



Kontoor Brands' Third Quarter 2021 Earnings Conference Call Transcript

November 4, 2021

Kontoor Brands Participants

Eric Tracy – Vice President, Investor Relations, Kontoor Brands

Scott Baxter – President, Chief Executive Officer & Chair of the Board, Kontoor Brands

Rustin Welton – EVP, Chief Financial Officer, Kontoor Brands

Operator

Greetings and welcome to Kontoor Brands' Q3 Earnings Conference Call. At this time, all participants are in a listen-only mode. A brief question-and-answer session will follow the formal presentation. If anyone should require operator assistance during the conference, please press "*" "0" on your telephone keypad. As a reminder, this conference is being recorded. I would now like to turn this conference over to your host Mr. Eric Tracy, Vice President, Corporate Finance and Investor Relations. Thank you, sir. You may begin your presentation.

Eric Tracy

Thank you, Operator, and welcome to Kontoor Brands' third 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, non-cash impairment 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. Also given the impacts COVID-19 had on prior year results, we will provide select references to the same quarter in 2019 for additional context where appropriate.

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

Scott Baxter

Thanks, Eric, and hello to everyone joining us today. If you take one thing away from today's call, let it be this; Kontoor and our *Wrangler* and *Lee* brands are in a meaningfully different and advantageous place compared to our past. We are now uniquely positioned to win in the marketplace and to create future value for all our stakeholders. This was evident in our third quarter results and it's even more evident in the confidence we have in raising our guidance for fiscal 2021 and the momentum we see in the holiday and fiscal 2022.

More on this in a bit but, simply put, our strategies are working. Our investments are yielding superior returns through the elevation of our brands, increasing permission to price, and accelerating growth. No doubt the current macro environment is placing significant challenges on companies and people and as we stated, Kontoor is not immune but we are keenly focused on controlling the controllables and on the execution of our strategic playbook that has consistently proven itself in setting our foundation during Horizon 1 and now in the Horizon 2, where we will look to catalyze growth.

When we started the Kontoor journey almost three years ago, our top priority in establishing our organizational culture was to take care of each other. And while we could not have predicted the obstacles we would face in the ensuing years, we believe that this core tenant and the great experience of our team could help us not only navigate difficult times but thrive through them, and I believe we have done just that. So I want to thank our colleagues around the world for the ongoing collaboration, teamwork, and resiliency, and continuing to take care and support one another.

So how are our strategies driving near term results? Let me provide some proof points from the third quarter that showcase our strategic emphasis on catalyzing growth across four key areas. First, elevating and accelerating our core U.S. business. Second, channel expansion primarily in our D2C and digital ecosystem. Third, diversifying our product mix through category extensions including outdoor, work wear, and t-shirts. And four, expanding the brands geographically with a focus on China.

Overall global Kontoor reported a revenue increase of 12% compared to last year and 2% to 2019. Important to note, this included a negative high single-digit impact from strategic quality of sales actions within our VFO in India businesses. Excluding these actions, global Kontoor reported revenue would have been up 11% over 2019, far outpacing the market.

Our U.S. business during the third quarter increased 8% not only to 2020 but also 8% to 2019. Again, this includes the impact of our proactive measures within our VFO

operations. So, excluding these actions, the U.S. business would have been up high teens in the third quarter compared to pre-pandemic 2019 levels. And what's crucial is that this growth is healthy, balanced, and broad based across brands, categories, and channels. The U.S. was once again led by our rapidly evolving digital platforms with U.S. own.com increasing 118% and digital wholesale increasing 237% compared to 2019.

U.S. wholesale increased 15% during the quarter with outsized performance within our western business augmented by emerging new programs and outdoor, ATG, work wear, and female. Demonstrating the health of the Lee and Wrangler brands, our elevated position in the marketplace, and increasing ability to take price, our digital AURs are up high single-digits in the U.S. year-to-date.

Turning next to our global digital business, our results in the quarter highlight how our strategic investments are unlocking significant value and connecting us closer to our consumer more than ever before. Q3 saw rate growth over last year, but was even more impressive compared with 2019 with reported global own.com and digital wholesale increasing 88% and 182% versus pre-pandemic levels. And the runway for future growth remains significant as we are still highly under indexed in this accretive channel relative to our peers.

Our new ERP platform will enhance our digital efforts. As we globalize our operations, we will continue to lean in on investments to achieve our goal of 10% digital penetration over the next three years. And while our channel with digital evolution has been extraordinary, we are equally excited by the performance of our tremendous expansion of new categories beyond denim including outdoor, work wear, t-shirts, western, and female. While our foundation lies in denim, we are rapidly developing a more diversified portfolio that augments and enhances our core offering.

Within outdoor and our ATG line, we are leveraging great performance innovations to drive incremental penetration of existing retail partnerships while also expanding into new points of distribution across the outdoor specialty and sporting goods channels both domestically and abroad. During the third quarter, our U.S. outdoor business saw 50% growth compared to 2019. Our test of ATG with academy sports here in the U.S. and Intersport in Europe are going very well, and we are excited about the opportunities for further expansion in these brand elevating points of additional distribution for the line.

Our work wear business is also seeing great momentum, as reflected in the third quarter results, with more than 60% growth in the U.S. compared to 2019 as we discussed on our last call. We've more than doubled our door count over 3000 stores for fall 2021 compared to spring with one of our key domestic retail partners and we are really excited about the future opportunities this program affords us in the quarters to come.

And the development of our t-shirt category is building momentum with significant new programs set for spring 2022. In addition to these new outdoor, work wear, and t-shirt categories our Wrangler Modern Female and Western businesses in the U.S. are performing exceptionally well with substantial year-over-year growth during the quarter, up more than 100% and 50% respectively. The broad-based third quarter performance across categories is a direct function of how investments are generating incremental business, development opportunities for our brands.

