Crocs, Inc.

Second Quarter 2023 Earnings Call

Thursday, July 27, 2023, 8:30

CORPORATE PARTICIPANTS

Andrew Rees - *CEO*

Anne Mehlman - *Executive Vice President and Chief Financial Officer*

Cori Lin - *Investor Relations*

PRESENTATION

Operator
Good morning and welcome to the Crocs Second Quarter 2023 Earnings Call. All participants will be in listen-only mode. Should you need assistance, please signal a conference specialist by pressing the star key followed by zero. After today's presentation, there will be an opportunity to ask questions. Please note, this event is being recorded. I would now like to turn the conference over to Cori Lin. Please go ahead.

Cori Lin
Good morning, everyone, and thank you for joining us today for the Crocs, Inc. Second Quarter 2023 Earnings Call. Earlier this morning, we announced our latest quarterly results, and a copy of the press release may be found on our website at crocs.com. We would like to remind you 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 laws. These statements include but are not limited to statements regarding our supply chain challenges, cost inflation, the acquisition of Hey Dude and the benefits thereof, Croc's strategy, plans, objectives, expectations, natural or otherwise, and intentions, future financial results and growth potential, anticipated product portfolio, our ability to create and deliver shareholder value and statements regarding potential impacts to our business related to the COVID-19 pandemic.

These statements involve known and unknown risks, uncertainties and other factors which may cause our actual results, performance or achievements to be materially different from any future results, performances or achievements expressed or implied by the forward-looking statements. Crocs is not obligated to update these forward-looking statements to reflect the impact of future events, except as required by applicable law. We caution you that all forward-looking statements are subject to risks and uncertainties described in the risk factor section of our annual report on form 10-K and our subsequent filings with the SEC.

Accordingly, actual results could differ materially from those described on this call. Please 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. Certain financial metrics that we refer to as adjusted or non-GAAP or non-GAAP measures. Reconciliation of these amounts to their GAAP counterparts is contained in the press release we issued earlier this morning.

Joining us on the call today are Andrew Rees, Chief Executive Officer, and Anne Mehlman, Executive Vice President and Chief Financial Officer. Following their prepared remarks, we will open the call for your questions. At this time, I'll turn the call over to Andrew.

Andrew Rees
Thank you, Cori, and good morning, everyone. I'm incredibly pleased with our second quarter results. We delivered record quarterly revenues of over a billion dollars. The Crocs and Hey Dude brands continue to perform extremely strongly, as evidenced by 26% direct-to-consumer revenue growth. We gained appreciable market share and once again delivered industry-leading profitability with 30% operating margins. Anne will review our financial results in more detail shortly, but here are a few highlights from the second quarter.

Revenues of over a billion dollars grew 12% on a constant currency basis. Crocs brand revenues grew in 15% constant currency, fueled by (inaudible) revenues increasing 39% and

global DTC comparable sales rising 20%. The Crocs brand continues to gain market share in North America with revenues up 13% driven by sandals and new product introductions. Hey Dude brand revenues were $239 million, with exceptional DTC growth of 30% and digital growth of 37% constant currency. Adjusted diluted earnings per share increased 11% to $3.59 per share. Gross leverage ended at 1.8 and net leverage was 1.7 times at quarter end, allowing us to repurchase $50 million of shares in July. Finally, Crocs, Inc. was named to the Time 100 most influential companies for 2023.

In summary, we had an excellent quarter, and our teams globally remain focused on driving brand health, market share gains and profitable growth in the back half of the year. I would now like to provide updates for each of our brands. Across brands, there's a lot of strong revenue growth since 2018, as we built both (inaudible) and brand relevance across the globe. This past quarter, our product and marketing efforts continued to deliver newness and excitement to the current clog trends, while simultaneously reaching new consumers who may not have considered our brand in the past.

With respect to product innovation, we're diversifying our clog offering and growing sandals. We've seen significant success with a number of height-orientated new clog introductions, including the Crush, Mega Crush, and more recently the Siren. In addition, our recent launch of Dylan, a more elevated and fashion-forward clog is very encouraging. The Echo continues to outperform our initial expectations and personalization continues to derive global relevance for the classic.

