



Kontoor Brands' Second Quarter 2021 Earnings Conference Call Transcript

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Corporate Participants:

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

Rustin Welton– EVP, Chief Financial Officer, Kontoor Brands

Operator

Greetings, and welcome to Kontoor Brands' Second Quarter 2021 earnings call. At this time, all participants are in listen-only mode. A question-and-answer session will follow the formal presentation. If anyone should require operator assistance during the conference, please press star zero on your telephone keypad. As a reminder, this conference is being recorded.

It is my pleasure to introduce Eric Tracy, Senior Director of Investor Relations. Thank you. You may begin.

Eric Tracy

Thank you, operator, and welcome to Kontoor Brands' Second 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 excluded the impact of restructuring and separation costs, business model changes and other adjustments. Reconciliations of GAAP measures to adjusted amounts can be found in the supplemental financial tables included in today's news release, which is available on our website at kontoorbrands.com. These tables identify and quantify excluded items and provide management's view of why this information is useful to investors.

Unless otherwise noted, amounts referred to on this call will be in constant currency, which exclude the translation impact of changes in foreign currency exchange rates. Constant currency amounts are intended to help investors better understand the underlying operational performance of our business, excluding the impacts of shifts in currency exchange rates over the period.

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

Scott Baxter

Thanks, Eric, and thank you, all, for joining us today. The momentum Kontoor experienced to begin the year continued in the second quarter, with results coming in well above our expectations. Our performance in the quarter once again illustrates the power of the KTB model, which affords us the opportunity to not only deliver on our near-term goals, but also to continue to invest in the strategic growth catalysts outlined at our recent Investor Day. A huge thank you to our colleagues all around the world, and a special call out to the teams engaged in the implementation of our ERP platform during the quarter, as their incredible efforts are helping to transform our organization.

Hopefully, you had a chance to attend our recent Virtual Investor Day, where we communicated our strategic vision for catalyzing growth over the next three years. During Horizon One, we optimized our

model and set the foundation for growth. As we execute on Horizon Two strategies, we expect to leverage investments to drive more sustained, profitable growth. We expect to accelerate revenue, primarily driven by focusing on the following growth catalysts. First, enhancing and accelerating our core U. S. wholesale business; second, elevating our D2C in digital ecosystem; third, expanding the brands internationally, particularly in the China region; and fourth, diversifying our product mix through category extensions, including outdoor, workwear, and T-shirts.

And to support this growth, we continue to invest behind critical TSR accretive enablers including enhancing demand creation platforms, scaling product in manufacturing innovation, with sustainability and ESG as our guiding tenants, unlocking efficiency and productivity gains through the implementation of our global ERP in digital infrastructure, and finally, leveraging our world-class talent to build a purpose-led high performance and increasingly growth-minded culture. And we have increased optionality within our capital allocation strategy, which is reflected in the \$200 million share repurchase program we announced today.

Let me now share some highlights from the second quarter that demonstrate how these investments come to life and how our strategies are working. Overall, reported revenue increased 41% year-over-year, or 37% in constant currency. Rustin will take you through some of the puts and takes in a bit, but I would note that our top-line results exceeded our internal expectations. Most importantly, underlying momentum of the business continued to strengthen, as revenue growth sequentially accelerated from the first quarter, with broad-based performance across our brands, channels and geographies.

In the U.S., despite the timing shifts associated with the ERP implementation somewhat tempering our growth rates, we continue to see improving trends with both brands posting strong growth during the quarter compared to last year. Our brands continue to benefit from the incremental investments we are making within talent, marketing, product innovation, and design, all of which support elevated pricing and products, allowing us to win in our largest channel, U.S. wholesale.

During the second quarter, we continued to elevate our branded demand creation platforms. Influencers, such as Georgia May Jagger not only connect the Wrangler brand with the younger female consumers, but also fuels significant brand heat across distribution channels. Another great example of our enhanced marketing efforts is Wrangler's recently announced collaboration with iconic surf brand Billabong. The Billabong and Wrangler collection launched in late July in anticipation of the back-to-school season with a second fall inspired installment planned for September of 2021. The collection celebrates the best of both brands and is the exciting result achieved when you put a western spin on a vintage surf. We launched with a heavy digital first approach, as well as paid social, influencers and amplified PR. We're estimating over 95 million social media impressions around the launch, and this collab continues to highlight our diversifying distribution with products sold on branded sites and in Billabong stores and other specialty channels.

In that lead, during the second quarter, we launched the collaboration with streetwear brand, The Hundreds. This collab masterfully blends the past with the present to achieve the perfect balance of classic workwear with a streetwear twist across denim, tees, hoodies, and outerwear. The collections are selling exclusively through the brand's digital platforms, as well as The Hundreds LA store. After the successful debut, a second collection is scheduled to drop later this year. And the pipeline of collaborations for both brands is only getting stronger. We look forward to sharing some incredibly exciting fall holiday partnerships with you, in the coming quarters.

From a channel perspective, we continue to see strong returns on our investments in transforming our digital ecosystem, as evidenced by our second quarter performance. Q2 saw great growth over the last year, but was even more impressive compared with 2019, with both global and U. S. own.com increasing more than 80% and digital wholesale increasing more than 100%. As we outlined at our Investor Day, we remain highly under indexed relative to our peers in this accretive channel, and we will continue to distort investments to drive towards our goal of 10% penetration, over the next three years.

