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Q2 2017 Crocs Inc Earnings Call

EVENT DATE/TIME: 08/09/2017 08:30 AM GMT

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PRESENTATION

Operator

Welcome to the second quarter 2017 Crocs, Inc. Earnings Conference Call. My name is Nicole, and I will be your operator for today's call. (Operator Instructions) Please note that this conference is being recorded.

I will now turn the call over to Marisa Jacobs. Ms. Jacobs, you may begin.

Marisa Jacobs ***Crocs, Inc. - Senior Director, Investor Relations***

Thank you. Good morning, everyone, and thank you for joining us today for the Crocs' Second Quarter 2017 Earnings Call. Earlier this morning, we announced our second quarter results, and a copy of the press release can be found on our website at crocs.com. We would like to remind everyone that some of the information provided on this call is forward looking and accordingly is subject to the safe harbor provisions of the federal securities law. These statements include, but are not limited to, statements regarding future revenues, gross margin or SG&A expenses and our product pipeline. Crocs is not obligated to update these forward-looking statements to reflect the impact of future events.

We caution you that all forward-looking statements are subject to a number of risks and uncertainties described in the Risk Factors section of the Company's Annual Report on Form 10-K. Accordingly, actual results could differ materially from those described on this call.

Those listening to the call are advised to refer to Crocs' Annual Report on Form 10-K, as well as other documents filed with the SEC, for more information relating to these risk factors.

The Company may refer to certain non-GAAP metrics on this call. An explanation of those metrics and a reconciliation to the most closely related GAAP metrics can be found in our earnings release, which was filed earlier today, and which has been posted on our investor website located at crocs.com.

Joining us on the call today are Andrew Rees, President and Chief Executive Officer; and Carrie Teffner, Executive Vice President and Chief Financial Officer.

Following their prepared remarks, we will open the call for your questions. At this time, I will turn the call over to Andrew.

Andrew Rees ***Crocs, Inc. - President, CEO & Director***

Thank you, Marisa, and good morning, everyone.

I'll begin with some comments on our results and on the strategic progress we made during the second quarter. Then I will turn the call over to Carrie who will go through the financial results for the quarter in greater detail and take you through our expectations for the third quarter and the full year. We will then take your questions.

Overall, I'm very pleased with our second quarter results. We met or exceeded the guidance we provided to you when we spoke in May. Equally important is that we continue to make progress against our strategic initiatives to strengthen the Company and the brand.

Revenues in the quarter were $313.2 million, and our gross margin rose by 180 basis points from Q2 last year, to come in at 54.2%.

SG&A at $140.4 million was $8.7 million lower than in last year's second quarter and included $1.8 million of charges associated with our SG&A reduction plan.

Our income from operations rose 42.9% over Q2 last year to $29.4 million. And our diluted EPS rose by 53.8%.

I also want to note that our inventory at the end of the second quarter was down $14 million or 8.3%, compared to the same time last year.

These results are tangible evidence that all of the hard work over the past few years to strengthen the Company and position us for a new profitable growth is taking hold.

On our last call, Gregg spoke about our ongoing initiatives to ensure that our product is fresh and relevant, our marketing builds engagement and drives sales, our wholesale, retail and e-commerce sales channels are being optimized to drive profitable growth, and corporate investments are concentrated in our core markets.

And that we continue to strengthen our organization from both an operational and talent perspective.

Since this is my first time speaking with you in my capacity as President and CEO, I want to reaffirm that we continue to be focused on these initiatives, each of which is essential to achieving our broader strategic objectives.

Let me provide some color on each of our ongoing initiatives, as it relates to our second quarter results.

First, product. As discussed with you on our last call, we are focusing heavily on clogs, along with sandals, flips and slides, as these silhouettes are most representative of Crocs DNA. Consequently, I am pleased to report that with respect to these silhouettes, second quarter growth exceeded our expectations.

Classic clogs turned in particularly strong results, as we continued to leverage our iconic clog with fresh colors and prints. Our Swiftwater collection exceeded expectations. The new Swiftwater Deck Clog is an example of a successful line extension developed to address an additional wearing occasion. New colors and prints are selling well and it is especially gratifying to see wholesale accounts expanding the range of colors presented in their stores and on their e-tail sites.