And finally, we continue to catalyze growth geographically with solid results in the quarter, despite an uneven COVID environment across the globe. Even with ERP Go Live in July, our European business saw nice year-over-year improvements up 19% constant currency compared with 2020 driven by digital, brick and mortar reopening, and new business development. And in China, our ongoing strategic investment continued to yield strong results. Reported third quarter revenue increasing 22% and up 14% in constant currency.

You've heard from some regarding a broader slowdown in China. And while we haven't seen impacts to our business, we're obviously monitoring this closely. However, our brands are in distinctly advantaged positions in the market. Lee has over two decades of experience in the region and is uniquely connected with the Chinese culture while Wrangler is just getting started in China with significant wide space ahead affording us the opportunity to grow in the most productive manner.

To fuel this growth across core channels, categories, and geographies you've heard us talk quite a bit about investing behind key enablers. These pillars and supportive growth include enhancing and amplifying demand creation platforms, scaling product and manufacturing innovations with sustainability and ESG as our guiding tenant. Unlocking efficiency and productivity gains for the implementation of global ERP, supply chain, and digital infrastructure. And last leveraging our world class talent to build a purpose led high performance and increasingly growth minded culture.

I'm going to focus my comments today on our man creation efforts while Rustin will provide greater insights with respect to our ERP implementation and supply chain. The reason I want to highlight our investments and demand creation is pretty straightforward. We are doing things with both the Wrangler and Lee brands that we've simply never done before. This is reflected in the brand's recently launched marketing campaigns.

First with Lee, if you haven't had a chance to see our new Lee originals campaign that launched in October, I would encourage you to go to lee.com to check it out. Hearing me talk about it simply doesn't do it justice. I promise you will be impressed at how this modern, elevated brand expression brings the Lee transformation to life and just how differently the brand is showing up in the marketplace. Produced in collaboration with preeminent photographer and creative director Mark Seliger and step to the title track

Struck by Lenny Kravitz, the works celebrates and encourages those who push boundaries through creativity, ingenuity, and hard work.

Our cast of originals reflects the multifaceted and diverse Lee consumer from climate warrior and fashion icon, Quannah Chasinghorse, to Venice beach skateboarding legend Haden McKenna, the unique character and personality of each cast member reflects what has always made Lee Original, the stories behind those who wear them. The campaign went live in North America in October and includes most all media platforms with a heavy lean towards digital that will run on streaming services such as Disney and Hulu as well as high impact display in key social media platforms including the brand's launch on TikTok.

And for those of you in New York, we've also introduced Lee Originals on the streets of the city where originality and creativity thrive via strategic out of home media in SoHo, Bushwick, and Williamsburg. The global campaign will be supported by existing and new collaborations and partnerships with key influencers.

We are excited about Lee's recent launch and newest partnerships with iconic brand Pendleton. This limited edition just dropped this week and reimagines essentials from the brand's combined 200 plus years in American apparel. Each pair of jeans is made in the U.S. with some of the last remaining selvedge denim from Cone Denims, White Oak Mill in Greensboro, North Carolina. And this is just the beginning of Lee's new brand messaging and repositioning. We couldn't be more excited to share what's on the horizon in the quarters to come.

Turning to the Wrangler demand creation platform, the brand's newest global ad campaign for the Ride of Life, debuted in September in North America with live coverage on the NFL Network. The campaign will also run on retail, digital, and social media platforms across North America and Europe. And our collaborations with the Wrangler brand just keep building. We had the initial launch of our Billabong and Wrangler collab in August with a second drop in September. Timed perfectly for back to school, the partnership helped drive significant brand awareness with 1.7 million videos created on TikTok using our summer mashup hashtag.

And for — and beginning this fall, Wrangler is officially partnering with Yellowstone for much of the anticipated new season of the highly acclaimed most watched series on cable TV. Wrangler will always be a symbol of authentic western fashion. The Wrangler and Yellowstone collaboration came to fruition after much of the denim apparel was organically seen on the show's beloved characters. Collaborating with Paramount Network's Yellowstone brings the lifestyle body for decades into the spotlight allows us to reach a new audience that is now learning what it means to evoke the cowboy spirit. We're thrilled to be able to add a layer of authenticity to the closets of Yellowstone fans as appreciation for the western lifestyle continues to surge in popularity in mainstream culture and fashion.

Augmenting our collabs, the brand continues to partner with key influencers that reach a younger, more diverse consumer base. For spring 2022, Georgia May Jagger will continue her role as lead brand ambassador and a female face of Wrangler and we are thrilled to announce our partnership with R&B Grammy winning musician Leon Bridges. The two-season collaboration will launch in spring of 2022 with Leon as the face of Wrangler's men's global product line followed by a fall limited edition collaboration of key denim and western styles inspired by iconic silhouettes from our archives in Leon's personal style.

Finally, as we look to 2022, our demand creation efforts only build in support of commemorating the Wrangler brand's 75th anniversary. We have a year-long celebration planned to honor Wrangler's historic presence in music and fashion while also highlighting the courage, optimism, and triumph of western culture.

Let me close with this. As you can see, there is a lot to be excited about with many proof points that our strategies and investments are fueling broad based strength across our business. We will continue to amplify these strategic investments particularly in demand creation and digital during the fourth quarter in support of our planned accelerating top line growth algorithm. And while we are extremely proud of how we have navigated the last few years in establishing a solid foundation off which to build despite the turbulent macro environment, I want to share a few thoughts on why we're even more confident about what lies ahead. Rustin will provide more details, but a few items based on our current views that support this confidence as we look to 2022.