We also continue to benefit from investments in new categories, such as outdoor, workwear, and T-shirts with nearly \$150 billion in total addressable markets, these categories represent significant opportunity for the incremental business. The new categories also augment and diversify the collection beyond our core denims bottoms business and do so in a highly organic way. Within outdoor in our ATG line, we've established a brand positioning and value equation that is a true white space in the market, and we are beginning to scale distribution within outdoor specialty in sporting goods channels, both domestically and abroad. As examples, we are excited to announce two great new partners for ATG. We are currently testing with Academy Sports in the U.S. and Intersport in Europe, both brand enhancing incremental points of distribution for the ATG line.

We also have some exciting new sports specialty product introductions on the horizon. This includes our Wrangler Angler line, focused on the rapidly growing fishing market that is expected to launch in the coming quarters. In T-shirts, a \$100 billion plus addressable market. There are three key areas we are aggressively pursuing: logo, lifestyle and licensed Tees. Tees are a natural category extension with a pair of jeans, and we are just getting started in realizing the significant opportunity ahead of us. Leveraging from the strong brand heritage of both Lee and Wrangler brands, we believe there are clear pathways to create great product that will resonate with current loyalists and attract new consumers. We recently won new T-shirt programs with both Wrangler and Lee, with a key domestic retail partner including selling in over 1,700 doors with store expansion to come in '22.

Our workwear business is also experiencing great momentum, with potential for strong expansion in the quarters and years to come. In the specialty and farm channel, we continue to see strong organic growth opportunities for our Wrangler RIGGS product line. These retail segments have shown resiliency throughout the pandemic, and we believe we can continue to scale with new products for men and women, in this tier of distribution. And finally, we expect to significantly increase our recently launched Wrangler workwear program with a major U.S. retailer this year. In fact, we will more than double our door count with this key domestic partner from spring '21 to fall '21, taking us into over 3,300 doors. This is a great testament to how additional investments in category expansion are generating incremental business development opportunities for our brands. We expect growth from our outdoor, work and T-shirt categories to add over \$200 million in revenue for Kontoor, over the next three years.

And finally, let me turn to how our investments in geographic expansion played out in the second quarter. We continued to see improvements, despite an uneven macro environment. Our European business saw significant year-over-year improvements, up over 250% in constant currency compared with 2020, and over 40% in constant currency compared with 2019, driven by digital and timing of shipments ahead of our European ERP go-live. While we expect conditions to remain difficult in Europe, the evolution of our digital platform and new business development programs should help mitigate near-term headwinds and position us for success in the region over the longer term.

And in China, our ongoing strategic investments continue to yield great results with reported second quarter revenue increasing 20% year-over-year, and up 10% in constant currency. Importantly, trends in the region accelerated throughout the quarter, largely dictated by some phasing within wholesale. Digital in the region remained extremely strong, up 33% to last year and 67% to 2019 on a constant currency basis. With a premium lifestyle offering, strong collaborations, and partnerships with key local influencers, the Lee brand continues to build on its leading denim position in the region. And the launch of the Wrangler brand in China continues to gain momentum, exceeding our expectations to date, building momentum throughout the quarter, and setting the foundation for scaled growth over time.

Before I hand it over to Rustin, let me close with a few comments about the balance of 2021. We continue to operate in a very fluid and uncertain environment that includes restrictions in select locations, inflationary pressures, and global supply chain disruptions. And as we have repeatedly said, we are not immune to these macroeconomic challenges. However, as we highlighted at Investor Day, our operating model has been resilient. We believe consumers migrate to trusted, quality, value-oriented brands like Wrangler and Lee in times of uncertainty. And in fact, we continue to see solid momentum across both our brands. Accordingly, we intend to distort and amplify brand enhancing investments in the second half

in areas like demand creation, digital, and international expansion to accelerate momentum in 2022, while leveraging our differentiated global supply chain to chase incremental demand, and mitigate or minimize global disruptions, where possible.

We believe Kontoor resides in a unique position of strength, as our accelerating fundamentals, coupled with increasing optionality of our capital allocation strategy provides a powerful combination that should unlock significant value for our stakeholders. Rustin?

Rustin Welton

Thank you, Scott. And thank you all for joining us on today's call. As Scott mentioned, we are very pleased with our strong second quarter results that exceeded our expectations, and I look forward to walking you through the details shortly. Before we dig into the quarter though, I'd like to briefly recap two key financial strategies that we outlined during our Investor Day. First, we reviewed in detail what we refer to as our "virtuous cycle." Specifically, this refers to our strategy to grow revenue and expand gross margins to create the oxygen in our P&L and allow us to distort investments in our brands and capabilities, to drive future topline growth while delivering enhanced operating margins. Our second quarter is a powerful illustration of how we are continuing to execute on this strategy, to drive meaningful improvement in our fundamentals.

Delivering near-term performance, while investing for long-term growth, is a cornerstone of our financial strategy. Accordingly, I'd like to provide an update on one of our key investment areas, our global ERP and IT infrastructure project. On our first quarter earnings call, we announced that we successfully went live early in the second quarter in our largest region, North America. Today, I'm pleased to announce that we also successfully went live early in the third quarter in Europe, our third and final region. While still early days, particularly for Europe, these implementations represent significant milestones for Kontoor, and I want to thank the organization for their tremendous efforts on these major accomplishments.