Given our focus on sandals, it was great to see products such as the women's Capri and Sloane exceed expectations as well. We're striking the right balance of comfort and style and consumers are responding favorably.

We are leveraging the momentum from spring/summer '17 to de-risk our fall/holiday business by focusing less on seasonal products such as boots, and driving an expanded selling season for sandals, flips and slides, and clogs - including lined clogs.

Second is marketing. Our COME AS YOU ARE campaign was in full swing during the second quarter. We launched the campaign to boost brand relevancy and consideration and to elevate our digital marketing effectiveness and consumer engagement. It is succeeding on many levels. Our brand's social engagement, social reach and PR coverage each roughly tripled compared to last year's second quarter. We will continue to introduce new content over the coming months. In addition, we are seeing a positive impact of our COME AS YOU ARE campaign on revenues. Wholesale accounts have enthusiastically embraced the campaign, utilizing our creative in window takeovers, end caps, on selling fixtures and on their own websites. In our DTC channel, our online and retail stores saw strong sell-through of the products featured in the campaign.

We are excited to announce that we have entered into a product collaboration with one of our celebrity brand ambassadors, Drew Barrymore. Her designs will be introduced as part of our spring/summer 2018 collection with fresh, exciting new product, reflecting her personality and infectious enthusiasm. We believe her designs will be a great addition to our lineup.

The third initiative relates to the optimization of our three business channels. At wholesale, accounts did well with our spring/summer 2017 collection. Sell-throughs continue to improve. Furthermore, full price selling improved, enabling our accounts to realize better product margin.

In conjunction with our activation of the COME AS YOU ARE campaign, we were given expanded shelf space by some of our important key wholesale accounts, secured longer placement periods at some accounts and in others, secured dedicated brand locations. All of those boosted the visibility of Crocs.

Retail performed in line with expectations. And while total retail sales declined, this was primarily due to a reduced store count, as our retail comp was flat. We continue to make progress against our plans to rationalize our store fleet, closing or transferring 39 stores during the second quarter, moving more quickly than we had originally estimated.

With respect to e-commerce, our comparable sales rose by 17.8%, driven primarily by Asia. These are strong results given that we're growing off a 20.6% comp in Q2 of last year.

The fourth initiative is strengthening our organization. From an operational perspective, we are continuing to drive process improvements that are leading to greater efficiencies.

During the second quarter, SG&A declined by $8.7 million or 5.8%. And we remain on target to hit our goal of eliminating between $75 million and $85 million of SG&A expenses annually by 2019.

As we noted previously, 70% of the SG&A reduction is tied to reducing Company-operated stores. We have accelerated the pace of our store reductions, and we are now on track to have 90 net fewer stores by the end of this year.

From a talent perspective, the transition between Gregg and me has been seamless. Throughout the organization, the team remains focused on our key strategic objectives.

In closing, we are right on track. The actions we have taken and additional actions to be taken through the balance of the year are transforming Crocs into a more nimble and stronger company capable of prospering in the face of a challenging retail environment.

I'm extremely grateful to the talented team we have in place across the globe and excited about the work we are doing to strengthen our business and drive shareholder value.

At this time, let me turn the call over to Carrie. She will review our second quarter financial results and present our third quarter and full year 2017 guidance.

Carrie W. Teffner ***Crocs, Inc. - Executive VP & CFO***

Thank you, Andrew. As Andrew mentioned, we are pleased with our second quarter results. The hard work of the past few years, which involved transforming almost every aspect of our business, is translating into tangible benefits.

Second quarter revenues were $313.2 million, down $10.6 million or 3.3%, from a year ago. These revenues came in at the high-end of our guidance. Furthermore, this amount includes a negative impact of foreign currency translation, which decreased revenues by $2 million, compared to Q2 last year.

The $10.6 million or 3.3% decline from last year's second quarter primarily relates to the sale of our Taiwan business, store reductions and the additional actions taken to improve the quality of our revenues that we have discussed with you on previous calls. Adjusting for these items, Q2 revenues would have been up low single digits compared to Q2 last year.