First, we expect fiscal 2022 revenue to accelerate above the long-term target of mid-single-digits we established at our recent Investor Day with particular strength in the first half, up low double digits. And second, despite macro inflationary pressures, we anticipate '22 gross margins to be at or above '21 levels. We possess a powerful combination of accelerating fundamental drivers and increasing capital allocation optionality that afford us the opportunity to deliver consistent near-term results while continuing to invest in our business and fund shareholder friendly actions, including our recent dividend increase of 15%, as well as opportunistic share purchases during the third quarter. As I said at the start, Kontoor is in a unique position of strength in the marketplace and we look forward to executing and delivering superior future TSR for all of our stakeholders. Rustin?

Rustin Welton

Thank you, Scott and thank you all for joining us on today's call. As Scott outlined, we are very pleased with our third quarter results and the momentum of the business as we head into holiday in 2022. Simply put, our brands are as healthy as they have ever been with the investments made and solid foundation that has been established since the spin. Before turning to the quarterly review, I want to address a couple of topics that I know are top of mind, macroeconomic inflation and supply chain challenges, as well as the status of the ERP implementation.

With respect to the widely discussed industry supply chain disruptions, cotton pricing, and inflationary pressures, I want to emphasize the following points that we have repeatedly stressed. First, while we are not immune to these issues we continue to leverage the agility of our best in class supply chain to navigate the environment. And second, we remain focused on what we can control and are steadfastly executing our strategic playbook.

In terms of the supply chain, we believe we are relatively advantaged in our position. Our diversified global supply chain operations are differentiated with over one third of our global production coming from our internal manufacturing facilities in the Western hemisphere, with the balance being sourced from over 20 countries and approximately 225 facilities around the world. No single supplier makes up more than 10% of our cost of goods sold.

Internal manufacturing combined with contracting in the Western hemisphere gives us greater flexibility, shorter lead times, and allows for enhanced inventory management in the North American market. Our significant footprint in the Western hemisphere has provided several advantages over the past few years, including being able to rapidly alter production to align with changing demand signals, minimizing excess and distressed inventory, and mitigating exposure to congested, coastal ports with extended lead times. In terms of sourcing, I know there are questions around China and Vietnam exposure, so I wanted to address each quickly. Less than 3% of our product comes from China and it is mostly China for China product and less than 1% of our product comes from Vietnam.

Finally, although we believe our global diversified supply chain is relatively advantaged, we have incurred elevated transitory cost as we anticipated and reflected in our revised outlook last quarter. These transitory costs were largely driven by air freight as we chased production to meet the accelerated strong demand that Scott highlighted earlier. In terms of inflation and cotton experienced roughly a decade ago, we want to be very clear, our model and our brands are significantly better positioned now to offset pressures.

So, what gives us confidence to make this statement? Let me provide the following specific reasons. First, our investments into our brands. From design to innovation to demand creation are substantially elevated to support higher price points in AURs. For illustration of how we are distorting investments, we anticipate our full year demand creation spend in 2021 to be up approximately 40% versus 2020, increasing approximately 100 basis points as a percentage of revenue and up approximately 20% versus 2019.

Second, our product assortment and composition has evolved with the emergence of new categories like Wrangler ATG. Distorted growth in categories like outdoor, channels like digital, and geographies like international are allowing us to mix up the higher AURs. Third, our cotton composition as a percentage of cost of goods sold, mid-teens

today, has diversified into more synthetic fabrications in denim bottoms as well as outdoor performance, ATG, and tops.

Fourth, our domestic distribution continues to evolve into healthier channels and retailers. A decade ago our first quality sales were predominantly in the wholesale channel and had much greater exposure to challenged mass and mid-tier retailers, such as Sears, Kmart, and ShopCo. Today with our segmented offering, our brands have amplified their tiers of distribution in wholesale, particularly in areas such as Western and digital and begun to distort growth in our own.com platforms.

Fifth, structural mix shifts to accretive channels such as digital and international have and should continue to support gross margin, particularly as we remain under penetrated relative to the market in these areas. Finally, given ongoing negotiations, we won't dimensionalize our inflation and pricing assumptions for 2022, but I will say we have good visibility into the first half and are confident in the back half given current market conditions. But I want to reiterate what Scott stated earlier, the combination of executing pricing actions, higher AURs, and structurally accretive mix shifts support our view based on current market conditions that full year 2022 gross margins will be at or above full year 2021 levels.

Turning to the ERP, on our Q2 earnings call we shared that we had gone live on our final regional implementation in EMEA early in the third quarter. Today, I'm very pleased to report that we also exit — exited the final Transition Service Agreements or TSAs with our former parent company in the third quarter. We are very pleased and proud of the team who has worked on this critical initiative for Kontoor as the ERP platform is foundational for the continued globalization of the business.

Now, let's get to our third quarter review. I will focus my comments on key highlights and refer you to this morning's release for additional detail on the quarter. Unless otherwise stated, growth rates are in constant currency compared to the third quarter of 2020. Also, given the impacts COVID-19 had on prior year results, I will provide select references to the same quarter in 2019 for additional context where appropriate.

Beginning with revenue, global revenue increased 11%. Strategic actions to rationalize our VF outlet fleet in the U.S., discontinued the sale of third party branded products in all domestic outlet stores, and transition to a new licensed business model in India represented approximately six points of headwind in the quarter compared to 2020. Compared to revenue in the third quarter of 2019, global revenue increased 1% or 9% excluding our strategic actions.

