It's not only the 38 door closures that we talked about in the quarter, but it's also the discontinuation of the third-party goods that are sold through that chain. And again, those were a little less than half of the overall sales in the chain. So, that's a little bit more color on the breakout.

Operator

Our next question is from the line of Jay Sole with UBS. Please proceed with your questions.

Jay Sole

Great. Thank you so much. I have three questions. One is on share gains, the other on digital, and the third on capital allocation. Maybe first, it sounds like both brands saw nice share gains in US wholesale. Can you speak to what's driving this? And who you're taking share from, whether it's other brands or private label? And then secondly on digital, the digital growth in 4Q seemed really strong. Can you walk through the digital wholesale piece versus the company's own.com? And what inning are we in with respect to development of the company's own.com channel? And

then lastly, it was another quarter of significant debt paydown. I think you're now below three times leverage. I'm sure you'll provide more detail at the Investor Day but was curious about how you are thinking about the capital allocation strategy at this point? Thank you.

Scott Baxter

Alright. So, Jay, we'll go ahead—and I kind of have that as four questions, and we're going to go ahead and divvy those up a little bit. But let's go ahead and start with the share gains, and you're absolutely right. We are gaining share both from a national branded and also private label. And we're driving that through our first quality goods. I think Tom and Chris both mentioned it. We are designing and building—and this is a credit to our team—better products across the globe and also here in North America, too, and we're gaining share across the wholesale channel. And we really like where we stand right now with our core partnerships and the people that we do business with. So, we're really excited about the future in all of our categories.

From a digital standpoint, we've talked a lot about the investment that we've made there, but there's a couple of things that I think are really important from a digital standpoint. We've been investing behind that. We've been investing in the platforms. You saw the gain that we had both on the owned .com. We re-platformed wrangler.com and lee.com, but I think the thing that's not talked about enough in these types of calls is the fact that you can have a really good platform, which we do. We've hired an incredible team, but we are now starting to put really exceptional product on the sites, and you're seeing that take out accelerate. That is the critical component. So, we put the whole team together, great team, great site, great products. Really helping us go forward. So, really pleased with that. In addition to that, our digital wholesale business is strong and getting stronger. Again, it goes back to our partnerships that we have with the winning retailers. It goes back to great products. So, really pleased with that, looking forward to the future there.

I will tell you this—if you want to talk about what inning it is, I would tell you it's very, very early stages. And the reason I say that is that we came out of the gate from a spin standpoint really at ground zero, no investment in our platform, very few people that were asked to do a lot—too much, actually, until we got a team built around them. A lot of things have happened from an investment standpoint globally in our .coms and our own .coms, and those are just now starting to pay off. And I think that we're really starting to learn what the consumer wants there. And we're advertising in a significant way digitally, and it's hitting specifically from a consumer standpoint. Before I hit capital allocation, I'll just ask if anybody has a comment from Tom or Chris or Rustin on digital.

Chris Waldeck

I think the only thing—Jay, this is Chris. The only thing I'd add in there is, this is also happening outside of the US. It's happening for us in China, and we're really seeing acceleration around our digital platforms in China and leveraging those key influencers. I talked about 340 million views on our social media platforms in the quarter. That's driving us to new consumers, younger consumers, and it's helping us capture share.

Scott Baxter

So, let me go ahead—I'm going to start on capital allocation, then I'll flip it over to Rustin for any comments. But you've heard us talk before multiple times about the fact that we really liked our position coming in the Horizon 2 relative to we can go ahead, we can increase our dividend. We could pay down additional debt. We can invest more in these brands, and we're seeing the response out in the marketplace when we do invest in these brands. And we can also embark upon M&A activity if we choose. So, having the ability to have all those options and decide what's best for our stakeholders over time puts us in an enviable position. And we look forward to talking about these things in our coming Investor Day in May. Rustin anything to add?

Rustin Welton

Yeah. I would just highlight, Jay, that we have been on an aggressive debt paydown piece. We paid \$300 million in discretionary payments in the last three quarters. I talked a little bit about \$75 million paid in the first quarter, as well. So, that will continue to be a focal point for us as we're sort of exiting out of Horizon 1 and transitioning into Horizon 2, as Scott talked a little bit about the net leverage ratio is less than three times. Gross is a little north of that still. So, again, will continue to be a focal point for us but really like the optionality as we head into Horizon 2 that Scott talked about.

Operator

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

Scott Baxter

I just wanted to thank everybody for joining us today. We really appreciate your support of Kontoor Brands, and we look forward to speaking with you at our upcoming first quarter call in May. And we're especially excited to spend time with you at our upcoming Investor Day on May 24th. So, thanks again for your time today. Really appreciate it, and we'll talk to you soon. Take care.

Operator

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