

**Kontoor Brands**  
**Third Quarter 2022 Earnings**  
**November 3, 2022**

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**Presenters**

**Eric Tracy – VP, Corporate Finance and IR**

**Scott Baxter –President, CEO & Chair of the Board**

**Rustin Welton – EVP, Chief Financial Officer**

**Q&A Participants**

**Bob Drbul – Guggenheim Securities**

**Mauricio Serna – UBS**

**Will Gaertner – Wells Fargo**

**Brooke Roach – Goldman Sachs**

**Paul Kearney – Barclays**

**Operator**

Greeting and welcome to the Kontoor Brands' Third Quarter 2022 Earnings Call. At this time all participants are in a 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.

I would now like to turn the call over to Eric Tracy, Vice President of Corporate Finance and Investor Relations. Thank you. You may begin.

**Eric Tracy**

Thank you, operator and welcome to Kontoor Brands' Third Quarter 2022 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.

Select comparisons to 2021 results will be on an adjusted dollar basis, and in certain cases, we will make comparisons to 2019 adjusted results, which we clearly defined in the news release that was issued earlier this morning and is available at our website at [kontoorbrands.com](http://kontoorbrands.com).

Reconciliations of GAAP measures to adjusted amounts can be found in the supplemental financial tables included in today's news release. These tables identify and quantify excluded items and provide management's view of why this information is useful to investors. Comparisons will be in constant currency, unless otherwise stated.

Joining me on today's call are Kontoor Brands' President, Chief Executive Officer and Chair, Scott Baxter, and Chief Financial Officer, Rustin Welton. We anticipate this call will last about an hour. Scott?

**Scott Baxter**

Thanks, Eric, and thanks for joining us today. We continue to operate in unprecedented times, so it's really important for me to start my comments today by thanking our Kontoor teams around the world. I'm so grateful to partner with them each and every day and proud of how our colleagues remain agile, resilient, and execute on our strategies even in the face of ongoing macroeconomic challenges.

We have a lot to cover, so let's get to it. There are three primary topics I want to address. First, as I know it is on everyone's mind, I'd like to offer some thoughts on the macro environment from our perspective, specifically acknowledging four key factors that are having the biggest near-term impact on our business at Kontoor. Second, I'll take you through key highlights from our third quarter and provide some select proof points of how our strategic investments and brand enhancement initiatives are paying off. And finally, I'll touch on our outlook, including what we are doing to address the implications of the broader trends and how our strategies will continue to help improve the model going forward.

I started my comments on the second quarter call with a sobering description of the macro backdrop, and we continued to see a dynamic landscape during the third quarter. As I said, we think about four areas that are impacting us in varying degrees.

Clearly, the first challenge we are seeing is the impact of inflation on underlying consumer demand in input costs. In the US, consumers are experiencing inflation levels that haven't been seen in nearly half a century, with elevated prices on everything from food, to housing, to apparel, and in Europe, consumers are facing similar inflationary pressures including severe energy crisis as we begin to move into the winter months. The second factor is the ongoing lockdowns in China. The zero COVID policy has weighed on consumer traffic in the world's second largest economy, and candidly, the pace of reopening has been slower than we've expected.

Third, while we anticipated significant inventory rebalancing across US retailers would inversely impact shipments as open to buy dollars were restricted, this dynamic had a bit more of an impact on our third quarter revenue in subsequent inventory build. Finally, the global supply chain challenges that have plagued the industry for the last year plus have begun to show signs of moderating from historic highs. Specifically, we have seen lead times from Asia moving closer to pre-pandemic levels, and ocean freight, while still well above historic levels, has begun to moderate.

As we've stated consistently, Kontoor is not immune to these factors, and we attempt to accurately reflect these impacts into our outlook, which I will cover in a bit. But I also know our

company is better positioned than we have ever been to continue to drive competitive separation, and I am extremely proud of the organization's overall ability to once again deliver profitability and earnings above our internal expectations while also positioning the company for more sustained, profitable long-term growth.

So let me now turn to addressing some of the key takeaways from our third quarter results. We anticipated third quarter revenue, particularly within our US wholesale business, would be challenged by reduced shipments at key retail partners as they aggressively rebalanced their inventory positioning. And this played out, as I said, a bit more than we planned with overall revenue down 5% in constant currency as US wholesale declined 9%.

However, we believe it is important to note that, while selling for traditional product was impacted by lower overall retailer opened by dollars, our Wrangler and Lee brands once again were able to outpace the market, expanding share, POS and AURs during the quarter. Further, when compared to the pre-pandemic levels, US revenue year-to-date has increased 7% versus 2019.

And beyond core product, we once again experience broad-based strength across categories including outdoor, workwear and t-shirts collectively up 9% in the quarter. This category expansion has been and will continue to be a critical piece of our growth strategy. Authentic brand extensions into areas such as outdoor, workwear and tees afford us meaningful white space opportunities in large growing addressable markets representing nearly \$150 billion in aggregate, while also diversifying our product portfolio beyond denim bottoms.

These new categories also provide permission to play in new channels of distribution. When combined with elevated product design and enhanced demand creation, the Lee and Wrangler brands are increasingly showing up in premium specialty, western, sporting goods and outdoor specialty, further diversifying from the core distribution. And as we drive closer connections with our consumers, there's no more important channel than the continued evolution of our own D2C in digital platforms.