On a regional basis for the quarter, U.S. revenues increased 8% compared to the same quarter last year. Growth was broad based with strengthened digital, wholesale, and Western. Wrangler's outdoor and female businesses also saw strong gains in the quarter. Within our digital business, U.S. own.com and U.S. digital wholesale increased 52% and 90% respectively compared to the same quarter in 2020.

As Scott mentioned, these growth rates were even stronger compared to 2019 with own.com and digital wholesale increasing 118% and 237% versus pre-pandemic levels. Outpacing the U.S., international revenues increased 20%. Growth in the quarter was partially impacted by the previously discussed timing shift into Q2 due to the European ERP Go Live. Despite this shift, we saw strength in all channels, double-digit growth in China, and continued strength in our digital businesses.

Turning to our brands. Global revenue of our Wrangler brand increased 21%. Wrangler U.S. revenue increased 20% driven by strength in our work wear and Western businesses, new focus areas such as outdoor and female, as well as ongoing gains in digital with digital wholesale and own.com increasing 93% and 67% respectively. Compared to the third quarter of 2019, Wrangler U.S. own.com increased 142%.

Wrangler international revenue increased 32%, another proof point that our distorted investments and geographic expansion are paying off. Strength from digital, new business development wins, including our ATG program and the sporting goods channel, were partially offset by the previously mentioned timing shift in Europe. Lee brand global revenue increased 4%. In the U.S. strength from improving sell through of new programs and increases in digital was more than offset by the previously mentioned strategic actions that accounted for nearly five points of headwind. Demand fulfillment challenges and comparisons to a significant new distribution gain in the third quarter of 2020.

Lee U.S. revenue decreased 4% compared to the same quarter last year, but is expected to return to strong growth in the fourth quarter. Lee international revenue increased 15% driven by amplified investments with digital and the ongoing recovery in our brick and mortar business. And finally, from a channel perspective, we saw continued broad-based strength compared to the same quarter in 2020. U.S. wholesale increased 15% while non-U.S. wholesale grew 21% — %. Despite the previously mentioned strategic actions within the VFO operations, global branded D2C increased 2% on a reported basis and was flat in constant currency with own.com up 39%.

Now, onto gross margin, adjusted gross margin increased 80 basis points to 44.1% of revenue. Favorable channel, customer, and product mix as well as business model changes were the primary drivers of the gains, partially offset by increased air freight. I will provide more on our gross margin expectations shortly, but we continue to see benefits from the structural margin enhancements I previously discussed. Mixed shifts to highly accretive channels and geographies, proactive supply chain initiatives, and AUR mix supported by innovation.

Adjusted SG&A increased 36 million versus last year to 186 million. Higher demand creation, digital investments, and compensation costs more than offset better fixed cost leverage on improving revenue and restructuring benefits. Prior year comparisons were affected by reduced spending in 2020 in light of COVID uncertainty.

As we have discussed and as seen in the third quarter, we believe these strategic investments such as in digital and demand creation will continue to unlock our catalyzing growth strategy and support expected demand in the fourth quarter and accelerating top line into 2022. Adjusted earnings per share was a \$1.28 compared to a \$1.33 in the same period in the prior year and compared to \$0.95 in the third quarter of 2019.

Now, turning to our balance sheet, third quarter inventories decreased 5% compared to last year. The decline reflects the fourth quarter 2020 actions to reduce the fleet and discontinue the sale of third party branded products in our domestic outlets as well as the business model change in India. Excluding these actions, inventory increased approximately 4% compared to the prior year in support of chasing higher projected demand.

We finished the third quarter with net debt or long-term debt, less cash of \$576 million and \$215 million in cash and equivalents. Our net leverage ratio or net debt divided by trailing 12 month adjusted EBITDA at the end of the third quarter was 1.4 times within our targeted range of 1 to 2 times. And as previously announced, our Board of Directors declared a regular quarterly cash dividend of \$0.46 per share, an increase of 15%, a testament to our Board's confidence in the strength of improving fundamentals.

Finally, during the quarter, we repurchased \$10 million in common stock. At the end of the third quarter, we had 190 million remaining under our current share repurchase authorization. When combined with the strong dividend, we've returned a total of \$79 million to shareholders through the first three quarters of 2021. We will continue to use the share purchase program to offset dilution while also opportunistically buying shares as market conditions warrant.

These accretive shareholder friendly actions reflect our increasing capital allocation optionality, allowing us to continue to invest in our brands and business while productively returning excess cash to shareholders. This is powerful and further highlights how our op — model is differentiated.

And now on to our outlook, based on the strength of the third quarter and demand momentum for our brands, we are raising our fiscal 2021 outlook, revenue, gross margin and adjusted EPS. Revenue is now expected to increase in the high teens range over 2020 to \$2.47 billion to \$2.48 billion as compared to a mid-teens range in the prior guidance. This includes a mid-single-digit impact from the VF Outlet actions and India business model changes.

Unpacking this a bit further and, importantly, comparing to pre-pandemic 2019 levels, third quarter 2021 revenue increased 1% compared to 2019 and was up 9% excluding the impact from the strategic actions in VFO in India. Our guidance implies fourth quarter revenue will be up 3% to 4% compared with 2019 or up 13% excluding the

impact from the strategic actions in VFO in India. At the midpoint of our guidance, 2021 revenue is expected to be approximately 6% above 2019 levels, excluding the strategic actions. Well above most in the industry.

Adjusted gross margin is now expected to increase at the high end of the prior guidance range of 44.5% to 45% of revenue, compared to 41.2% achieved in 2020. The increase is expected to be driven by growth in more accretive channels such as digital and international, somewhat tempered by higher transitory air freight expenses in support of strong demand. SG&A investments will continue to be made in brands and capabilities. Due to the strengthening revenue and gross margin outlook during the fourth quarter, the company expects to make incremental SG&A investments in demand creation and digital to support expected accelerating revenue growth in 2022.