These IT investments have both short and long-term implications on our operations and results. In the short-term, our quarterly cadence was affected by timing shifts in shipments in advance of the implementations. As expected, this resulted in net transitory pressure during our second quarter with certain North American shipments shifting into the first quarter, while certain European shipments shifted from the third to the second quarter. Since North America represents roughly 75% of our global business, the net pressure was most pronounced on our second quarter results but is not expected to have an impact on the full year.

In the long-term, the IT investments will enable us to run our operations globally, as opposed to regionally, while delivering the efficiency improvements in phase two cost saves that we have previously outlined. The investments we are making in the business, including technology, support our catalyzing growth strategy to deliver long-term sustainable and profitable growth. Investments will scale thoughtfully throughout Horizon Two in areas such as digital, innovation and demand creation, to support growth in under-penetrated channels, geographies and categories. Based on early proof points, we will continue to look for ways to distort and amplify investments in these TSR creative areas in the quarters ahead.

The second key financial strategy I want to highlight is our enhanced capital allocation optionality. In Horizon One, we focused on two foundational capital allocation priorities, de-levering the balance sheet, and paying a superior dividend. Accordingly, we've made considerable progress in paying down debt to help optimize our capital structure. In terms of the dividend, a superior dividend will continue to be a key element in the Kontoor investment thesis. As we pivot to Horizon Two, we have the ability to add powerful optionality to augment our organic foundational capital allocation elements. Strong fundamental performance has been and will continue to be an increasing component of our mid-teens plus targeted TSR, fueled by the investments we have discussed today.

Over the next three years, we are expecting approximately \$1 billion in cash from operations that will enable us to support a multifaceted capital allocation strategy. Accordingly, as Scott mentioned, and you saw on this morning's release, we announced a \$200 million share repurchase program as a powerful

example of this optionality. In addition to offsetting dilution, we believe share repurchases provide another attractive vehicle to return cash to shareholders, through opportunistic buybacks, pending market conditions. Combined with improving fundamentals and our superior dividend, we remain committed to strong total shareholder returns. We are pleased with how the virtuous cycle within our model is evolving and are excited about the capital allocation optionality materializing in the early days of Horizon Two.

let's turn to our second quarter review.

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

Beginning with revenue, global revenue increased 41% on a reported basis and was up 37% in constant currency, compared to the same quarter last year. Even with the controlled ramp up of our ERP post go-live and timing shift of shipments discussed earlier, we saw topline upside to our internal expectations. Strength in the second quarter revenue was also partially impacted by the strategic actions announced in the fourth quarter of 2020 to rationalize our VF Outlet fleet in the U. S., discontinue the sale of third-party branded products in all domestic outlet stores, and transition to a new licensed business model in India. Combined, these actions represented approximately three points of headwind in the quarter. Compared to adjusted revenue in the second quarter of 2019, global revenue decreased 19% on a reported basis due to these factors, and continued COVID-19 impacts in select markets and channels.

On a regional basis for the quarter, U. S. revenues increased 27% compared to the same quarter last year. Growth was driven by wholesale, new business development wins, and continued strength in our Western Channel. In addition, we drove continued strength in digital. As Scott mentioned, our digital penetration remains under-indexed, and we will continue to amplify investments in this important channel. These investments are yielding strong returns, despite being adversely impacted by our North American ERP cutover activities, U. S. digital wholesale, and U. S. own.com increased 49% and 28% respectively, compared to the same quarter in 2020. U. S. digital wholesale and US own.com increased 106% and 89% respectively, compared to the same quarter in 2019.

International revenues increased 106% on a reported basis and 87% in constant currency, compared to the second quarter of 2020. Growth was broad based across all regions aided by easing lockdowns and timing shifts in Europe, continued growth in China, and strength in our digital businesses.

Turning to our brands, global revenue of our Wrangler brand increased 24% on a reported basis and 22% in constant currency, compared to the same quarter in 2020. Wrangler U. S. revenue increased 14%, driven by strength in our Western business, new product categories such as outdoor and female, as well as digital, with digital wholesale and own.com increasing 82% and 25%, respectively. We are particularly pleased with the strength in our Western business, which continues to carry strong momentum from the first quarter with second quarter revenue up 42%. Wrangler international revenue increased 137% on a reported basis and 115% in constant currency. Digital, new business development wins with our ATG program, as well as easing lockdowns and timing shifts in Europe contributed to the strong growth in the quarter. Compared to adjusted revenue for the same quarter in 2019, global Wrangler revenue decreased 14% on both the reported and constant currency basis.

Lee brand global revenue increased 105% on a reported basis and 96% in constant currency, compared to the second quarter of 2020. Lee U. S. revenue, which was more adversely impacted than Wrangler by retail door closures in the same period in 2020, increased 118%, driven by wholesale, new distribution wins, and our digital businesses, with digital wholesale and own.com increasing 3% and 33%, respectively. Lee international revenue increased 91% on a reported basis, and 73% in constant currency driven by digital. In addition, the quarter benefited from the easing of lock downs on our brick-and-mortar stores and timing shifts due to the ERP go-live in Europe. Compared to adjusted revenue for the same quarter in 2019, global Lee revenue decreased 15% on a reported basis, and 17% on a constant currency basis.

And finally, from a channel perspective, we saw continued broad-based strength compared to the same quarter in 2020. On a reported basis, U.S. wholesale increased 29%, while non-U. S. wholesale grew 100% in constant currency. Global branded D2C increased 48% in constant currency, with own.com up 33% compared to prior year.