As you all know, we remain in the early days here, well below our competition in terms of penetration. Within digital, our globalown.com increased 14% over '21 and 111% over 2019 while our USown.com experienced mid-teens year-over-year growth in the quarter, great proof points that our investments including digital demand creation in this highly accretive growth channel are paying off.

And within our brick and mortar stores, we have some exciting developments to share. First, in Europe, we recently opened a dual Lee Wrangler branded premium retail concept in Berlin with plans to opportunistically roll out the format in select markets across the European region. The expertly crafted retail destinations will offer consumers a unique immersive experience with products from both brands. The stores will maintain separate frontages for each brand, unified by a design concept that underscores the brands' combined 200-plus years of denim expertise.

I actually just spent time with the team in Europe last week, including a trip to Antwerp and my first visit to our new AMEA headquarters in Geneva. It was fantastic to see folks in our new environment, and I was able to commend them on their really storm quarter as Europe revenue increased 27% year-over-year. But we also spent a great deal of time on the go-forward strategy, understanding that the near term will be confronted by the inflationary pressures I discussed earlier. I have no doubt that our teams will come together to support one another through these challenging times while positioning our great brands for long-term success.

Within our APAC region, we knew the ongoing lockdowns in China will continue to challenge results. We did see sequential improvement from Q2 in China with third quarter revenue down 20%. In areas that have reopened, we have seen really great performance. So while we continue to be cautious with respect to reopening in the region, we continue to build on momentum when conditions normalize, and the long-term opportunities remain significant.

Similar to Europe, our APAC team is pushing forward despite the near-term backdrop to strategically enhance the global KTB model. This includes the recent launch of our retail excellence initiative of program aimed at transforming Kontoor Asia into a world-class retailer. A reformatted store footprint, improved POS technologies and enhanced product assortments will amplify the consumer experience.

Based on the success of early testing, we are rolling out the retail excellence initiative across the region now, and over the next 12 to 18 months, we will look to do so globally. The opportunities to leverage our learnings in Asia as we more fully develop our brick and mortar strategy globally are tremendous. More to come on this in the coming quarters.

These retail developments in Europe and Asia will be critical as we seek to navigate the respective challenges in each market while also continuing to build our globalized platform, and these opportunities for growth across categories, channels and geographies don't happen without the significant investments we continue to make in brand building. Some of you were able to join us during Fashion Week as our Lee and Wrangler brands took over lower Manhattan and Brooklyn for a night and were able to see how these investments in product design, innovation and demand creation come to life as our teams collaborate with iconic leaders such as photographer Mark Seliger and brand ambassador and Grammy Award winner, Leon Bridges.

The Lee brand is thrilled to once again partner with the preeminent creative Director Seliger in launching our second global brand equity campaign, Lee Originals, inspired by those who don't just stand the test of time but define it. The campaign highlights the new Sam Tinnesz song aptly entitled New Wave, Lee's celebration of individuals who approach small and big moments of their lives with one part boldness, two parts optimism.

From the new Lee Originals campaign to sponsoring this year's Bonnaroo Festival to the innovative X-line collaboration with Seven Up in China or Brooklyn Circus here in the US, the Lee brand continues to embark on amplified demand creation efforts in support of its enhanced global brand repositioning.

And similar to Lee, the Wrangler brand continued to drive greater connection with consumers during Q3 in its 75th anniversary, using creative brand activation events, unique collabs and authentic brand partnerships to extend its reach to younger, more diverse consumers.

In addition to the launch of the Leon Bridges collection I mentioned earlier, Wrangler continues to build world class partnerships with cultural influencers and iconic brands. Importantly, these partnerships are highly authentic to the brand's Western ethos. While organically taking the brand to new heights, collabs such as our college program with Coliseum, brings the Wrangler brand to university ambassadors all across the South and Midwest. Teaming up with the iconic Gant brand, we were able to bring our cowboy culture to fashion forward signature pieces while staying true to our roots. Anecdotally, during my trip to Europe, I saw firsthand how this Gant collaboration with shirts selling for over 900 euros supports the premiumization of the Wrangler brand.

And finally, our ongoing partnership with Yellowstone continues this fall. With a much anticipated fifth season premier hitting in a few weeks, expect Wrangler to show up in a big way.

The multitude of these great demand creation initiatives when coupled with ongoing investments in talent, innovation and supply chain hopefully demonstrate our commitment even with the challenging macro environment to strategically invest behind our brands in powerful ways that support our improved long-term position, which takes me to my final comments as it relates to the go-forward. As you've seen, we've tweaked our revenue and earnings guidance down a bit here today with incremental currency headwinds impacting top line by about a point as well as our acknowledgement of the four challenges I touched on earlier.

From a high level, while we don't have a crystal ball on the macro, as I stated earlier, we are assuming that inflation in subsequent tight monetary policy weighs on demand, resulting in economic conditions remaining challenged over the near term.

So given that assumption, why are we planning revenue to sequentially accelerate in Q4? A few points here - first, we base our outlook on the combination of still strong domestic POS share gains and new business development. Second, while certain US retailer inventory levels remain challenged, the significant rebalancing efforts from select retailers has materially improved with aggressive actions taken early from many of our key retail partners with open to buy dollars opening back up and accelerating into Q4.