In terms of our channels, second quarter wholesale revenues declined 7.3%. This is attributed to our intentional pullback on sales into discount channels, and reduced shipments to select overstocked distributors in Asia. We began those initiatives during the third quarter of 2016, and as a result, they will have less of an impact on our year-over-year comparisons in the back half of this year.

Our global second quarter DTC comp was a positive 5.7%. While overall retail sales declined 4.4%, our retail comp was flat. We had 55 fewer stores compared to the end of last year's second quarter, ending the quarter with 503 stores.

Our e-commerce business grew 14.5%, compared to Q2 last year, while generating a 17.8% comp. I will discuss regional results in a moment.

We sold 17.4 million pairs of shoes in the quarter, a 1.8% decrease from the prior year. The average selling price of our footwear was $17.66, down 2.2%. As discussed on last quarter's call, this is due to our focus on core molded product, which carries a lower ASP, but also generates a higher gross margin, driving profitability gains.

Turning to our regions. First, let me note that given the limited impact of currency in the quarter, the following revenue amounts are as reported.

In the Americas, our revenue came in at $136.2 million, up 0.8%. The key takeaway is that we returned to growth in every channel in this region. Wholesale grew in absolute dollars, and we simultaneously delivered both positive retail and e-commerce comps.

Wholesale revenues grew 4.9%. Key accounts saw better-than-expected sell throughs, and in response, increased at-once orders and bought into a more diverse product range than last year. Marketing collaborations with key family footwear accounts contributed to an improved quarter as well.

Our Americas second quarter DTC comp increased by 1.1%.

Our retail comp rose by 0.4%, while retail sales declined 3.8%, reflecting the fact that we were operating 11 fewer stores, as compared to last year's second quarter.

E-commerce sales rose 2.6%. Throughout the quarter, after a slow start, we saw comp sales accelerate, with double-digit comps in June, as we adjusted our pricing and promotions in response to the highly competitive environment.

In Asia, our terrific growth in e-comm enabled us to partially mitigate the decline in wholesale revenues. Revenues in Asia were $124.6 million, down 4.7% versus the prior year.

Wholesale revenues declined 12.7%, the majority of which is associated with the sale of our Taiwan business in the fourth quarter of 2016 and reduced sales to select overstocked distributors in the region. The impact of these items offset the growth we saw in our China wholesale business, where the work done over the past couple of years has enabled us to put our China wholesale business back on a healthy footing.

Our Asia second quarter DTC comp increased by 13.3%.

The retail comp declined by 0.9%. Retail sales declined by 4.6%, reflecting the comp performance and 30 fewer stores, as compared to last year's second quarter.

E-commerce sales rose by 34.8%, while our e-commerce comp rose by 44.5%, reflecting the exclusion of our Taiwan e-commerce results from last year. Most of this growth was due to outstanding results in China and Japan. Our Henry Lau event on China's TMall and our Line launch in Japan are examples of activities we used to support our e-commerce business.

Europe delivered a solid second quarter. While the wholesale channel is still reflecting the impact of the reduced discount channel sales, the retail channel delivered positive comps and e-comm grew double digits. Revenues were $52.3 million, down 9.3% versus prior year.

Wholesale revenues declined $5.2 million or 14.5% due to the planned reduction in discount channel sales.

Our European second quarter DTC comp increased by 5.1%.

Retail comps increased by 0.7%, while retail sales declined 6.3%, reflecting 14 fewer stores, as compared to last year's second quarter.

E-commerce sales grew 10.4%, driven by high conversion rates.

Our gross margin was 54.2%, improving 180 basis points. The year-over-year improvement reflects continued focus on higher margin molded product and fewer discount channel sales.

Our SG&A expenses were $140.4 million, down $8.7 million from the prior year. Our SG&A includes $1.8 million of charges related to our SG&A reduction program, which is below the $3 million we guided to at the end of Q1.