Now onto gross margin. Reported gross margin increased 760 basis points to 46.1% of revenue, compared to the same period in the prior year. Favorable channel, customer, and product mix benefited the quarter, as well as strength in the accretive businesses such as Western. We continue to see structural benefits from the fundamental drivers we outlined at our Investor Day, mix shifts to under indexed and highly accretive channels and geographies, proactive supply chain initiatives, and AUR mix supported by innovation and select pricing. As you would expect, given compares, the second quarter also benefited from certain discrete prior year items.

As we discussed during the second quarter last year, gross margin was negatively impacted by COVID-related headwinds, particularly from downtime in our owned manufacturing. In the current quarter, leverage of our owned manufacturing, relative to these 2020 impacts, favorably benefited the second quarter by 370 basis points on an adjusted basis. Given these transitory distortions, I want to provide additional context relative to 2019, which more clearly highlights the progress we have made against our gross margin strategies. Relative to the second quarter of 2019, gross margin increased 750 basis points on a reported basis, or 610 basis points compared to adjusted gross margin, driven primarily by the fundamental factors previously mentioned.

Now on to SG&A. Adjusted SG&A increased \$39 million on a year-over-year basis to \$168 million. Increased demand creation, digital and higher volume related variable expenses were partially offset by better fixed cost leverage on improving revenue and lower bad debt expense than in the prior year. Adjusted earnings per share was \$0.70 compared to a \$0.22 loss in the same period in the prior year and compared to \$0.96 in the second quarter of 2019.

Now turning to our balance sheet. Second quarter inventories decreased \$30 million dollars versus the prior year to \$403 million, or down 7%. The year-over-year 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 VF Outlet in India, inventory increased approximately 4% compared to the prior year, in support of higher projected demand. We made \$25 million in debt repayments in the quarter and finished the second quarter with net debt or long-term debt, less cash, of \$615 million and \$176 million in cash. Our net leverage ratio or net debt divided by trailing 12-month adjusted EBITDA, at the end of the second quarter, was 1.5 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 \$0.40 per share, payable on September 20th, 2021, to shareholders of record at the close of business on September 10th, 2021.

And now on to our outlook. As Scott mentioned earlier, we are not immune to macroeconomic challenges, including recent global supply chain issues experienced in most all industries. However, we believe our diversified global supply chain offers a distinct competitive advantage in scale and speed, and we remain focused on being agile and responsive while working to mitigate disruptions. Our brands have momentum and are winning in the market, and we intend to continue amplifying investments in the back half to support topline growth in 2021 and 2022. To best position for the accelerating demand we see, we anticipate select, elevated, transitory costs such as freight in the back half of 2021. These transitory costs have been contemplated in our increased gross margin guidance.

Based on the strength of the second quarter and momentum of and demand for our brands, we are raising our fiscal 2021 outlook for revenue, gross margin and adjusted EPS. Revenue is now expected to increase in the mid-teens range over 2020 to \$2.39 billion to \$2.42 billion as compared to a low teens

range in the prior guidance, including a mid-single digit impact from the VF Outlet actions in India business model changes. Gross margin is now expected to increase by 330 to 380 basis points to 44.5% to 45%, as compared to 230 to 270 basis points in the prior guidance. The increase reflects higher anticipated structural growth in more accretive channels such as digital and international.

SG&A investments will continue to be made in our brands and capabilities. Due to the strengthening revenue and gross margin outlook, we expect to amplify SG&A investments in demand creation, digital and international expansion to support second half 2021 revenue and accelerate momentum for 2022. These increases will be partially mitigated by ongoing tight expense controls, and sustained structural, post-pandemic cost containment initiatives. Adjusted EPS is now expected to be in the range of \$3.90 to \$4 per share, as compared to \$3.70 to \$3.80 per share in the prior guidance. This EPS guidance does not assume the benefit of any share repurchases.

Before closing, I think it is important to consider our updated fiscal 2021 outlook in context of our historical results and our Investor Day projections. Relative to 2019, our updated fiscal 2021 outlook, at the midpoint of our ranges, imply revenue is projected to be at or slightly higher than adjusted 2019 revenue levels, excluding the mid-single digit impact from VF Outlet in India. Gross margin is projected to be up nearly 400 basis points compared to adjusted gross margin in 2019 and adjusted earnings per share is projected to be above 2019 levels, even with amplified investments in SG&A. Finally, our updated fiscal 2021 outlook puts us well on track, if not ahead of plan to deliver on our three-year financial targets outlined at our recent Investor Day.

In closing, I would like to reiterate Scott's earlier remarks. We are very confident in our team and business and are pleased as we enter the second half of 2021 with great momentum. This concludes our prepared remarks, and I will now turn the call back to our operator. Operator?

QUESTION AND ANSWER

Operator

Thank you. We will now be conducting a question-and-answer session. If you would like to ask a question, please press star one on your telephone keypad. A confirmation tone will indicate your line is in the question queue. You may press star two if you would like to remove your question from the queue. For participants using speaker equipment, it may be necessary to pick up your handset before pressing the star keys. One moment please while we poll for your questions. Our first questions come from the line of Jay Sole, with UBS. Please proceed with your questions.