Turning to sandals, as we have shared, this category is an important growth initiative for Crocs, allowing us to expand into the adjacent $30 billion global sandal category, where we believe our molded technologies, accessible price points, strong go-to-market, will allow us to compete effectively in a relatively fragmented market. We're excited by our incredible sandal performance, where revenues grew 34% Compared to Q2 last year, and 40% growth on a trailing 12 month basis. Growth was robust in all regions, driven by our diversified sandal offerings, new product introductions and robust marketing calendar.

The classic (inaudible) continue to be a leading sandal franchises. In addition, the more recent Mellow and Crush introductions have been extremely successful and are also top selling styles. We will continue to drive some awareness and customer acquisition with activation such as the new Pollex slide with Salehe Bembury. Overall, we're pleased with the sandal trajectory and very confident that sandal revenues will grow to in excess of $400 million this year.

From a collaboration perspective, we announced plans for a two-year partnership with Salehe Bembury, who will serve as creative director of the Crocs x Pollex pod to introduce innovative new styles. This quarter, we introduced the Pollex slide, was sold out instantly, and provided a halo for our sandal offerings globally. More recently, we partnered with rapper Lil Nas X, to showcase a high collection such as Siren and Crush.

During Paris Fashion week, we took over the same Merci popup space. Other marketing highlights from the quarter include our Mellow slide with Taco Bell, a (inaudible) collaboration with (inaudible) running brand Satisfy, and a slide and clog partnership with Korean food brand Ottogi. Finally, this month, our Barbie collection featuring clogs, sandals and (inaudible), quickly sold out ahead of the blockbuster movie launch last weekend.

Asia is another important long-term growth driver for the Cross brand, as the brand is currently under-penetrated relative to here in the US. In Q2, Asia your revenues grew by 39% constant

currency. Growth was again broad-based was strong brand momentum throughout the region, including China, Australia, South Korea and Southeast Asia. We were particularly encouraged by another exceptional quarter of growth in China where Q2 revenues increased over 100% ahead of our expectations, and one more sign of the potential within this market. The leadership team and I had the opportunity to visit China in June for the first time in three years, and it was wonderful to see how much the brand had grown. We met with our partners, suppliers, and visited many stores.

We've been deploying the same playbook we've used globally, including influences, collaborations and personalization. We've partnered with local celebrities, including (inaudible) and Zhou Yutong, to style collaborations and products in their own authentic way. Crocs creations by for merging Chinese designers from fashion (inaudible) were featured at Shanghai Fashion Week. And (inaudible), our vehicle to self-expression continues to (inaudible) and delight consumers and create great excitement in our stores. Cross rising popularity in China has created a passionate following with a hashtag known as Dongman (ph) or clog's followers on RED, a leading Chinese social app. Topics related to Crocs have accumulated over 310 million views.

During the popular midseason festival in June, Croc sales ranked second on (inaudible) within casual footwear brands. In Douyin, Chinese TikTok, we ranked first in sales during midseason festival. In summary, we're incredibly excited by the Crocs brand momentum in China, and we're even more confident about the potential for the Crocs brand in the second largest footwear market in the world.

Now, to Hey Dude. We're incredibly pleased with the exceptional DTC growth, the 30%, and constant currency digital growth of 37%. Our product and marketing innovation is driving new customer acquisition and is growing awareness on the coast. Our ecommerce data demonstrates that Q2 revenues of both the East and West coast increased 45% compared to last year. New product introductions, which range from new colors to new silhouettes are driving excitement. Our Americana styles were top sellers ahead of memorial day and Fourth of July holidays, in most men, women and kids.

As a demonstration of our test and learn approach, this year, Americana collection featured over 20 patterns and colors, building on the early success we saw last year. The new Wally and Wendy Funk and washed canvas styles performed strongly in both DTC and wholesale, and our efforts to expand the brand beyond the iconic Wally and Wendy within sneakers are off to a great start. The Carina for women and the newly introduced Serape sold out quickly and we're in the process of getting them back in stock.