Based on this second point, our quarter to date US orders and shipments have been strong, but we want to be prudently conservative given the uncertainty in the current environment. With respect to our own inventory, Rustin will take you through more detail in a bit, but let's be clear - we exited Q3 heavier than we would've ideally wanted, but we haven't -- have and will continue to productively address particularly in utilizing planned capacity downtime in our plants. This downtime, coupled with the fact that roughly 90% of our current inventory is in core product, significantly mitigates markdown or brand health risks facing many of our competitors.

Most of our key customers have seen meaningful adjustments to Kontoor's specific inventory as sell through of our brands has outpaced shipments, affording us a relatively advantageous position to navigate through the holiday even into next year.

And regarding full year '23, I know all of you would like some color. While we are not going to guide specifically, rest assured that we are well into our planning process already. As I've stated, we assume ongoing challenges on the macro front, operational headwinds to be more pronounced in the first half on both the top and bottom line, and the opportunity to accelerate fundamentals in the second half of '23 as inflationary pressures both on demand and input costs are more likely to begin to ease.

We also recognize the need to be more flexible in this environment and will accordingly look to tighten discretionary expenses as we did in the third quarter. Further, the substantial actions we've taken over the last several years to bolster our balance sheet and enhance our capital structure, provide us increased agility to navigate the uneven landscape. This is evidenced in the recent 4% increase in our quarterly dividend reflecting the confidence of our board that our fundamental improvements coupled with our proven strong cash flow generation, even in challenging times, support our unique competitive position in the marketplace and ability to continue to drive industry leading returns for all our stakeholders. Rustin?

### **Rustin Welton**

Thank you, Scott, and thank you all for joining us today. As Scott stated, these are clearly unprecedented macroeconomic times. Inflation, consumer spending and confidence, interest rates, inventory rebalancing and global geopolitical events are creating a cross current of factors. But as we have discussed, the strength and positioning of our brands and resiliency of our operating model is a competitive advantage during times of uncertainty, one that is allowing us to drive competitive separation in the marketplace.

For the balance of the call, I'm going to cover a number of these topics and how we are thinking about their impacts on our business more broadly and what actions we are taking to best position Kontoor for success, not only over the near term but long-term as we execute on our Horizon 2 strategies to deliver superior TSR.

Finally, I will provide an update on our full year guidance in light of these considerations before opening up the call to your questions. But first, let me start with a review of our third quarter results, beginning with revenue. Global revenue decreased 5% compared to the prior year. Growth in our global direct to consumer business was offset by US retailer rebalancing and ongoing lockdowns in China.

On a regional basis, US revenues decreased 8%, driven by reduced shipments as retailers took significant broad-based actions to reduce inventory in the quarter. Partially offsetting the softness in wholesale was ongoing strength in our own digital business, which increased 14%. We are also encouraged by the progress we are making in key non-denim categories such as workwear and tees, which delivered solid growth in the quarter.

International revenues increased 7%. COVID related lockdowns in China continue to weigh on the region while AMEA increased 27%, driven by strength in digital and timing related to the ERP implementation in 2021.

Turning to our brands, global revenue of our Wrangler brand decreased 2%. The US was down 5%, significantly impacted by aforementioned retailer inventory rebalancing during the quarter. That said, we continue to drive growth in categories such as Western and female, which each posted double digit increase, while in tees, momentum was even more pronounced with a triple digit increase during the quarter.

And in our own digital channel, revenue increased 16%, driven by increases across traffic, conversion, AOV and AURs, reflecting the strong returns we are seeing from the investments we have made in our digital platform. Wrangler international revenue increased 15%, driven by gains in China and Europe as well as timing shifts related to the 2021 ERP implementation.

Turning to Lee, global revenue decreased 9%. Lee US revenue decreased 19%, driven by the retailer inventory rebalancing actions, partially offset by a 10% increase in own digital. Lee International revenue increased 3%. In China, COVID related lockdowns had a significant impact on the quarter with the region decreasing 20%. That said, we did see a sequential improvement from the second quarter, as Scott discussed. And in our eCommerce business, revenue grew 11%, building a great momentum into the all-important 1111 shopping holiday.

Moving to EMEA revenue increased 34%, with own.com growing 27%, fueled by brand investments that are yielding great results. Wholesale channel was also helped by the aforementioned prior year timing shifts related to the ERP implementation. And finally, from a channel perspective, US wholesale decreased 9%, non-US wholesale increased 8%, and global own.com increased 14%.

Now on to gross margin, gross margin decreased 60 basis points compared to adjusted gross margin last year. As we discussed last quarter, inflation pressures, elevated ocean freight and foreign currency pressures weighed on margin rates. Somewhat offsetting these headwinds, we

saw sequential improvement in transitory impacts such as air freight in addition to ongoing structural benefits to accretive channels and pricing. Channel and product mix contributed approximately 70 basis points of benefit in the quarter. Adjusted SG&A expense was \$174 million or a \$12 million decrease versus third quarter 2021 adjusted SG&A. Tight discretionary expense controls as well as lower compensation costs were somewhat offset by higher distribution expenses as well as continued strategic investments in digital and IT. As a percent of revenue, SG&A deleveraged by 20 basis points in the quarter. Adjusted earnings per share was a \$1.11 compared to a \$1.28 in the same period in the prior year.