Jay Sole

Great, thank you so much. You just obviously raised the guidance today, and the tone and some of the things you mentioned sounds like you have confidence in that raised guidance, but can you just talk us through a little bit more and maybe elaborate on what's giving you confidence to be able to raise the guidance today, and looking forward why you might be ahead of your Investor Day plan?

Scott Baxter

Hey, Jay, how are you? It is Scott. Good morning. Thanks for the question. Jay, when we look at it, it all goes back to our strategy from the very beginning on how we started this and the amplification of the brands. We knew--and the reason we wanted to spend is we had such a great opportunity ahead of us. And these brands were super powerful, but they hadn't been invested in. Well, now we're starting to see with this incredible investment that we're making supported by some really strong demand creation programs, my hats off to our global demand creation teams, and we're starting to see the brands really come to life.

What I'm most pleased with is how we're communicating with the consumers around the globe, and how that's a two-way communication that's really taking root. And we think there's a lot more there, as far as the future. There are some uncontrollables in the background, but you saw how well we handled that during the pandemic, which I thought was really important. We've got an incredible playbook. And we're

really happy about what's happening here. Going forward, we've got some visibility in the future from a business development standpoint, from a category extension standpoint, and geography. So, that's all reflected in our guidance. But just to sum it up is, we wanted to take this company public, because we knew we really had something special in these brands and that's starting to come to life as we play out our strategy.

Jay Sole

Understood. Maybe if I can ask one more, just on that point. You mentioned the virtuous cycle of growth and the company seems to be funding a lot of that demand creation, Scott, that you mentioned, with the strong gross margin gains. It sounds like you're talking about the topline could really accelerate, the topline growth rate, I mean, could accelerate over the long-term, and even in the second half a year. Is that fair? And maybe just can you connect the dots for us on how these demand creation investments are really going to--whether it's category expansion or new business wins, like, how that's really going to drive the top line to appropriate above maybe what we've seen in the past?

Rustin Welton

Yeah, good morning, Jay. It is Rustin, I'll go ahead and take that. Yeah, you absolutely are correct on the virtuous cycle. It's something we talk about quite a bit. Our strategy really is to start to grow that topline revenue, which you've seen us do over the last several quarters, and expand gross margins to create that oxygen in the P&L. And so, you've seen some pretty significant gross margin gains as well, with some of the efforts we've taken to obviously distort and accelerate growth in a more accretive channels, quality of sales, restructuring actions, and that's creating that oxygen in the P&L that's really allowing us to distort investments in the brands and capabilities that Scott talked about earlier, to drive that future topline growth while delivering the enhanced operating margins. And I think that's really important. You've heard us talk a lot about earning our way to investing into these brands and we're clearly doing that, and you're seeing the investment start to manifest. And I think this quarter's results are a great illustration of kind of how that virtuous cycle comes to life.

Operator

Thank you. Our next questions come from the line of Erinn Murphy, with Piper Sandler. Please proceed with your questions.

Erinn Murphy

Great, thanks. Good morning. I was hoping you could speak a little bit more about the shelf space games that you're securing across a number of new categories and retailers, and if you could talk about the phasing of some of these new programs? And then a follow-up for Rustin, I guess relatedly, why would that not imply a better than a 2% back half sales guide? I mean, by running the math, if we're at mid-teens, it feels like the back half is around 2%. So, just curious with some of the selling (PH), why that would not be higher?

Scott Baxter

Good morning, Erinn. I'll go ahead and start. Yeah, we're really pleased, Erinn. One of the things is the brands hadn't had a chance to go ahead and really flex what they can do, and the consumer has really shown us a really big opportunity for us to go ahead into different categories and channels. And one of the things that we did is, from the very beginning, we identified several categories: outdoor, workwear and T-shirts, that are really fundamental to what we do.

And we have seen that as we've gone ahead and built--and this is a great complement to our teams, built incredible product at a really great value with a trusted brand and brought those to these different categories that we've seen really good acceptance, and we've seen really good shelf space, as you mentioned, acceptance. And that has been translating for a while, as we've talked about in several of our last calls. But now it's really starting to take hold. And we talked about outdoor in our last couple of calls with some big programs internationally and domestically, and now we're just layering on with some really key customers like Academy here, at Intersport in Europe. And workwear was a big topic as Investor Day, really important for us from a category standpoint, and we had a customer that was going to come in with

almost 2,000 doors. And because the program is so good, the product is so good, and it's such a great value, they're going to come in at 3,300 doors in the fall. So another great example of how we're phasing that in.

And then we've talked a little bit from a T-shirt standpoint, a big \$100 billion dollar category, which complements our bottoms denims business really well for both genders globally, a category we should be stronger in. We've hired a really good team there. We're really excited about that, and we're going to address that several different categories and areas within T-shirts. And we've won a couple of big programs here recently, which we're really pleased about, 1,700 plus doors that will happen both in fall and spring. So, as you can see, a lot of concentrated efforts into these categories that we hadn't been in before, but are really complimentary to what we do, as a company.

Rustin Welton

Hey, Erinn. Good morning. It is Rustin. I'll take the second part of your question about the sales improvement in the back half. You're correct in terms of when you look at the guide that we issued this morning, it implies a low-single digit back half improvement relative to 2020. But I also want to highlight you have to take into consideration as well the strategic exits that we made in the fourth quarter of 2020, specifically to reduce the VFO fleet in half, discontinue the sale of third-party branded goods in all of our domestic outlets, and then transition the India business from direct to a licensed model. All of those are weighted disproportionately, a little bit more towards the back half, because, clearly, Q2 was most impacted last year, as it related to COVID. And so, you need to take that into consideration at mid-single digit annual impact from those strategic exits as well, a little bit more weighted on that back half. Hopefully that helps answer your question.