On the marketing front, we focused on enhancing brand awareness. We launched our first ever Hey Dude collaboration this quarter with outdoor lifestyle brand Mossy Oak and we saw a great sell through. We've also started to see our back to the campus collection on social channels and look forward to launching our collection featuring colleges from the Southeastern Conference or SEC in September.

Finally, with respect to wholesale revenues, as we discussed in June, the last part of last year's revenue related to pipeline fill for some of our new strategic alliance partners. We estimate pipeline fill was $70 million for the second quarter of last year, and $220 million for fiscal '22. This pipeline fill was very conscious decision on our part to secure self-space, knowing there will be competition in the marketplace. Aggregate consumer takeaway for the brand across all channels, we estimate to be up approximately 27% during Q2 2023, based on over 80%

increase in our strategic alliance accounts, shrinkage in our non-strategic wholesale accounts and 30% DTC growth.

Retail tracking service data from Circana, formerly NPD, indicates that Hey Dude rose from the number 15 fashion footwear brand in Q2 of last year to number eight in Q2 of this year, based on the US sales. As we look towards the remainder of the year for Hey Dude, we are lowering outlook for revenues. Wholesale growth is expected to be low. As we outlined in June, there is $220 million dollars of non-comparable sales last year due to the rapid expansion to major US strategic customers and the discontinuation of relationships with some smaller customers. Since then, while our wholesale partners are very pleased with the performance of Hey Dude and a number of called us out in the recent earnings, many are cautious in terms of future bookings based on the overall market outlook and lack of historical data on Hey Dude's performance.

Finally, as we previously shared, we anticipate constrained distribution capabilities, particularly related to (inaudible) in the back half of the year due to ERP and warehouse transitions. Even with this low near-term revenue outlook, the Hey Dude brand is acquiring new customers and is gaining penetration in strategic accounts and on the coasts. We remain incredibly optimistic about the long-term potential of the brand on a global basis. Finally, turning to digital for both brands, we saw exceptional 21% constant currency growth driven by new product introductions that are resonating well with consumers globally. For the Crocs brand, the app is rapidly scaling and gaining consumer traction, reaching penetration over 20% in South Korea.

In the US, we continue to be excited by our launch of customization, and on our site, now offering an online configurator for organizations to design custom clogs and jibbitz. Our global CRM databases also accelerating in key markets with the expansion of programs like SMS and the app. As we mentioned last quarter, to gain better control of our brand or realize higher ASP, we anticipate transitioning some of our Crocs ETL business that sits in our wholesale segment to a direct digital sale, both on Crocs.com, as well as marketplaces where we will sell directly to the consumer. This will result in lower wholesale sales and high DTC sales.

For Hey Dude, we're investing in digital capabilities, such as enhanced site experience payment offerings to improve the customer journey. We're also scaling our digital marketing investments to acquire and retain new customers. These efforts, coupled with new product introductions, have led to strong growth rates across all our digital channels, including being a top performing brand during Amazon's recent Prime Day. Overall, digital first approach is working and is driving strong growth globally.

In summary, we have tremendous confidence in and clear evidence as to the underlying strength and growth potential of both the Cros and Hey Dude brands. Sell through from both brands continues to be robust, and we believe we're benefiting from our democratic price points and gaining share a difficult market. I will now turn the call over to Anne, who will review our second quarter financial results in more detail.

Anne Mehlman
Thank you, Andrew, and good morning, everyone. I will begin with a short recap of our second quarter results. All revenue growth rates will be cited on a constant currency basis unless otherwise stated. For a reconciliation of the non-GAAP amounts mentioned to their equivalent GAAP amounts, please refer to this morning's press release. We had an excellent second quarter with over a billion dollars in consolidated revenues, representing 12% year-on-year growth. We delivered another quarter of industry-leading profitability with adjusted gross margin of 58.1%, adjusted operating margin of 30.3%, and adjusted diluted EPS growth of 10.8%.

Our portfolios diversified from a brand, channel and geography perspective. On a trailing 12 month basis and in Q2, Hey Dude brand revenues were 26% of total revenue. Channel mix was well balanced with hotel revenues representing 54% of trailing 12 month revenue, and TTC at 46%. Finally, approximately 31% of total TTM revenues and 40% of Crocs brand TTM revenue were from international markets.