Now turning to our balance sheet, third quarter inventories increased 66% compared to last year and increased 24% compared to 2019. I'll touch more on inventory in a bit.

We finished the third quarter with net debt or long-term debt less cash of \$774 million and \$58 million in cash and equivalence. Our net leverage ratio, or net debt divided by trailing 12 month adjusted EBITDA at the end of the third quarter, was two times, within our targeted range of one to two times. And as previously announced, our board of directors declared a regular quarterly cash dividend of \$0.48 per share, a 4% increase.

As Scott mentioned, the increase reflects our confidence in the business and our resilient operating model, even in a challenging macro environment, and our commitment to deliver superior cash returns to our shareholders.

Finally, at the end of the third quarter, we had \$62 million remaining under our share repurchase authorization.

Before we review the specifics of our updated outlook, at the onset, I mentioned key factors impacting the global operating environment and how we have incorporated these elements into our updated guidance. I'd like to step through these now, starting with the top line.

As Scott discussed in his remarks, there are several themes impacting the global demand environment, namely US retailer inventory rebalancing, consumer spending and confidence in the face of inflation, and China lockdowns. Starting with inventory rebalancing, following an extended period of supply chain disruptions and chasing demand, channel inventories across a wide range of consumer products and categories became elevated in the marketplace. The subsequent retailer rebalancing actions, combined with cost inflation and improved lead times on source goods, led to third quarter inventory levels heavier than we would want. But let's be clear - we are taking action.

A couple points I want to emphasize - first, the quality of our inventory is good, with approximately 90% in core styles as Scott mentioned. Furthermore, while we expect a relatively more promotional environment broadly over the near term, we will be thoughtful and balanced in light of this fact, adjusting our internal manufacturing as well as adjusting receipts on source goods to right size our inventory position in a manner that is profitable and more brand



appropriate than many of our competitors. This will continue over the next few quarters, but we anticipate more normalized inventory levels by mid-2023.

And second, while we expect the fourth quarter to be impacted by the uncertain consumer backdrop and inflationary environment, we are encouraged by the healthy underlying demand for our brands, with the investments and strong value we deliver to the consumer resonating in the current environment. In fact, despite the impact on shipments we saw in the third quarter, we continue to gain share in the US with healthy point of sale.

When combined with the improving contour specific inventory position, we are already seeing signs of progress. As a great proof point, after a slower start in July and August, our revenue trends have accelerated meaningfully in September and quarter to date, with both September and October US shipments growing versus 2021.

Regarding China, we continue to take a long-term view on the region for both brands. As Scott stated, the reopening has been slower than anticipated, and we are accordingly reflecting in our outlook, as I will cover shortly. And while this also has an impact on our gross margins, we believe it is prudent in light of the current uncertainty.

Moving to gross margin, inflationary and supply chain impacts on commodities, wages, and ocean freight were the largest contributor to the year over year decline in the quarter and more than offset the benefits we are seeing from strategic price, product and category mix. While input costs such as cotton and freight remain elevated relative to historical levels, we are seeing sequential improvement in commodity prices and moderating lead times.

And although we expect these headwinds to continue in the near term, when combined with the aforementioned inventory actions, the long-term structural margin drivers are still very much in place -- mixed shifts to a creative channels, categories, and geographies that will support gross margin expansion over time.

And finally, on SG&A, we have made significant progress in improving the health and position of our brands over the last three years. That will continue as we prioritize investments to support both long-term momentum and the greatest TSR potential, investments in areas such as digital and IT, for example, that leverage our global ERP platform and set the foundation for a more data and insight driven organization.

That said, as you saw in the third quarter, we have a strong culture for cost discipline. Over the near term and in light of the current macro environment, we will be prudent, particularly on non-strategic spend, and have adjusted our full year SG&A guidance to reflect our Q3 performance and updated plan.

Now onto our outlook - additional details can be found in today's release, but to summarize, revenue is now expected to increase approximately 4% on a reported basis and approximately

6% in constant currency compared to 2021. The updated revenue guidance includes an incremental one point negative impact from foreign currency. Gross margin is now anticipated to approximate 43% compared to adjusted gross margin of 44.6% achieved in 2021. The updated gross margin guidance includes the incremental impacts from capacity downtime, geographic mix, and foreign currency. The benefits from continued structural mix shifts to a creative channels such as digital, ongoing cost savings initiatives and strategic pricing are expected to help offset these higher costs.

Adjusted SG&A, excluding an estimated one time charge of \$16 million associated with our globalization efforts and European headquarter relocation, is expected to increase at a low single digit rate compared to adjusted SG&A in 2021. And adjusted EPS, excluding an estimated one time charge of \$0.23 per share associated with our globalization efforts in European headquarter relocation, is anticipated to be in the range of \$4.35 to \$4.40 per share compared to prior guidance of \$4.40 to \$4.50 per share.

To close, as I discussed earlier, we are clearly operating in a dynamic environment, but we couldn't be more proud of the steadfast execution and agility of our global team and remain confident in the resiliency of our business to drive competitive separation while delivering superior returns for all stakeholders.