Specifically compared to our prior guidance, we have chosen to invest in additional 15 million in demand creation and digital during the fourth quarter. Adjusted EPS is now expected to be in the range of \$4.15 to \$4.20 per share, as compared to \$3.90 to \$4 per share in the prior guidance. This EPS guidance does not assume the benefit of any future share purchases. This EPS guidance includes a \$0.20 impact from the incremental demand creation and digital investments in the fourth quarter compared to prior guidance, somewhat offset by lower interest expense, a lower expected effective tax rate, and year-to-date share purchases, which in aggregate should benefit EPS by approximately \$0.19.

Finally, in light of the current environment, I would like to close with a few additional comments on 2022. First, our catalyzing growth strategy is working. The health of and demand for our brands has never been better and this is manifesting in accelerating demand going into 2022. Based on solid visibility, we expect 2022 revenues to increase at a rate above our mid-single-digit long term algorithm outlined at our Investor Day. We expect first half top line growth to be particularly strong, up low double-digits.

And second, we are not immune to the current inflationary environment. However, assuming current conditions, our best-in-class supply chain combined with increasing permission to price and elevated AURs as well as expected ongoing benefits from structurally accretive mix shifts, we anticipate 2022 full year gross margins to be at or above 2021 levels.

To close, I want to reiterate Scott's comments on the momentum of the business as we head into holiday in the first half of 2022. Our brands are as well positioned as they have ever been and we are well on our way to meet and exceed our multi-year targets. This concludes our prepared remarks, and I will now turn the call back to our operator. Operator.

Question and Answer

Adrienne Yih

Great, good morning. And boy, that's a whole lot of good news in 30 minutes. So congrats, really well done. Scott, my first question —

Scott Baxter

— Thanks, Adrienne.

Adrienne Yih

You are welcome. My first question is on the low double-digit, you know, first half guidance. There are a few companies that are willing to go out and start giving us, you know, 2022 guides. So then, clearly, what you've talked about is, you know, things that you're seeing now. And so my question is, are you seeing that in the order book, and how much confidence do you have there?

And then the drivers of that, Scott, I always like to get your opinion on the denim cycles of how strong is that, how long is that? And then, Rustin you mentioned something on average unit retails. Are you planning on taking initial retails up in spring of next year, like many others are? And I do have a follow-up. Thank you.

Scott Baxter

Great. All right. Well, thanks — thanks Adrienne. I'll go ahead and start. So really proud of the results that we've shown year-to-date. And I think that's a real catalyst as we grow this company. And I'm really proud of how we've pivoted from Horizon 1, standing the company up to Horizon 2, turning ourselves into a growth company. And as you look at all that we've done, I think the thing that's really beneficial for us as we head into 2022 is that that opportunity for us to go to low double digits is a blanket approach.

So all, I mean by that is it's happening everywhere. So it's not just in one specific area, it's in our channels, it's in our geographies, China and Europe, it's in our categories. And you know, we introduced all train gear and work and t-shirts, and they're all working really well. So it gives us really good confidence as we head into 2022.

And yes, it is because we have a really good understanding of our business and we know where it's going to be. So from an order book standpoint, that does give us confidence. And as we think about the denim cycle, very, very early stages. And I've said before, it's much more than the denim cycle. This is a casualization of what's happening around the world. And we are seeing that take hold. I mean, from one part of the globe to the other part of the globe, and it's really exciting to see and denim is a big, big part of that.

But I'll tell you what, what we've done with t-shirts and altering gear and the outdoor category and — and people coming back to work, I think the one thing that as I look at the team, how we've pivoted ourselves to go ahead and play in the categories that are really meaningful going forward as an organization, I think has been very strategic. So thank you.

Adrienne Yih

Great.

Rustin Welton

Yeah, good morning. To your second question about AUR retails, certainly we're in — we're in active negotiations now. So I'm not going to go into specific assumptions as I indicated in the prepared remarks around 2022 cost inflation or pricing assumptions, but I will make a couple of comments. You know, certainly as we think about 2022, you know, we're not immune, as we've said, from inflationary pressures that are out there.

You know, the second half of 2022, we'll see stronger inflationary pressures than — than the first half as you would expect. And then, we're — we're confident given existing conditions that we can offset the COGS inflation through the combination as we talked about of the ongoing KTB specific actions around structural mix shifts, higher AURs and cost efficiencies you've heard us talk about for several quarters as well as strategic pricing. So we'll get into more details on the fourth quarter and specifically around assumptions.

Adrienne Yih

Great. And then Rustin, a really quick housekeeping one, if you will. What percent of — of sales is cotton, as, you know, as raw material? We've been off —

Rustin Welton

— Yeah, we said cotton in the prepared remarks, Adrienne, was — was approximately mid-teens percent of our cost of goods sold.

Adrienne Yih

Okay. Thank you so much. Sorry about that. Great job. Good luck.

Rustin Welton

Yeah. Thanks, Adrienne.

Scott Baxter

Thanks, Adrienne.

Operator

Our next question comes from the line of Bob Drbul with Guggenheim Securities. You may proceed with your question.

Bob Drbul

Hey guys. Good morning. And Scott, congratulations on the — the Chairman title.

Scott Baxter

Oh, thank you, Bob. Appreciate that.