During the second quarter, cross brand revenues were $833 million, growing 14.9% to prior year and driven by strong DTC growth of 26.8%. The brand sold 33 million pairs of shoes, an increase of 1.8%. The Crocs brand average selling price during Q2 was $25, which was at 12.8% on a constant currency basis, driven by price increases and fewer DTC promotions internationally. Within the Crocs brand, clogs grew double digits and continue to generate demand with newer products such as Echo, Crush and Dylan. Sandals, an important growth pillar for the future, increased 34% in Q2, with growth in all regions to represent 16% of Crocs brand sales. Finally, jibbitz continues to create excitement and engagement with consumers around the world, growing 13% from last year with strong growth internationally.

Now, let's discuss a few Crocs brand highlights by region. In North America, second quarter revenues increased 12.5% to $475 million, and first half revenues increased 11.5%. We gained significant market share in a declining us footwear market. The North America DTC channel for the Crocs brand, indicator of underlying consumer demand, was a key growth driver with DTC comparable sales up 12.9%. Wholesale revenues were also robust, increasing 5.5% despite a more challenging wholesale environment. Asia Pacific delivered significant growth as we execute on our long-term growth plan to ignite the brand in the region. Crocs brand Q2 revenues in Asia grew 39% to $190 million and growth was broad-based across countries and channels.

China and Australia led to growth with revenues increasing over triple digits, while South Korea and Southeast Asia also had strong double digit growth. Crocs brand revenues for EMEALA were $160 million, a decline of 1.4% from the second quarter of 2022. As a reminder, Q2 last year benefited from a $40 million revenue shift out of Q1 and following the Vietnam shutdowns. This quarter, strong growth and direct markets, including the UK and France, as well as outstanding DTC comp growth of 30.6% was offset by a decline in distributors.

In connection with a newly implemented marketplace management program, in the quarter, we terminated a relationship with a significant distributor servicing Africa. This was not anticipated going into the quarter, and we terminated the relationship after finding evidence product diversion to the gray market outside of their approved territories. This impacted revenue by $8 million in Q2 and will impact second half revenues by $21 million. We expect EMEALA revenue growth to re accelerate in the back half of this year.

Turning to Hey Dude, Q2 revenues were $239.4 million, an increase of 2.9% from last year. During Q2, the brand sold 8.3 million pairs of shoes, an increase the 3.6% over last year. Hey Dude average selling price during Q2 was $28.80 or 0.6% lower than prior year due to price pressure from gray market selling on Amazon. The DTC channel, which is predominantly ecommerce, led the growth was revenues increasing 29.7% from last year. Digital sales increased 36.6% and digital penetration increased 1,000 basis points to 41.8%.

As Andrew explained earlier, underlying consumer demand for the Hey Dude brand is incredibly healthy. Consolidated adjusted gross margins for the second quarter were 58.1%, increasing 290 basis points from last year, driven by favorability in ocean freight rates and the absence of

air freight that was partially offset by higher overhead and fulfillment costs associated with our Hey Dude distribution network inefficiency. Currency negatively impacted consolidated gross margins by approximately 50 basis points.

Turning to the brand. Adjusted gross margin for the Crocs brand was 62% or 410 basis points higher than prior year. Reduced airfreight of approximately 380 basis points, combined with lower inbound freight rates, higher prices internationally, and channel mix, were partially offset by product mix. Currency negatively impacted margins by 80 basis points. Hey Dude adjusted gross margins were 47.1%, flat with prior year. We continue to see a reduction in inbound freight rates; however, this has been offset by additional inventory storage and network costs related to the transition of our subscale distribution network, combined with gray market pressures on ESP and our digital channels.

During the second quarter, consolidated adjusted SG&A represented 27.8% of revenues, which is 270 basis points higher than last year, as we invested more in marketing and talent for both brands to support our growth trajectory in annualized additional investments for Hey Dude. Our second quarter consolidated adjusted operating income was $325 million, an increase to prior year by 11.7% and consolidated adjusted operating margins remain best in class and increased 20 basis points to 30.3%. Our second quarter non-GAAP diluted earnings per share increased 10.8% to $3.59. Our continued strong free cash flow generation enabled us to repay approximately $300 million of debt in the first half, reducing borrowings to $2 billion.