During the quarter, we benefited from approximately $1 million related to a bad debt recovery, which had previously been reserved for in China. And we had a timing benefit of approximately $2 million related to marketing expense. The remaining improvement over prior year reflects the benefit of our SG&A reduction efforts, which includes store closures, store transfers and business model changes combined with operational improvements. Our continued focus on controlling costs allowed us to deliver SG&A reductions in excess of what was included in our guidance.

Our income from operations grew 42.9% over Q2 last year, increasing to $29.4 million. This reflects our improved gross margin offsetting lower revenues and the progress we have made in reducing SG&A.

Net income attributable to common stockholders, after preferred share dividends and equivalents of $3.9 million, was $18.1 million.

Our earnings per diluted share, at $0.20, rose 53.8%. The weighted average diluted common share count used to calculate EPS was 74.6 million shares for Q2.

Turning to the balance sheet. We ended the quarter with $157 million in cash compared to $146.7 million at the end of Q2 last year.

We repurchased $10 million of our common stock during the second quarter. And at June 30, there were no borrowings outstanding on our credit facility.

We ended the quarter with $155.7 million in inventory, 8.3% below Q2 last year.

Through Q2, we generated approximately $39 million of cash from operating activities, almost double the approximately $20 million of cash generated during the first six months of 2016.

Let me now turn to guidance.

Regarding currency, I want to note that our guidance is on an as-reported basis. I also want to call out that our guidance does not reflect any meaningful changes to foreign currencies compared to today.

With respect to the third quarter of 2017, we expect revenues to be between $230 million and $240 million, compared to $245.9 million in last year's third quarter. This guidance incorporates the impact of store closures and transfers reflecting the 39 net store reduction in Q2 and a planned reduction of 25 stores in Q3, and the sale of our Middle East business in the second quarter of 2017 and our Taiwan business in the fourth quarter of 2016.

We expect third quarter gross margins to be essentially flat compared to last year. Keep in mind that last year's third quarter benefited from an inventory adjustment, which favorably impacted the gross margin rate by more than 200 basis points.

Our SG&A for the quarter is expected to be down approximately $3 million from last year. This guidance includes approximately $2 million of charges to support our SG&A reduction plan.

For the full year 2017, we continue to expect revenues to be down low single digits compared to the prior year. This guidance incorporates our updated store reduction plan, business model changes and the reduction in discount channel sales, as we continue to improve the quality of our revenues.

Our full year gross margin rate guidance of approximately 50% remains unchanged.

And our SG&A for the full year 2017 is now expected to be between $490 million and $495 million. This is down from the range provided on our last call, and $10 million to $15 million below our 2016 SG&A of $506.3 million.

This change reflects continued progress against our plan to reduce SG&A by $75 million to $85 million and to deliver an incremental $30 million to $35 million in income from operations in 2019, and reflects the benefit of accelerating store closures.

Please keep in mind that approximately $7 million to $10 million of charges associated with the implementation of our SG&A reduction plan are included in our full year SG&A guidance.

I'm very pleased that our Q2 results were in line with or above the guidance we provided. We have made significant progress improving our business processes as well as the quality of our revenue and this is resulting in our improved ability to predict the business.

With the first half of the year behind us, we remain confident that our initiatives to drive higher-quality revenues, to rationalize our retail footprint and to reduce our SG&A will enable us to improve our bottom line profitability.

Now, I'll turn the call back over to Andrew for his final thoughts.

Andrew Rees ***Crocs, Inc. - President, CEO & Director***

Thank you, Carrie.

Throughout the quarter, we continue to advance our strategic objectives and strengthen our brand. Our spring/summer 2017 product, amplified by a successful COME AS YOU ARE marketing campaign, generated higher-quality revenues and improved gross margins. Our focus on expense management led to a significant SG&A expense reduction. In combination, these resulted in a meaningful profit improvement.

In summary, Q2 was another solid quarter. And I want to reiterate our confidence in the business and its ability to generate enhanced shareholder value in the future.

Before closing, let me once again express my sincere thanks to our incredible associates around the globe, whose dedication and hard work is so essential to the success of our company.

Now operator, I will open the call up for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our first question comes from Erinn Murphy from Piper Jaffray.