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

**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 Bob Drbul with Guggenheim. Please proceed with your questions.

**Bob Drbul**

Hi, guys. Good morning. A couple of questions.

**Rustin Welton**

Morning, Bob.

**Bob Drbul**

Morning. I guess the first one really, when you talked about the acceleration in trends that you're expecting in the fourth quarter, you talked a little bit about it -- can you just elaborate

some more in terms of exactly what you're seeing? And I think you talked about your Q4 trends, the call out, so if you could spend a little more time on that, I think sort of ties together, would be pretty helpful for us. Thanks.

**Scott Baxter**

Sure. Bob, it's Scott. I'll go ahead and take that one. You saw that we tweaked down the top line a little bit here from a currency standpoint and some of the things that are happening in China, the lockdowns have happened, they aren't opening as fast as we thought we wanted them to. But we are seeing some acceleration in Q4, and really what we're seeing, it's a multitude of different things that we've been working on for a long time, but it's the continued strength in our POS. So we get, visibility to that and see that, so that gives us a little bit of confidence.

And then in addition to that, the share gains, which I know everybody gets a chance to see, too, but we've seen nice share gains from both brands. So we're really optimistic about that, and we're optimistic because of the work that we're doing from a demand creation to tie ourselves back to those share gains. So, what I mean by that is we have confidence that we're going to hang onto those consumers because we now know how to have a conversation with our consumer and talk to them in a really elegant way that seems to be working. Our folks in our demand creation teams are really dialed in, so I'm really pleased with that.

And then the other piece is our new business development team, which continues to go out there and do really, really great work. And that's because our brands have gained such relevance in the marketplace. So we do have some visibility to the new business development. But I'll tell you the other thing, too, is some of our retail partners are much cleaner than they were from an inventory standpoint, so some open to buy dollars are improving. So that's been real important to us. And we're just seeing really good strong quarterly trends from that standpoint. And it's within the breadth of our business, right? So it's with our core US biz, and it's augmented by the additional growth across our channels and our geographies and digital, of course.

But one of the things that I want to mention, because we've talked about it before, is we're seeing it in our categories, too, specifically some of our new categories like ATG, work and t-shirts. We're really pleased with those initiatives that we've had ongoing here for a while. So I think really it boils down to our brands are really gaining relevance, gaining share the POS is nice, and the work that our demand creation teams and the work that our design teams have done, too, is really all synchronizing together at this point in time. And we feel real confident as the economy will improve at some point in time, and we'll be right there with it. So thanks, Bob. Thanks for the question.

**Bob Drbul**

Thanks, Scott.

**Operator**

Thank you. Our next questions come from the line of Jay Sole with UBS. Please proceed with your questions.

**Mauricio Serna**

Hi, good morning. This is Mauricio Serna on behalf of Jay Sole. Thanks for taking our questions. I guess wanted to ask if you could please talk a little bit more about the puts and takes baked into your Q4 gross margin guidance. I'm interested in hearing more about the impact of the capacity downtime. And maybe on the wholesale side, wanted to hear more, how is the Wrangler brands positioned in the channel, primarily with key partners like Target? Thank you.

**Rustin Welton**

Okay, Mauricio, good morning. It's Rustin. I'll take the first part, and Scott will take the second, if that's okay. As we look at our Q4 gross margin outlook, as we indicated in our release this morning, there's really three primary drivers that are expected to incrementally affect Q4 gross margin. The most significant, Mauricio, will be the impact of downtime in our plants.

Clearly, Scott and I both spoke about the elevated inventory levels in our prepared remarks, and we're taking proactive actions here in the quarter to begin to work that down to address those elevated inventory levels caused by that retailer inventory rebalancing efforts and softer consumer demand that we spoke of. In addition, we anticipate seeing an adverse geographic mix impact caused by lower sales in China due to the COVID related lockdowns, and then, obviously, the last point, softer sales in EMEA due to the inflationary impacts on consumer demand that we've talked about.

The final sort of impact I think, Mauricio, that we're seeing in the fourth quarter is the FX impact that's going to continue to be a headwind for us on our margins. But again, those are the three primary drivers that are incremental to what we've seen to date with downtime being the most pronounced. Scott?

**Scott Baxter**

Hi, Mauricio. How are you? Thanks for the question. I'll go ahead and take that. As a general practice, we don't really talk about our individual customers, but what I will tell you is, unless it's material, and this is not material to us, we haven't experienced any issues that we need to discuss, but since there's some commentary in the marketplace, Target's one of our top accounts. It's a great partner for Kontoor and the Wrangler brand. And like we do with all of our accounts, we'll continue to optimize our denim assortment there, continue to work with their teams. We have a great relationship. And while we'll strive to perform with outsized growth, but we'll also work to go ahead and enhance the other categories that we have there, too – outdoor, work and tees. So it's a big complimentary picture. And we'll also continue to drive our own D2C and our international expansion also at the same time. So thanks, Mauricio.

**Mauricio Serna**

Thanks so much, and good luck.

**Operator**

Thank you. Our next questions come from the line of Will Gaertner with Wells Fargo. Please proceed with your questions.