At the end of Q2, adjusted gross leverage was 1.8 times, achieving our mid-year leverage goal and net leverage was approximately 1.7 times, as we ended the second quarter with $166 million of cash and cash equivalents. Our exceptional free cash flow generation has enabled us to quickly deleverage and resume our share repurchase program. In July, we completed $50 million of share buybacks, repurchasing 425,000 shares at an average price of $117.72. We currently have a billion dollars remaining on our share repurchase authorization, and we will continue to methodically balance debt repayment and share repurchase as we approach our long-term net leverage target of one to one and a half times.

Our inventory balance at June 30th, 2023, was $436 million, a decline of 13% to Q2 last year. Crocs brand inventory was $307 million, down 8.4% to prior year, and Hey Dude inventory with $130 million, a decrease of 22.3% to prior year. Inventory turns continue to improve and we are very pleased with the health of our inventory. As we look forward, I would like to share our current outlook for the third quarter and the balance of 2023. All numbers will be on a reported basis unless otherwise stated. Having completed an exceptional first half, and with improved visibility and competence around the second half, particularly for the Crocs brand, we are raising our full year 2023 outlook for revenue and profitability. We now expect revenue growth of 12.5% to 14.5% on a reported basis compared to 2022, up from prior guidance of 11% to 14% growth and resulting in full year revenues of approximately $4 billion.

On a consolidated basis, as always, we are focused on best-in-class profitability and are raising our adjusted operating margin to be approximately 27.5% for the full year. We are confident in our ability to deliver higher operating margins, as gross margins have outperformed, and we've been able to closely manage SG&A while investing for future growth. We are also raising our adjusted diluted earnings per share outlook to be between approximately $11.83 to $12.22, up from the prior guidance of $11.17 to $11.73. From a brand perspective, we are raising our expectations for the Crocs brand and now expect to grow 12% to 13% on a reported basis, up from 7% to 9% previously, with Asia expected to deliver the highest growth and PPC (ph) outperformance expected to continue.

For Hey Dude, as Andrew mentioned we are lowering our full year growth outlook to be between 14% and 18% revenue growth on a reported basis. This translates to approximately 3.5.% to 7.5% growth in 2022 performer revenues of $986 million. While we continue to anticipate strong growth and wholesale sellout for the Hey Dude brand, our wholesale partners are planning to manage their inventory very closely for the remainder of the year and we have a constrained warehouse that limits our at once capability.

On a two -ear basis, Hey Dude growth is very healthy at approximately 80%, and we remain excited about the long-term growth potential of this young brand. For Q3, we expect consolidated revenue to grow approximately 3% to 5%, as we want significant pipeline fill for Hey Dude. We expect Q3 adjusted operating margin to be approximately 27% and adjusted diluted earnings per share of $3.07 to $3.15. In summary, we are incredibly pleased that we were able to raise expectations for revenue, operating margin and EPS.

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

Andrew Rees
Thank you, Anne. As we look forward, we're incredibly confident in the strength of the Crocs and Hey Dude brands and our ability to drive market share gains and sustainable profitable growth. Our focus remains squarely on sustaining brand health and create long-term shareholder value. Operator, please open the call for questions.

QUESTION AND ANSWER

Operator
Thank you. We will now begin the question and answer session. To ask a question, you may press star then one on your touchtone phone. If you're using a speakerphone, please pick up your handset before pressing the keys. To withdraw your question, please press star then two. At this time, we'll pause momentarily to assemble our roster.

Our first question comes from Jonathan Komp from Baird. Please go ahead.

Jonathan Komp
Hi. Good morning. Thanks, everyone. I want to start just by asking a little more detail about your outlook for Hey Dude. Could you give a little more color what you're expecting for the third quarter, embedding in your total revenue guidance and just how to think about the channel expectations in third quarter for Hey Dude? And then maybe a bigger picture question. I know when you bought the brand, you pointed to at least a billion of revenue by 2024. You're delivering that this year, but how should we think about the growth drivers as we get beyond 2023?