Bob Drbul

I guess, a couple of questions, when you look at the digital acceleration, you know, it was just quite impressive. So when you look at your capabilities in terms of your ability to continue to meet that high demand, do you think that the — the 10% number appears too low when you look at it over a longer period of time, because it just seems like it's really taken off? And then, the second question is, when you look at the returns you're getting on the demand creation, you know, just, how do you think about that longer term, I guess, when you think about 2021 into 2022 as well? Just you know, more thoughts around the — the levels and — and sort of how you're spending that. It seems like you're getting great returns. Thanks.

Scott Baxter

Yeah. Thanks, Bob. I'll take the first one and Rustin and I'll take the second. From a digital standpoint, you know, when we spun, we had a huge opportunity here. And I think it's really a real tribute to the leadership that we've developed within that category for our company, the really great folks that we've hired, the investment that we're making within that, you know, category relative to the fact that it's very accretive, and the fact that a couple of things have all come together for us.

So we have rolled out a new ERP system. So we have new platforms across the globe. We're creating much better products, which is driving higher AUR's in that category with much better demand creation. So people are driving to our sites. And as you can see, 118% up for the quarter in our own.com is all there. But I think your question's great because it's a challenge that I have out to the team that we can do better than 10%.

You know, that's our goal, but we have to do better for our shareholders and we are going to work really hard to do that. And I have a lot of faith in our group that we can do that. But I'll tell you, Bob, we're going to continue to make investments there, too, because we see it as really, really important.

From a demand creation standpoint, you know, it's part of our virtuous cycle of growth, right? When we spun, we knew these brands needed big time investment and we also had to have smart investment, so we hired two exceptional leaders from a marketing standpoint and they've really helped us. And you have heard me talk about these two new, big global campaigns. But we've never done anything like that before and the reception has been from the community amazing.

So as we continue to do that, and as we continue to grow our gross margin, we're creating that oxygen and that fuels to invest back in these brands in a really smart way, which I'm most encouraged about with the team. So really focused on that. And — and Rustin, maybe a few comments about second half.

Rustin Welton

Yeah. Good morning, Bob. So — so to Scott's point, I think, you know, we're seeing those returns Bob, that you mentioned earlier, and that's what's causing us to lean in

and invest, again, an additional \$15 million or \$0.20 into accelerating that digital and demand creation in the fourth quarter. And it's because we're seeing those strong returns from the investments and — and certainly you called it out in the Q3 results.

You know, as you think about sort of getting to the — the guide of \$4.15 to \$4.20, Bob, you know, that's partially offset with — with, again, in our prepared remarks, we talked a little bit about \$0.19 of benefit from below the line items like tax and — and lower interest and year-to-date share purchases. But you know, feel really good about that combined raise in revenue and gross margin guide that's really netting us to that \$4.15 and \$4.20 from an operational perspective. We're just seeing those returns and — and really playing out, and — and so that plays into 2022 as well.

So you know, and just one other point just to call out, Bob, as a reminder, you know, is with this updated guide if we go back to the Investor Day, we talked about a 15% plus operating margin by 2023 with triple-digit expansion in 2021. And as you can see, we remain well on track with our raised full year guide. So — so very confident in the investments we're making. Thanks, Bob.

Operator

Our next question comes to the line of Mauricio Serna with UBS. You may proceed with your question.

Mauricio Serna

Great. Good morning, everyone. And thanks for taking my question. Just a couple of questions. First, on inventory, can you tell us a little bit more about where you stand on inventory? I know you mentioned you are up 4% excluding the digital model changes, but I just want to understand if there's an in transit component there and, you know, just to make sure do you have enough to support growth and what you're — what you're doing in terms of air freight and logistics?

And secondly, the capital allocation optionality, you know, you did also repurchase \$125 million in shares. So how should we think about that, like, going forward in terms of, could that be like a quarterly number or, like, on an annualized basis, could that — could we see like a triple-digit in terms of maybe some dollars of — of — of capital returns to shareholders based on just share repurchases? Thank you.

Rustin Welton

Thanks Mauricio. This is Rustin. I'll start with the first one around inventory and air freight, and Scott can jump in on capital allocation. We will kind of tag team that one. So in terms of your question around inventory, you know, as we indicated in our prepared remarks, we continue to chase demand based on the momentum of the business. And you know, retail inventories remain lean, as everyone knows. You know, we are projecting kind of year-end inventory to increase double-digits year-over-year to support this momentum, not just in the fourth quarter, but obviously heading into the first half of — of 2022.

You know, we do expect, as you — as you think rolling forward here that inventory is going to — going to grow slower than revenue due to those lean retail inventory. So as we're getting product in, we're shipping it out. And then, certainly, we've got some internal initiatives as well around SKU Rad activities, as we talked about a little bit at Investor Day. So we're going to lean into inventory where appropriate, given some of the inflationary pressures and, again, the strong demand signal that we're seeing.

You know, in terms of air freight, I mentioned last quarter and we reflected it in our outlook that — that we were not immune and expected some transitory air freight costs, which you saw, certainly in the third quarter here with 180 basis points headwind from air freight. We — we believe that will continue. You know, we certainly utilize in the third quarter. We'll continue to utilize air freight where possible and appropriate to meet that strong demand.

Believe that elevated air freight is transitory, as we talked about, but likely, Mauricio, to continue into 2022. And maybe just to dimensionalize it a little bit for you, in Q3, our gross margins were 44.1 with 180 basis points of headwind from air freight. And at the midpoint of our outlook we provided here, implied margins are around 43 for the fourth quarter. Again, elevated air freight will continue to be a headwind as we chase that strong demand. So — so certainly aggressively going after the demand signals that we see. Scott, you want to take capital allocation?