Operator

Thank you. Our next questions comes from the line of Adrienne Yih, with Barclays. Please proceed with your questions.

Adrienne Yih

Good morning, everybody and congratulations, great quarter. Scott, so I always like to ask you about sort of high-level trends. Levi's recent success with their denim offering, the strength this morning, I know it's not exactly your price point, but buckle reporting kind of blowout numbers over '19. And so, how are you seeing back-to-school denim shaping up? And then how do you foresee it, as we go into kind of the back half the year? More importantly, how long can that trend last?

And then for Rustin, really want to focus on, you talked about modest inflation, maybe hitting the AUC, but then the gross margins are so robust that it seems like either you're just--your supply chain's working for you, so any commentary on how you're going to manage that. And then remind us that the Far East really is not impactful to you, in terms of sourcing. Thank you so much.

Scott Baxter

I'll go ahead and start, Adrienne. Good morning. Nice to hear from you.

Adrienne Yih

Good morning.

Scott Baxter

So couple things, let's start with back-to-school. I have a school-aged child at home, and we haven't bought school clothes for him for two years, he's 40 pounds heavier than previously. There's no way he can fit into his school clothes from two years ago. In addition to the fact that styles and trends have changed in those two years. So, we think there's really some pent-up demand because kids just aren't going to want to go back to the clothes they were in, and they aren't going to fit those in. And there was no back-to-school season at all last year. So, we believe that's going to be really good for both us, the industry, and also our consumers and our customers. So that'll be a good moment in time for us all, as we return to normal.

As far as denim goes, you've seen our survey that we put out a little while ago. And we think that there is a positive, just structural change sweeping the globe in the casualization, and we've seen it in all the major metropolitan markets across the globe, whether it be London, Paris, New York City, San Francisco, people are moving to casualization as the worker comes back into the office, even if it is a flex environment, it doesn't matter, they're wanting to be casual, like they were at home. So, they're reinvesting in a casual wardrobe, which I don't believe is cyclical, I believe it's here to stay for the long-term, going forward.

And then I would also complement that with, we like where we are and where we're positioned as a company, because if you think about the evolution of our strategy, and we've only been around now, as a public company, for a shade over two years, we've been able to go ahead and build these great categories like outdoor, workwear and T-shirts that are very complimentary, that we believe are at the very beginning stages of being powerful categories for us, as a company, over the very long-term. So, as I think about the future, I think about denim, I think about the categories that we've entered, and the opportunities that we have in front of us. I'm really, really excited.

Adrienne Yih

Excellent.

Rustin Welton

And Adrienne, it is Rustin. Good morning. I'll go ahead and take the second part of your question. First, let me touch upon kind of the last bullet that you mentioned, which was kind of Far East sourcing. So just as a reminder for everyone, our supply chain, our global diversified supply chain, we really feel is differentiated for us and does offer a competitive advantage, with a little over a-third of our global production internally manufactured in this hemisphere and approximately two-thirds that are sourced out of overseas, predominantly out of Asia. As we think a little bit about the second half gross margin to your question, we've clearly have focused on gross margin expansion. It's an important part of that virtuous cycle that you heard me speak about a minute ago with Jay, just really creating that oxygen to be able to invest back into our brands.

And over the last four quarters, you've seen triple-digit growth from us and that expansion and really on a fundamental structural basis, being driven by that distorted growth in those accretive channels, the geographies and categories we've talked about, as well as pursuing quality of sales and restructuring actions. And we anticipate those structural benefits will continue into the back half of 2021 and beyond. However, we do anticipate, they will be moderated in part by some of the elevated transitory cost to chase some of the incremental demand that Scott talked about, and we talked about earlier.

Certainly, the global supply chain disruption is well chronicled, and as we've stated today and previously, we're not immune from that, but we are certainly pursuing the demand and the momentum that we've got behind our brands, and our second half gross margin outlook has taken those factors into consideration.

Your last point was really, about inflation and, as we think about moving forward next year, we mentioned a little bit at Investor Day that we anticipated that 2022 and 2023 gross margin improvement to be modestly more weighted towards 2023, as some of these growth catalysts that we're investing in, like digital and international opportunities really scale. And so, we're really proud about the guidance, I mean sorry, the gross margin we're delivering this year. And we'll just draw you to sort of the conclusion in my remarks that the gross margin in our outlook here is projected to be up nearly 400 basis points, compared to adjusted gross margin in 2019. So, clearly a focal point for us and will remain so going forward. Thanks, Adrienne.

Operator

Thank you. Our next questions come from the line of Bob Drbul, with Guggenheim Securities, please proceed with your questions.

Bob Drbul

Hey, guys. Good morning. Congratulations on the nice work.

Scott Baxter

Thanks, Bob.

Bob Drbul

I guess I had two questions. The first one is, with the announcement of the share repurchase program, does that imply just in the near-term that M&A is off the table? You talked a little bit about your capital allocation. Just wondering, if you can maybe address that, as you think about Horizon One into Horizon Two. And then I think the second question I have, I'm not sure if you gave it, Rustin, but some of the buckets in this gross margin expansion, I don't know if you could sort of break it down a little bit more, just around where you see? How it delivered in the second quarter, but also when you look at this outlook, for the rest of the year, the biggest buckets, etc., will be helpful. Thanks.