Andrew Rees
Great. Thank you, Jonathan. So yeah, so maybe I'll do the last part of your question first, and kind of set the stage for Hey Dude then we can come back to Q3. So as we look at the period since we've owned Hey Dude, look, we've rapidly expanded distribution, to what I would say is essentially the same or very similar distribution to Crocs. A large part of that expansion was last year, and I'll come back to that. At the same time, we've introduced new innovative silhouettes that we think are doing well, well, we know are doing well. And we've dramatically strengthened the team.

As we look at Q2 sell-out for the brand, up 27% as we look across all channels, and consumer satisfaction is incredibly high. NPS for the brand is 71, which is about 50% higher than, frankly, most brands in the casual footwear space. As we look at the back half of the year, we're reducing our expectations for the brand, principally related to wholesale, and there's a few things going on there. Number one, as I talked about in prepared remarks, we've got $220 million of sell-in that we did last year, that it is pretty hard to comp. Second, we are seeing our wholesale partners be pretty cautious in the back half of the year. I think they've been cautious for kind of three reasons. One is they're just cautious about overall traffic trends and the trajectory of the consumer. They've got some overstock in some other brands, principally some of the big athletic brands that they've got to work through. And they don't have good history on Hey Dude in the back half of the year. So we're seeing very cautious bookings.

When we combine that with some constraints that we have around our at once business. We are transitioning towards the end of the year, our warehouse and our ERP system, so we're being realistic about our at once capabilities. And then lastly, I think, we've seen some gray market on the Amazon platform, which we think it's principally coming from the distributors that we closed last year. We are seeing a slight mitigation of that, but we're also working hard to clean up the Amazon presentation. So I think hopefully that gives you a strong picture of what's happening with Hey Dude. We're incredibly confident with the brand, incredibly confident that long-term growth trajectory. We're not ready to go next year. growth. I think that was embedded in your question, but we feel well positioned for the long-term growth of the Hey Dude brand, both here in the US and internationally. And I'll let Anne add some commentary around Q3.

Anne Mehlman
Thanks, Andrew. Hi, Jon. I think the biggest thing for Q3 is just to remember we're still dealing with, as Andrew mentioned, the non-(inaudible) of Hey Dude, or the pipeline fill. So for Q3, we do expect Hey Dude to be down, and that's primarily--that's really related to the wholesale part of the business, as Andrew just mentioned. And you can see from our presentation, we had about $60 million of pipeline fill last year. And then we expect direct-to-consumer to be up and then Crocs, obviously, to continue to grow and that provides the color around the overall Q3 guidance for revenue growth.

Jonathan Komp
Okay. That's very helpful. Then, if I could just ask separately about Crocs. Given some of the sales that looks like you're going to miss in the second half, maybe close to $30 million from the distributor you mentioned, but you're still raising guidance for the year, could you just highlight maybe where you're seeing upside for Crocs? And maybe tie in with that any updated thoughts on the gross margin for the year for Crocs, since it looks like it was quite strong in the quarter? Thank you.

Andrew Rees
Yeah. Thanks, Jon. Look, our Crocs business is very strong, and we're seeing the brand perform strongly in, frankly, many regions. I'd probably call out a couple. DTC is very strong, particularly here within North America, but also in Asia. Our US wholesale business is probably a little bit stronger than we thought it was going to be, so we feel really good about that. China, I think we gave you a lot of color around China in our prepared remarks. It's performing very well. Broader Asia is also performing well. So I think what we're seeing is continued strength in Crocs, really driven by the same things that we've kind of talked about a few times, but it's really product innovation. It's marketing innovation. We see it across clogs, as well as sandals, as well as jibbitz, so we feel very confident in the overall Crocs trajectory. I will let Anne pick up on your first margin point.

Anne Mehlman
Yeah. I would also just add that EMEALA DTC is actually incredibly strong as well. So even though the distributor part is impacting that, we saw very strong growth in EMEALA DTC. It was, I think, around 40%. But overall from a gross margin perspective, so Crocs gross margins are also flowing through stronger. Some of that is just stronger channel as DTC outperforms. The second piece is we've taken quite a bit of price in our international markets, which are really supporting margins, and then we've seen promotional levels kind of level out in North America. And then obviously, we've been able to recoup the air freight last year, as well as just lower freight rates.