**Will Gaertner**

Hey, guys. Thanks for taking my questions. Maybe we start with the cost controls; they've been pretty impressive. You've down SG&A from high single digits; now it's low single digit guidance. Maybe just sort of discuss what's come out of that, those costs, your strategic versus non-strategic spend.

**Scott Baxter**

Yeah, good morning, Will. It's Rustin. I'll go ahead and take that. As we indicated on the second quarter call, Will, we really expected tighter expense control in the second half of '22. Certainly, we were seeing a softer macro backdrop, and we wanted to make sure that we were taking a look at non-strategic and discretionary items and really using cuts there and tight expense controls to fund a continued investment in strategic areas such as digital demand creation and IT. And I think that's a really important distinction. We are going to continue to invest behind our brands and capabilities. And the third quarter I think played out as we expected, Will.

We continue to intend to use a TSR lens as we evaluate all investment opportunities. And as you would expect, given some of the challenges around the globe, there are some near term dislocations in the market that have caused the softening consumer demand, COVID related lockdowns that are adversely affecting kind of near term returns on select investments. So we're reprioritizing accordingly as needed. But I think the key point to really take away, again, as I indicated in the prepared remarks, we have a strong bias for cost control, but you've also seen from us at Kontoor, we will continue to invest in our brands and capabilities.

**Will Gaertner**

And then maybe if I could follow up, just another follow up, just on the brick and mortar, it sounds like you're making a big push into Europe and Asia -- I guess, how many stores do you have in the region now, and how many stores do you have globally, and how are you going to sort of leverage these new stores in Europe and Asia, maybe in the US?

**Scott Baxter**

Yeah, sure, sure, Will, no problem. So, yeah, we have talked a lot about our strategy and our Horizon 1 and Horizon 2, and one of the things that we talked about is we were going to lead with digital from the very beginning. And we've done that and made really nice and appropriate investments, and we've seen really good traction.

But from a strategic standpoint, we really think that we need to make sure that it's an omni presence that we have, and that's also a strong brick and mortar to compliment and have the

opportunity for the consumer, because we see that shopping continuing and being a strong component going forward to compliment that with a strong brick and mortar presence. So we have a really strong presence, as you know, in Asia, over 700 doors with multiple partners, but it's more of a franchise business that we have there.

But what we've done in Asia, which is really interesting, and we're going to roll it out around the rest of the country, is we've -- excuse me -- the globe -- we've created this retail excellence initiative, and we really like it because it's been an ongoing program. We've tweaked it really nicely. The team has embraced it, and more importantly, our partners have really embraced it, and we're seeing it really come to life. We think it has real legs, and we're going to roll that out in Europe, here in the United States, also, just kind of leverage some of the learnings that we've had.

But we think there's opportunity in Europe, too. And you heard me talk a little bit about the new concept of rolling out our dual branded concept with really great product. I was just there in Europe and had a chance to visit our stores and see that there's a really nice opportunity relative to our brands and specifically because -- and this is really important -- our brands have now become much more relevant, and the consumer is asking for them.

So we're morphing into a much bigger and more dynamic company relative to the power of our two brands, and it's pretty significant. And when you go to our stores now, we augment that with our t-shirt programs, our work wear programs, our ATG. So we have a much more broad offering. So it really helps for us, and it also helps the consumer to be able to see that. So we're really pleased with that.

So look for a little bit more detail here in the future as we roll these out across the globe. And we'll share some more detail going forward in my commentary and Rustin's commentary so that we can make sure that you're aware of some of the things that we have going on. But pleased with where we are, but a lot more work to do. And actually, this is kind of fun work, too. We get to see the fruits of our labor pretty quickly, and our consumers are responding really nicely. So thanks for the question

#### **Will Gaertner**

And -- sure, absolutely. And maybe if I could just squeeze one in, maybe can you just discuss -- and I know -- you're not guiding '23, but just the general puts and take and how you're thinking about FX next year, AUCs and AURs into next year?

#### **Scott Baxter**

Yeah. We'll address -- and we -- as you indicated, we won't specifically guide. I think Scott made some prepared remarks from a top level perspective. Certainly, as he indicated, we expect particularly the first half of the year to be pressured, a little more pressured on the top and bottom line from inflation and those type of things. As we think about gross margin and some of your questions around cost, certainly, we'll provide more detail on the Q4 call, but maybe a

little bit of color about how to think about the first half of '23 at least, particularly in light of the elevated inventory situation, we do expect to see those continued impacts of inflation on input cost in the first half of the year as higher costs in the second half of '22 begin to move through the P&L. We've talked in the past, Will, as you know, about the lag that takes place from when you see spikes in the commodity markets, and it takes a couple of quarters to work through the P&L, and certainly, cotton as an input cost spiked in Q2.

Further, we expect that manufacturing downtime to continue into the front half of '23 as we work to address these elevated inventory levels thoughtfully. I would say from a downtime perspective, it's fair to think about the impacts of downtime being most pronounced in Q4, as I already indicated, and then Q1 and kind of improving in Q2.

However, the inflation and downtime will be tempered by lower transitory costs, driven by air freight, structural mix improvements, strategic pricing and cost savings initiatives, as you've heard us kind of consistently talk about. So hopefully, that dimensionalizes at least and provides a little more color, Will, as to how we're thinking about the first half of '23.