Scott Baxter

Thanks, Mauricio for the question. So Mauricio, I just want to remind everybody, if you go back to how quickly we paid down our debt, it's a really proud moment for us as an organization. During a really difficult time, we paid our debt down quickly in Horizon 1, as we said we would, you know, meeting our — our promises. And we talked a lot about, and this — this means a lot, we talked a lot about the optionality. We said, you know, dividend increases, we said share buybacks, we said M&A, we said that we had the optionality to do that after we paid down the debt. And I think what you're seeing right now is you're seeing the execution of that.

So in a very short period of time, this quarter we've increased the dividend 15% superior dividend, which is important to our TSR. And in addition to that, we've started our, you know, stock repurchase program. So we've started doing what we said we would do, and we're generating \$1 billion over this three-year period. So we still have a lot of action — optionality. Just because we've done those two things, we still have a lot more power that we can use going forward, as we see as the best thing to do for our shareholders. Rustin, anything to add?

Rustin Welton

Yeah, I would just sort of say Mauricio that the multifaceted approach that Scott just laid out really speaks to the power of our operating cash flow, that we can pursue a multifaceted optionality concurrently. I think that's really important to take away. You

know, certainly, this quarter we talked about the share repo beginning. Just as a reminder as the guide that we gave this morning raising our guide is all organic. So you should think about any future share repurchases as incremental. So just wanted to highlight those points, but thanks Mauricio for the question.

Operator

Our next question comes from the line of Erinn Murphy with Piper Sandler. You may proceed with your question.

Erinn Murphy

Great, thanks, good morning. And let me add my congratulations. I am personally very pumped about your Yellowstone collaboration as well, so very good job on securing that.

Scott Baxter

— It starts Sunday night, Erinn.

Erinn Murphy

I know, it's on my calendar.

Scott Baxter

All right.

Erinn Murphy

A couple of things for me — for me that hasn't been asked yet, first on China, I'd love it if you could share a little bit more about what you're seeing with the Wrangler business on Tmall now that you're starting to fully annualize that relationship. And then for both brands, how are you positioned into 11/11? And then, secondly, could you just remind us how your consumer was impacted by U.S. stimulus last year? And then, what have you taken into consideration with that low double-digit first half guide for stimulus? Thanks.

Scott Baxter

Sure Erinn, I'll go ahead and take those. This is Scott. So from a China standpoint, you know, we are really — and I talked about this a little bit on my prepared remarks. We're really pleased with how we're interacting with the Chinese consumer right now. That dates back to the fact that we've been in the market since 1995 and have a really loyal following there, in addition to fact that we have really strong leadership throughout that region. So I'm really pleased with that. So the Lee brand continues to do well.

From the Wrangler brand kickoff standpoint, yes, it has been about a year now, coming up on a year, actually. And it continues to meet the targets that we've set for from the standpoint of how we're rolling it out, how the brand is being received. I think the one thing that'll be exciting for us is you're going to see some more demand creation on the Wrangler brand here really soon in China. So that's really exciting.

And then, from a stimulus standpoint, you know, the consumer for us, we play in all markets. So for us, that's really important. We play at the highest market and we play in the mass market. So we have a wide range in consumer. In addition to the fact that we have picked up multiple different programs, which is really important for us and it's broad based.

So it's not just here, it's in Europe, it's in China, and it's not just in our core, but I do want to make mention of that. Our core business is really important to us, it's really strong, we're really pleased, but we're continuing to do more and we're not stopping from a sustainability and innovation standpoint, a demand creation. We're pushing the envelope, hiring great people, gearing up for a really good horizon to turning this into a real growth vehicle going forward. So thanks for the question. Really appreciate it.

Operator

Our next question comes from the line of Brooke Roach with the Goldman Sachs. You may proceed with your question.

Brooke Roach

Hi, good morning and thank you so much for taking our question. Scott and Eric —

Rustin Welton

— Good morning, Brooke —

Brooke Roach

— I was wondering if you could talk a little bit about the recent success of your new distribution wins that you've achieved over the course of the past year. It's great to see how many wins you have seen across partners and channels and sub segments of the brand but I was wondering if you could talk a little bit about how those programs are performing with each of your partners. Are they comping positively as they anniversary the first year? And how important are some of the new realized distribution wins to the strong 1H revenue outlook into 2022? Thank you.

Scott Baxter

Okay, thanks Brooke. This is Scott, I'll take that. Let's start with Lee. So a year ago we kicked off a new program with a major, you know, customer, one of our win with the winner customers, and that has gone really well. The POS has continued to improve. In addition to that, it's gone so well on the consumer take out and the acceptance has been good, we're really pleased with the products, we have won some additional programs on the Lee brand with that customer. So really important to us.

T-shirt category, which we entered and we talked a lot about, is \$100 billion category. It just accessorizes so well with our bottoms, and we've got a couple of really big wins there. We talked about 1700 doors. And again, we're really pleased with the initial take

out and the POS. Workwear is another example of, you know, this year 3300 new doors, a category that's really, really important.

And then, I think about things like outdoor. So you know, a couple of years ago we introduced this line and it has grown significantly. It's really important to our business. It's given us confidence as a company that we can do things outside of our core, and we've got, you know, multiple, multiple points of distribution that are working.

But you know, specific to your question, you know, we're testing right now, for instance here in the U.S. and also in Europe with Intersport and we are testing here with Academy, and both of those tests are going very well and the POS is going very well and the consumer take out is really good. They love the product. So I'm feeling really confident from a new business development standpoint, from a new category standpoint for our team. You know, there's going to be more that we're going to come out with in the future, which is really exciting. But for those specific instances, feel really good about first half relative to that and about what we're building going forward in the future. Thanks, Brooke.

Brooke Roach

Thank you.

Operator

Our next question comes from the line of Sam Poser with Williams Trading. You may proceed with your question.