So I would say overall, we expect margins to be higher than the kind of original guide. We thought they were going to be a little bit higher than 58, and now we're thinking they're probably going to be North of that. So overall, our gross margin expectations for the year are higher than the kind of 55.5 we talked about last time, and that supports the operating margin raise.

Jonathan Komp
All right. Thank you very much.

Anne Mehlman
Thank you.

Operator
The next question comes from Abbie Zvenjnieks from Piper Sandler. Please go ahead.

Abbie Zvejnieks
Hi. Yeah, thanks for taking my question. So just first, can you just comment on any differences, I guess, that you're seeing from your wholesale partner behavior between Crocs and Hey Dude, in the US specifically? Is there any difference between sellout between the brands, or is this really that non-comp dynamic and then just not having that historical data on what happened in the second half for Hey Dude?

Andrew Rees
Yeah. I think that is obviously a question that we've definitely been kind of asking ourselves and looking closely at, Abbie. And I would say, a lot of it is really the newness of the brand, we feel. Crocs is clearly performing well, and I would say, Crocs at US wholesale, it's the newness. It's both clogs; it's both sandals, and it's performing well. I would say the Hey Dude sell-out is also very strong. I think we gave you some visibility to that and the strategic partners. It's up dramatically, I think, close to 80% and sell-out in aggregate across all channels, our estimate is up 27%. So consumer takeaway is strong. It's definitely performing at wholesale.

We think the principal issue is they have years and years in history on Crocs and how it performs in the back half of the year. The history is very light and to some of the wholesale partner, non-existent for the back home for the year, and we're seeing cautious bookings. And as I highlighted in my earlier answer, it's hard for us to react to that with at once, given our kind of warehouse situation, so that's really our diagnosis.

Abbie Zvejnieks
Got it. That makes sense. And then just on the--inventory management is really strong during the quarter. So you talked about Hey Dude gross margin was flat year-over-year, but some

pressure from those storage costs. So as you've cleared through inventory, when do you think you could start to see maybe some benefit to the Hey Dude gross margin? Thanks.

Anne Mehlman
Yeah. We're very pleased with overall inventory, obviously, down for both brands, and really coming in line with our longer term target, return targets for both brands to be about four times. I think, from a gross margin perspective, overall, there's kind of two pieces pressuring Hey Dude gross margins. One piece, as you mentioned, is the additional kind of storage and subpar logistics situation for that brand, which we expect to obviously cure next year with the opening up of our new Las Vegas distribution center. And the second piece is, we are seeing quite a lot of gray market activity on Amazon pressure our Hey Dude AFPs. And that's really related to some of the terminations that we did when we went through and terminated some of the legacy international distributors, and also some of the legacy US partners. So we expect to work through that and that to improve throughout the year. So I expect next year, our gross margins should be back in line kind of with where we originally thought, which is more on the lines of around 50% in the shorter term.

Abbie Zvejnieks
Got it. Thank you.

Operator
The next question comes from Tom Nikic from Wedbush Securities. Please go ahead.

Tom Nikic
Hey. Thanks for taking my question. So, I guess when we think about Hey Dude, obviously, and I believe you said, down in Q3, and that would imply that there's a pretty significant step up in the fourth quarter. Based on the slide deck, there's also a pretty significant amount of new door contribution last year. I'm not sure if that's channel fill or sell through, channel fill that happened earlier in the year or whatever, but I guess, how do we get comfortable with kind of the reacceleration that's embedded in Hey Dude for the fourth quarter?

Andrew Rees
Yeah. I think, there's a few things. One is, in the fourth quarter, we anticipate that the DTC balance in the business is bigger. Right? It typically is with the holiday period. So we think DTC is the bigger--as you can see, we've gotten nice trajectory on our DTC business. And we also look at our wholesale business, and yes, there is still a component of sort of pipeline fill that's harder to comp in the fourth quarter, but I think the balance of the business, we will see a rebound in Q4.