#### **Operator**

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

#### **Brooke Roach**

Good morning, and thank you so much for taking our questions. Scott. I was wondering if you could provide a little bit more context on the relative outperformance in share gains that you've had in some of your emerging categories, which has helped to offset some of the pressures from macro? As you think -- as you look ahead, how much incremental opportunity is there to continue to drive that outsized growth over the course of the next few quarters against the current macro? And how are you thinking about share gains in the US in particular?

And then maybe as a follow up for Rustin, as you looked at rebalancing inventory -- thanks so much for the helpful color that you provided on downtime at the plants. Could you provide a little bit more color on your expectations on the cadence of inventory growth that we should expect as you work through that level? And any additional color that you can provide on how you're working through that level, whether that's additional clearance or just slower sell through, that'd be super helpful. Thank you.

#### **Scott Baxter**

Thanks for the questions, Brooke. Good to hear from you. So I'll start, and then Rustin will go ahead and take the second one, obviously. So I think for us, the really important thing is, when we embarked upon spinning this company off is that we knew that we had two great brands, but they were pretty much landlocked, as you've heard us talk about, also specifically kind of category locked. And yet, we knew that we could build upon that like great brands do.

And we kind of embarked -- started with the outdoor group, and then we went into work, which we already had a little bit of a foothold in, and then went into t-shirts. And I think the thing that I come away with every quarter and every time I see the new seasonal product from the teams is how we've evolved that brand, those categories over time. And we are really becoming a presence in all three of those.

So what we've seen, Brooke, is we've seen that the consumer and also our customers, so both have gained great confidence in us in those three categories, and then we're going to continue to roll more out. But the thing for us is are we evolving the product line, yes, are we gaining new distribution that, gives us great confidence, yes in all three of those, and are we seeing acceleration of POS in those, and yes, the answer is yes to all those.

And so we're seeing that even in tough times right now with those categories. So it says to me that the consumer is giving us permission in those. And so that gave us the confidence then to go ahead and add Wrangler Angler to the mix, right? So we think that there's a big opportunity in that fish category, and we're going to go ahead and play a little bit in that and think that, because of the power of the brands and the demand creation platforms that we're putting behind the brands, that the consumer has just kind of guiding to us in allowing us to do that.

Now, I think it would be really appropriate for me to let you know that one of the reasons that I think, and certainly the team does, too, is that we offer a really compelling value in these categories. So if you think about -- let's just start with outdoor. We are positioned from a price standpoint in a really good place, right? So we play under some of the other players that are in that category, but we offer great product with a really good name.

So the folks, even in tough times, are turning to us because it's a really good product, made really well by a trusted brand, but it's also showing up in places that they shop, which is really important. So it's where they are, where they're going to be, and then they can also get it online. So I just have a lot of confidence in how the teams have approached this.

And I think the most important thing for us, as we think about these categories -- and we'll be real thoughtful because we're not done yet. There's more in the pipeline that you're going to hear about in the future. But I think the single most important thing, and I said it a little bit in my commentary about the addressable market and how big it is, it's just that we've just got a small foothold relative to the t-shirt business, relative to the outdoor business, relative to the work wear business -- we have got really big opportunity and expansion in front of us and ahead of us, and the teams are pretty excited about it and create some great product to go ahead and do that.

So again, we'll continue to bring that up in our meetings. We'd love to share more of that with you as we go ahead in our quarterly calls. We will definitely do that. I hear you loud and clear that everybody wants to hear more about it, and maybe the next time, I can talk a little bit more and bring a little more color to what we're doing there so that everybody has an idea and



understands kind of where we're going. But thanks for the question, and I'll turn it over to Rustin.

**Rustin Welton**

Great. Good morning, Brooke. Thanks for the question, as well, and thanks for joining. So as we step back and think about inventory a little bit, we did finish the quarter about \$678 million in inventory. That was up about 66% to prior year and 24% to pre pandemic levels. And so as you heard Scott and I both discuss in our prepared remarks -- and I just want to be clear, it is elevated. We were chasing demand in the third quarter last year after our ERP implementation.

But there's a lot of drivers for the reasons on the increase, including the inflationary impact on consumer demand, the US retailer inventory rebalancing. You heard us speak about cost inflation, inventory availability to meet some of these category extension growth drivers, as Scott just spoke about. And then we are seeing improved lead times on Asian source goods, as well. So receipts were a little heavier in the third quarter than originally anticipated.

As you mentioned in your question, Brooke, we are taking proactive actions to drive levels down by executing downtime in our plants and adjusting future orders and receipts to bring us back in balance. And I think that ability to take downtime is a real differentiator because it allows us to avoid clearing product in dilutive channels and better protecting our brand health.

So I think, as we think about the inventory specifically, the quality of the inventory is good with 90% of our inventory in core styles. And so with that, we intend to sort of right size our inventory position over the next several quarters in a manner that is more profitable and brand appropriate, given that the goods are much more excess than distressed.

In terms of the cadence, I know you asked about that in your question, we do expect to sequentially improve on a dollar basis and be back to more historical levels in inventory by mid-2023. Thanks, Brooke.

**Brooke Roach**

Thank you.