Erinn Elisabeth Murphy ***Piper Jaffray Companies, Research Division - MD and Senior Research Analyst***

I guess, first, Andrew, for you. I was curious about your comment when you talked about June's promotional cadence. You made some adjustments there and drove some incremental improvement in the comp. I'd love to hear what you learned about that? And how that is shaping your strategy in North America as you get into the back half?

Andrew Rees ***Crocs, Inc. - President, CEO & Director***

Yes, thanks, Erinn. So that was specifically relating to e-commerce, right? So as we look at our global e-commerce business, we're pleased with where we are on a global basis. Obviously, our comps were up 17.8% on a global basis, really driven a lot by China and Japan. In Europe, we made a lot of progress putting in place key capabilities and adjusting our go-to-market strategy that has led to a double-digit comp in Europe off of a relatively poorer performance in the back portion of last year. As we look at Americas, it started off slow. I mean, we started off slow in the quarter. And that was really driven by our overall strategy to drive higher-quality revenues. We started off with a probably less aggressive promotional cadence than we had been last year. So we tried to pull back. And as we looked at where we were placed relative to everything else going on in the marketplace, it wasn't driving the results that we expected and it wasn't competing effectively online where the consumer is obviously one click away from a different opportunity. So we went back to where we had been historically, and where we think the marketplace was. We didn't go any further than that, and that had the desired effect of really driving the revenues that we desired.

Erinn Elisabeth Murphy ***Piper Jaffray Companies, Research Division - MD and Senior Research Analyst***

Okay. That's helpful. And then, on the wholesale side in North America, can you just talk about the retailer appetite for product when they are looking at taking some of the fall/winter product this year versus where it has been in the past. We've just heard from some of the other broader global vendors that we're getting this calendar shift deeper into the season. I'm curious if that impacts your third quarter at all in terms of how you're thinking about the guidance there?

Andrew Rees ***Crocs, Inc. - President, CEO & Director***

Yes. first, I think we're focusing on what we're good at, right? So we're focusing on our clogs, sandals, flips and slides. And similar to last year, we are seeing that season go longer into the third quarter. So you can certainly sell that product through July, through August and into September. And I think from your comment that's the impact that's having on the marketplace on those people who are trying to sell boots, it's constraining that season for boots and transitional products. And consistent with that observation, we talked about de-risking of our back half business. We've really cut fairly significantly the proportion of our product that is boot or transitional, and are really focusing on selling our clogs and lined clogs in that period. So we actually think that's working in our favor.

Erinn Elisabeth Murphy ***Piper Jaffray Companies, Research Division - MD and Senior Research Analyst***

Got it. And then, just one last question for me. On your store fleet optimization, that's been going a little bit faster than planned. Can you just talk about the ideal footprint you see in the business over time? And then, I guess, Carrie, for you, was the faster store closures the biggest piece of the SG&A reduction for the full year in the guide?

Carrie W. Teffner ***Crocs, Inc. - Executive VP & CFO***

I'll take both those, Erinn. So as we talk about the store footprint, obviously, what we've guided to is approximately 400 stores by the end of 2018. And I really think having a perfect model right now is not possible. So our goal at this point is to continue to evaluate what the fleet should look like, what the footprint is and the mix of outlet, and it will be primarily outlet, is of that store base, but we'll keep reassessing. But right now, our goal is to get to that 400, and then continue to evaluate from there. And then to your other question with respect to the SG&A for the quarter, certainly, the accelerated store closures had an impact. But we also saw a much higher focus on controlling costs in the business. So that played a part as well. But if I break down the $8-plus million dollars that we are favorable year-over-year, we did have some timing benefit. So I do want to acknowledge that. We had about $2 million of marketing expenses moving from Q2 into Q3. We also had a reduction in our estimate of charges associated with our SG&A reduction plans. We had originally thought it was going to be about $3 million, and it came in a little bit under that at about $1.8 million, and then we also had essentially a one-time pickup that was unexpected related to the bad debt recovery in China. So, in essence, we had about $4 million favorable. And that was, I think, fairly split between additional store closures and then just continued cost focus.

Operator

Our next question comes from Scott Krasik from Buckingham Research.