Sam Poser

Hi, thanks for taking my questions, guys. One, the guidance for the fourth quarter, the implied guides for the fourth quarter, I mean, how should we think about the Lee and Wrangler business? And are you constrained by inventory at all in Q4 from a revenue perspective given it's implying a fairly good deceleration and, you know, just based on what I'm looking at, I mean, it's — it's a fairly good deceleration and it looks like your momentum is a little bit stronger than what you have given us?

Rustin Welton

Yeah, Sam. Good morning. It's Rustin. I'll go ahead and take — take that piece. You know, as we think about the fourth quarter, you know, certainly Scott laid out all of the things that, you know, we're confident — confident about moving into holiday as well as into 2022. You know, we've tried to take into consideration the chasing on the demand and — and the inventory side and — and reflecting that guidance. Didn't split out sort of commentary by brand, but we did talk a little bit about the fourth quarter for Lee, you know, returning to strong growth.

And so we wanted to, on the Lee piece, you know, what we are seeing there is really strong POS that's really pulling from consumers and that's supported by, you know, some increased air freight to meet that demand. You know, Lee tends to be, Sam, a

little bit more of a sourced business than Wrangler and we're seeing strong momentum from a POS perspective. Seeing strong momentum on the digital side as well, and then there's some additional business development wins including a holiday program the Lee piece. So — so that's driving it.

I think the point I would really bring home on the fourth quarter, Sam, because certainly as you recall last year there was a 53rd week, et cetera, is going back to 2019. And if you exclude those actions around VFO and India, you know, the fourth quarter projection is scheduled to be up 3% to 4%. If you exclude those actions, it's 13%. So again it speaks to the momentum of the business and really the investments. And to Scott's point earlier, the broad based support we're seeing across channels, categories, and geographies that's giving us that confidence.

Sam Poser

Okay, thanks. And then, on the — on the — on the SG&A, I mean I'm just sort of backing into — I'm sort of just backing into numbers, but it looks like, I mean, it looks like you're going to spend, you know, over — over, you know, a lot of money on SG&A. And even with the — even before, like on the old numbers, it looked like it was going to be a large number. So I mean, how — is SG&A going to be up, you know, \$35 million, \$45 million from Q3? I mean, is that I should think about it?

Rustin Welton

— Yeah, a couple — a couple things — yeah, a couple things to comment on, as you think about comparisons, Sam, to prior year, you know, particularly Q3, you know, there were some — some COVID related sort of expense reductions given the uncertainty around COVID last year. So — so that distorts the comparison to prior year a little bit. You know, as you think about Q4 and the investments, you know, I'd draw you back to the prepared remarks with the Wrangler and Lee campaigns just now dropping.

So certainly, we want to get out and support those campaigns. We are very excited about it, as you heard us talk about on the call, and the opportunities that are there. And based upon the returns that we've seen, you know, that's what's giving us that confidence that we want to dial up that \$15 million of — of incremental investment into digital and demand creation. And again that's going to be a \$0.20 headwind on EPS, but we think that is the right move for the investment on the brands, not just in 2021 but in 2022 and beyond.

And — and you know, in my prepared remarks, you saw how we're inflecting there, Sam. You know, we're going to be up in advertising, projected to be up an expected 40% compared to last year's numbers, and it's about 100 basis points and 20% over 2019 numbers as well. So again, very pleased with the investments and that's what's giving us the confidence to store and make sure the brands are healthy for the long run.

Operator

Our last question comes the line of Jim Duffy with Stifel. You may proceed with your question.

Peter McGoldrick

Hi, this is Peter McGoldrick on for Jim, good morning. It seems like —

Rustin Welton

— Good morning, Peter.

Peter McGoldrick

Hi guys. It seems like you've got a lot of momentum in the marketing messaging for both brands. Can you provide any insight to demand creation priorities between them? Where — what are the biggest dollar opportunities for investment? And then, looking into 2022, are there any marketing opportunities that might not have been there at the beginning of 2021?

Scott Baxter

Yeah, Peter I will take that. This is Scott. We feel really good about both brands and about the opportunities to invest in both brands. And I think that you heard me talk a little bit earlier about these new global ad campaign that we kicked off in both. And you know, fairly significant for us, Peter, because that hasn't been done in these brands before. And it's something that's going to set us apart. It's also something that, I think, is a springboard for the organization to build upon as we go forward and we think about the power of these brands. We're going to learn a lot from both of those, too, and I think that's really important.

But I think if — if there's anything I want you to take from it, I want you to take from the fact that there's a ton of opportunity left here. Demand creation is a huge opportunity for us. We're going to continue to invest in it, and we're starting to invest at a level that our competition has been investing in for a very long time. And it feels good to get to that point that we need to so that we can go ahead and continue to grow these brands globally.

Much more to come going forward. Really excited about the Georgia May Jagger, Leon Bridges, all the different things and the collaborations with Pendleton that Lee is doing. There's just so many things that we haven't done before, but it's all in the logical sequence that will play out over the next couple of years and our big mobile ad campaigns work exactly where we wanted to put them, when we wanted to put them because we hit our playbook metrics. So thank you, Peter.

Operator

Ladies and gentlemen, we have reached the end of today's question-and-answer session. I would like to turn this call back over to Mr. Scott Baxter for closing remarks.

Scott Baxter



Thanks, everyone. Really, really appreciate the time that you afforded us today. Thanks for being here with us on the journey, and I want to wish all of you a safe, happy holiday season, and we'll look forward to talking to you again next year. So thanks, everybody. Have a great day.

Operator

Thank you for joining us today. This concludes today's conference. You may disconnect your lines at this time.