Scott Baxter

Hi, Bob. It is Scott. Good morning. Thanks for the questions. From the share repo standpoint, I think it all boils down to, as we talked about in the Investor Day, we're creating a billion dollars in cash over the next three years. So, as we've talked about, from an optionality standpoint, and as we phased into Horizon Two, like we've talked about, it's really about optionality. And we think it's all an "And" (PH) equation and that we can do multiple things. So, we're really happy about the share buyback. We think that's just a component of our allocation here, as we go forward. It's part of our options. And everything is still on the table and will be, as we move forward and we'll continue to update the team and everybody going forward, so we feel real good.

Rustin Welton

Good morning, Bob. I'll take the second part on the gross margin in the second quarter. And you've certainly seen this trend continue for the last several quarters, as I've talked about. This was our fourth consecutive quarter with triple-digit margin improvement; has been a focal point for us, certainly focusing on those structural drivers, really being favorable channel mix, geographic and product mix. Those are kind of the largest drivers, I would say, Bob, of that. And certainly, as we're continuing to invest in these under-indexed categories and geographies, as we've talked about, we see that continuing.

Certainly, Q2 did benefit from some discrete items such as the downtime. You'll recall last year, we modified our production in our own facilities to account for the COVID impact last year. So, roughly half of that improvement in the second quarter relative to last year was kind of due to discrete items last year. But certainly the gross margin expansion remains a focal point for us. It's critical. And this enables us to invest back into the brands, as you've heard me mentioned multiple times this morning. So really, really happy with the delivery on Q2, it allowed us to exceed our expectations in the quarter.

Operator

Thank you. Our next questions come from the line of Sam Poser, with Williams Trading. Please proceed with your questions.

Sam Poser

Good morning. Thank you for taking my questions. And just I want to follow up on the marketing spend, I guess, and the gross margin, but really, in the quarter, did you spend more in your demand creation investments than you anticipated, or did you get a better return? Can you measure the return on those investments? And then in the guidance of the increased investments in the back half of the year, what kind of return are you expecting on that?

Rustin Welton

Yeah. Sam, good morning. It's Rustin. I'll go ahead and take that. Certainly, I won't talk to the marketing spend in the quarter but make it a little bit more general comments for you. Certainly, you know Sam, with all the engagements we've had, we're a total shareholder return driven organization. And as we look at investment, Scott and I, that we can make into the brands and into the business and capabilities, we measure everything that we do, on a TSR return basis, on both the near-term and a long-term perspective. So, certainly, we've been distorting investments into things like digital, from a marketing perspective. And I think you certainly saw the results of that play out this quarter.

We talked a little bit about the growth in the quarter, but on a two-year stack basis, both digital wholesale and our own.com, very impressive results relative to 2019. So we're very happy about the investments that we're making. And now that we're live on the ERP side, in both North America and Europe, certainly an opportunity we see to distort and amplify those investments in the back half here that not only helps deliver the back half of '21, Sam, but really accelerates the momentum moving into 2022, which is really important for us.

Sam Poser

No, I do understand that. I'm looking really for--it sounds like based on your guidance that you're going to probably de-lever your SG&A in the back half of the year, and you got good leverage on the front half of the year. And that's telling me that just sort of automatically some of those investments on a relative basis, just won't give you the kind of same return. So I'm really trying to figure out how much of the beat in Q2 was better return on those investments? And are you sort of guiding it the same way you've guided Q2, relative to those investments upfront? I'm saying, because you guide the year and then do better. Because it sounds to me like you're getting a better sort of near-term result, than you may have put into the numbers, despite the fact it's helping the long-term and it was intended to help the long-term.

Rustin Welton

Yeah, and Sam, I would just say that we measure the returns on both in near-term and the long-term basis. And clearly, as we distort investments, on the marketing side, specifically, we are looking more to accelerate the brands and the strength that they're demonstrating in this quarter, to continue to accelerate in future quarters. So, it's not just the next quarter, we're looking for the longer-term as well. And obviously, as you've seen, the investments that we're making in the brands certainly have been paying off in terms of the topline growth.

Operator

Thank you. Our next question comes from the line of Brooke Roach, with Goldman Sachs. Please proceed with your questions.

Brooke Roach

Thank you. Good morning, and thanks for taking our question. Scott, Rustin, owned digital continues to deliver momentum. Can you talk to the areas where you're seeing the most success? Whether that's within a particular customer segment, conversion or new customer acquisition?

Scott Baxter

Yeah, certainly can. So, Brooke, I think we have to start at the beginning of the journey. We were so under-indexed in digital. And it wasn't just from the standpoint of physical, we've now brought ourselves up to speed from an ERP standpoint, put in the right platforms around the globe, that's at an infancy stage then when we started with the company, we went ahead and had to hire the right teams and we've started to do that in a pretty robust way, we hired the right leader. And then, we had to start thinking about how we communicate in a powerful way with our consumers, and we started to do that with some really good programs. And then we started to build better product into different categories, like we've talked about today to make our site more robust and more exciting from a content standpoint, for that consumer to come into and join the journey with us going forward.