Matthew R. Gulmi ***The Buckingham Research Group Incorporated - Research Analyst***

This is Matt Gulmi on for Scott. I have a couple questions. First off, I just want to know what you guys had planned for bookings for the spring '18 season?

Andrew Rees ***Crocs, Inc. - President, CEO & Director***

Yes, thanks, Matt. Sometime ago, we stopped disclosing pre-bookings or booking information. As we look at spring '18, it's really early in terms of the spring '18 selling. We started meeting key accounts relative to that line. And I think the feedback we're getting is very positive and supportive. So we feel good about where we are from a spring '18 perspective.

Matthew R. Gulmi ***The Buckingham Research Group Incorporated - Research Analyst***

Okay. And what is the hurdle rate to get reorders in season and are retailers interested in optimizing sales with the products?

Andrew Rees ***Crocs, Inc. - President, CEO & Director***

I'm not quite sure what you're referring to around a hurdle rate. But the way we plan our business is generally about 75% of our business is pre-booked in the back half and about 25% is at-once or in-season orders. And that's generally how the business flows in the back half.

Matthew R. Gulmi ***The Buckingham Research Group Incorporated - Research Analyst***

Okay. And then lastly, do you mind speaking to your strategy around pricing going forward for the rest of FY '17?

Andrew Rees ***Crocs, Inc. - President, CEO & Director***

Yes. Most of our margin improvement and the improvement in the quality of our revenues has really been coming from greater sell-throughs and more full price sell-through. So that has allowed us to firm up our net pricing, if you like. We haven't impacted our MSRP or our high-level pricing. But we have seen some improvement in net pricing and margins from the more careful management of the business. As we look at the marketplace, we continue to evaluate opportunities for pricing, and as we introduce new products, we look at what is the competitive environment and the competitive products that we're comparing that to, to ensure that we're, one, delivering exceptional value to the consumer, but also getting paid for the amount of innovation that we put into the product.

Operator

(Operator Instructions) Our next question comes from Benjamin Bray from Robert Baird.

Benjamin Bray ***Robert W. Baird & Co. Incorporated, Research Division - Junior Analyst***

I wanted to ask a little more about the accelerated pace of retail closures. What impact is that having on the full year revenue guidance? I would imagine there is some sort of negative impact and if so, is there a positive offset that is causing you to hold the guidance for the year?

Carrie W. Teffner ***Crocs, Inc. - Executive VP & CFO***

Yes, great question. So we are still guiding at the low single digits, which is consistent with the guidance from last quarter despite the fact that we do have accelerated store closures. Part of the offset there is really around the fact there has been a favorable change in FX from the rates in place when we guided earlier after Q1. So really, we're holding because we have the tailwind of FX against the headwind of accelerated store closures.

Benjamin Bray ***Robert W. Baird & Co. Incorporated, Research Division - Junior Analyst***

Okay. And then, looking out at Q3 and Q4, I just wanted to know if you can provide some perspective on what's driving the decline in Q3? And then, what gives you confidence that Q4 can return to growth? It looks like there is a little bit of implied growth for Q4 in what the current guidance is. So any perspective on your outlook for the back half and what is giving you confidence there would be helpful?

Carrie W. Teffner ***Crocs, Inc. - Executive VP & CFO***

Yes, if I talk to Q3 first, so we are guiding at $230 million to $240 million. The major difference versus prior year is essentially the business model changes and the store closings and transfers. If we take the midpoint of that range, that means we'd be essentially flat to last year absent them. So that's kind of the assumption we've made relative to Q3. And then as we get into Q4, we do have continued benefit of FX based on the current rates today. And then, we are lapping an easier Q4 last year because what we saw there is people pulling back on some of the at-once business. We also had some challenge in e-comm performance in the fourth quarter last year as well. So we think it's up against an easier compare.

Operator

(Operator Instructions) I'm showing no further questions at this time.

Andrew Rees ***Crocs, Inc. - President, CEO & Director***

Okay. Thank you, everybody, for your continued interest in the Company. And we look forward to another strong quarter.

Operator

Thank you, ladies and gentlemen, this concludes today's conference. Thank you for participating. You may now disconnect.