**Operator**

Thank you. Our next questions come from the line of Paul Kearney with Barclays. Please proceed with your questions.

**Paul Kearney**

Hi, everyone. Good morning. Thanks for taking my question. On the US wholesale, should we think of it as kind of Q3 was a low point in terms of the right sizing of retailers and we start to improve from here, or are you anticipating further pressure into '23? Thanks.

**Scott Baxter**

Well, we think that, from the standpoint -- the pressure was really great in Q2 and the beginning of Q3, also. We think it's starting to mitigate because I think that our partners have done a great job of addressing their inventory, and so they've really figured out how to do that. And these are sophisticated retailers, too, I mean, just folks that are top tier. So we think they've done a really nice job.

And then I think the most important part is where you sit in the pyramid with that retailer or where you sit in the pyramid with that customer, so how important are your brands to their customers, to their consumers? And over the last several years, we've demonstrated why Wrangler, Lee and ATG have become extremely important and a big part of the vernacular for our big customers and why they have to be on the floor. And the reason they have to be on the floor is because they turn and because we're gaining share.

So as I stated before, our POS is trending up, it's really good, we're happy about that. And our share gains are good, so we're really happy about that. So we work hard every day to make sure that we have a presence and continue to keep and grow our presence with our big customers, and that puts us in a really good place when the open to buy dollars are there if we want to go ahead and put it to good use, so feel really good about that. Thanks.

**Paul Kearney**

Thanks. Just a quick follow up, speaking of the pyramid with your customers - and can you talk about maybe your private label competition and what you're seeing with retailers? Are you seeing any change with retailers, whether they're leaning in more with the price on private label, and kind of where you're seeing your pricing position and whether it's changed at all over the past year? Thanks.

**Scott Baxter**

Yeah, sure, no problem, Paul. From a private label standpoint, we've been competing against private label for 40 plus years, right? And so we've always done a really good job. There are a couple distinctive factors that are really important here.

One, we're a national brand, so we create real excitement and energy around our brands with national and global campaigns, right? So that's a big differentiator for both our brands. And then we've accelerated that conversation in a pretty significant way in the last few years prior to where we were from a spinoff standpoint. So we've put the -- a big differential between ourselves and those private label brands.

I will say that, five years ago, we were a little bit closer to them because we didn't have a stronger voice and we weren't -- truly, we weren't spending as many dollars as we should have behind the brands from a marketing standpoint. So now we do that in a really sophisticated way. But in addition to that, one of the things that you heard me say a couple of questions ago, I believe it was with Will or -- I think it was with Will, where I talked about -- and this is really

important, the fact that our brands are priced really sharp. So we really price our brands really well. We fall under some of our competitors from a pricing standpoint.

So when the consumer comes in, they really know our brand, they're asking for our brand, they're seeing a really good price point. So when they have a choice to pick between a global brand that they really know and that they've gotten to recognize and they have a trust in, they go ahead and they migrate to ours because it's at a really good price point with a really good value.

So we like our positioning, we like where we are, it works really well for us. We're going to continue down that strategic path, and we know that there's a differentiator from a global brand and how our consumers think about that, so.

**Paul Kearney**

Great, thank you.

**Scott Baxter**

Thanks, Paul

**Paul Kearney**

And if I can just squeeze one more in there, just lastly on the capital allocation strategy, can you maybe just comment on your ability to continue to repurchase shares and how you're thinking about that changing just kind of with all the macro headwinds? Thanks.

**Rustin Welton**

Yeah, Paul, it's Rustin. I'll go ahead and take that. First and foremost, we've talked a lot about optionality, and with the strong cash generating aspects of our model, really creating that optionality, which I think is really critical in an uncertain environment. As we talked about and you saw recently, the -- our board of directors approved a 4% increase in our quarterly dividend, and I think that's a really important statement about how we feel about the state of the business and the cash generation moving forward. Near term priority is going to remain on cash generation and conversion as we work down the inventory levels we've talked about.

You saw in the quarter, Paul, we did not repurchase any shares during Q3, but we have repurchased \$62 million this year in shares. And that share repurchase remains an important option in our capital allocation model. We have approximately \$62 million remaining under our share repurchase authorization. And as talked a little bit about, we're going to continue to use that share repurchased offset dilution while opportunistically buying shares as capital allocation priorities, excess cash flows and market conditions warrant.

First and foremost, though, we're going to continue to invest in the brands, and I think that's the most important thing to take away, Paul. As you heard Scott lay out, the investments we've made in demand creation, that's always going to be our first option. But I think when you

couple that with the fundamental improvement in the business, increasing the dividend, having the share repurchase option that's out there as well as strategic M&A, we really like the optionality that our model affords with that cash generation. Thanks, Paul.

**Operator**

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

**Scott Baxter**

Well, thanks, everybody, for joining us today. I hope you know how much all of us appreciate your interest in our company and your support, and we certainly enjoy this time that we get to spend together. But I also wanted to, because we won't be -- have a chance to chat before the holidays, I wanted to wish everybody a happy and healthy and of course a safe holiday season. And we look forward to your continued support, and thanks again for today. Have a nice day, everyone.

**Operator**

Thank you. This does conclude today's teleconference. We appreciate your participation. You may disconnect your lines at this time. Enjoy the rest of your day.