So at the beginning of that journey, we saw some really good core momentum, from the standpoint the core really did well. But what's happened as that journey has kind of expanded and we've gone into other

categories, we've seen really good gender momentum across the globe, both male and female, and we've seen really good category momentum. So what I mean by that is, our outdoor line, for instance, has done really well. And then, there's one other thing that I think is really interesting, our consumer is now starting to come to us because, one, they like the story, and they like what they're seeing and hearing, and they're very pleased with the product. But in addition to that, we've done some really incredible collabs. And those collabs are highlighted on our digital presence, too.

So if you think about our big Wrangler/Billabong collab that we have going on right now, as we head into back-to-school, that's done really well. And if you think about Lee and our Hundreds collab and some of the things that they've done recently, those have done really well.

So combining all of those assets together and being at the very early stages and building better products in expanding categories, we really like how the consumer is communicating with us going forward in our digital space.

Rustin, would you add anything there?

Rustin Welton

Yeah, I think you said it well, Scott. The only thing I would add, Brooke, as well, is that we've continued to make investments in our capabilities. And so, certainly we're under indexed, we're at about 5% of revenue. Now we see that opportunity, as we laid out at Investor Day moving to 10% penetration. And all the areas, Scott mentioned, in terms of product and consumer, very, very relevant. We've also made investments on the technology side, as you well know, going on to new platforms in 2020, in both North America and Europe, and I think you're starting to see those results manifest in our P&L here. So lots of early days, lots of momentum, and lots of opportunities still to go, Brooke.

Brooke Roach

Great. Thanks. And as if I could just ask one quick follow-up. Can you talk a little bit about what you're seeing across your key U. S. wholesale partners, maybe both in terms of program momentum at recently launched new initiatives or new business versus some of your legacy partners with more established programs such as Western versus department store, or off-mall department store versus mass? Thank you.

Scott Baxter

Thanks, Brooke. I'll go ahead and take that. Yeah, we were--like we mentioned in our pre-prepared remarks, we are really pleased with all the programs that we're launching across the board. I think it goes back to we win with winners; we've talked about that a lot. We are really pleased with how we've placed ourselves in that line of communication and with the big customers that we have across the globe. And it's been all part of the strategy from Horizon One, win with winners, and go forward, build great products that the consumer loves, the takeout will be there and continue to drive that with really good demand creation platforms. So from a strategic standpoint, we are really running our playbook and we're pleased with it right now.

Operator

Thank you. Our next questions come from the line of Jim Duffy, with Stifel. Please proceed with your questions. Thank you.

Jim Duffy

Thank you. Good morning, guys. Great execution.

Scott Baxter

Good morning, Jim.

Jim Duffy

Congratulations on getting the ERP implementation through. Rustin, I want to build on others' questions on the gross margins. Sorry to do so, but just working through the annual guidance, it looks like it implies

roughly a 44% gross margin for the back half of the year. That's more than 200 basis points below the run rate in the first half of the year. Can you just, maybe, itemize some of the factors that would cause it to be such a big step down? And you mentioned pricing in your prepared remarks. I'm curious if you could speak to the balance between pricing and input costs inflation, and how we should think about pricing, as a tool to leverage brand vitality and manage the margins?

Rustin Welton

Yeah, so let me go ahead and start here, Jim, on the gross margin side. Absolutely, you are correct, it implies kind of our guide of 43%, 44% gross margin in the back half, and a couple things that I would highlight. Certainly, our first half was around 46. That was definitely a high watermark for us in the back half of last year, we were more around the 43 range. So, certainly continuing to strengthen and improve there. A couple of things, as we're thinking about the back half, we mentioned in our prepared remarks and a couple times here, some of the global supply chain disruptions and the fact that we're seeing increased demand. And so, from our standpoint we do see elevated transitory costs in the second half to meet some of that demand, and we've certainly reflected that in the gross margin outlook for the second half of the year.

Also, as Scott mentioned, and you've heard us talk numerous times, still a lot of uncertainty out there in the marketplace and very, very fluid. So, we certainly have taken that into consideration, as we've got good gross margin here in the back as well. So I'll flip it over to Scott. And, Scott, if you want to take the second part of that with the question around inflation and pricing that'd be great.

Scott Baxter

Thanks, Jim. Jim, good to hear from you. Jim, we're being real strategic with our pricing as we go forward. We're investing in the brands, as you know, and we're also investing and we haven't talked a lot about it on this call, but from an innovation standpoint, pretty significantly to go ahead and keep our brands first and foremost in front of the consumer's mind. So, we really like where we are. One of the things that we've talked about that I think is really important for our brands is that we offer incredible value already. So, we have trusted brands, and in times like this, Jim, being a value brands with a great brand behind it, being a value play with a great brand behind it, with high, high quality, and innovating and coming into different channels only helps us going forward. So, that's the investment that we're making to go forward, and make sure that we're putting ourselves, our brands, and our company in a really good place.

CONCLUSION

Operator

Thank you. There are no further questions at this time. I would like to turn the call back over to Scott Baxter, for any closing comments.

Scott Baxter

Just a quick thank you to everybody for taking the time to spend with us today. It's much appreciated. I'll look forward to spending time with you all here sometime in the next month or two, and then, obviously, look forward to talking to you again in the next quarter. But thanks again for your time this morning. Have a great day everybody.

Operator

Thank you for your participation. This does conclude today's teleconference. You may disconnect your lines at this time. Have a great day.