Tom Nikic
All right. And then I just want to follow up on inventories. So I think inventory was down 13% year-over-year, if I'm not mistaken. Should we think about inventories being down year-over-year in the back half as well?

Anne Mehlman
Yeah. We don't typically guide inventory. I would say that we expect by the end of the year to be closer to our four turn target. So I think it depends a lot on, obviously, from a revenue perspective. And we will, for both brands, tend to bring in inventories ahead of a very high selling season for wholesale in Q1. So some of that depends on our Q1 orderbook, obviously, but we think that our inventories will be back in line, probably around four turns by Q4.

Tom Nikic
Understood. Thanks, Anne. Thanks, Andrew. Best of luck in the back half.

Anne Mehlman
Thanks.

Andrew Rees
Thanks, Tom.

Operator
The next question comes from Jay Sole from UBS. Please go ahead.

Jay Sole
Great. Thank you so much. The slide deck, you gave us that nice data point that sandals continue expected to be $400 million for the Crocs brands. You also mentioned some new styles from Hey Dude. I think you pointed out in the slide deck, the Funk, the Sirocco. What percentage of Hey Dude, revenue is the Wally and the Wendy right now, and maybe where was it a year ago? And where do you see it going from here? Thank you.

Andrew Rees
Yeah. We will not be providing that data, Jay, but I can qualitatively tell you that a very large portion of the Hey Dude business is Wally and Wendy. That's the iconic silhouette. And while we're highlighting new styles, which we think is important to continue to diversify, and build out the brand and take the brand into kind of other silhouettes and other wearing occasions, a ton of our effort from product innovation and newness perspective is going into the Wally and Wendy. I think we highlighted a great example is the patriotic pack. Right?

So last year, essentially, when we bought the brand, they had a stars and stripes shoe that did really well going into Memorial Day and Fourth of July. We saw great traction with that, so we expanded that to, I think we said 20 plus style, colors, across men's, women's and kid's, and that did amazing. So a very large portion of business is Wally and Wendy, our innovation is going into Wally and Wendy, plus, also the additional silhouettes. And I would call out Scirocco in particular, which is kind of a running orientated silhouette, casual running, is performing very well in our DTC business and in our key wholesale accounts.

Jay Sole
Okay. Got it. And if I can maybe ask one more. Can you give us an update on the cash use plans for Q3 and Q4? Obviously, you've paid down a lot of debt in the quarter, bought back some stock. I mean, do you expect those trends to continue at a similar rate or different rates? That would be helpful. Thank you.

Anne Mehlman
Yeah. Thanks, Jay. Yeah. We're incredibly pleased with our historical debt pay down and what we anticipate to paydown. So we've obviously done a lot of work on de-risking the balance sheet and paid down $850 million of debt since we purchased Hey Dude. We do expect to continue to generate incredible free cash flow. So that free cash flow, given these dynamics, after we will--funding our business, obviously, we will continue to deploy capital. So we'll prioritize paying down debt to get to a target net leverage longer term ratio, one to one and a half, as we've stated, and we will look to opportunistically also buy back shares. So we will balance both in the back half of the year.

Jay Sole
And is that included in the EPS guidance?

Anne Mehlman
No. The EPS guidance includes debt paid down and excludes any opportunistic share buybacks.

Jay Sole
Got it. Okay. Thank you so much.

Anne Mehlman
Thank you.

Andrew Rees
Thank you.

Operator
Our next question comes from Samuel Mark Poser (ph) from Williams Trading. Please go ahead.

Samuel Mark Poser
Good morning, everybody. Thanks for taking my questions. All right. At the fanny (ph) show, we were told that when showing a lot of new product that to help balance, you run a math program, but you have map holidays. My question to you is, what are you doing with core product in both Crocs and Hey Dude, to create more relative scarcity, so you don't need the map holidays so you can drive more of a full price business? Because I think everybody out there has seen a good amount of promotion. And then I want to follow up on how you're controlling Amazon and how long that's going to take to get that all cleaned up.

Andrew Rees
Okay. All right. So I think, let me do the first part first, Sam. So what I'd say, is for Crocs and Hey Dude, we operate map, as you well know. We try and make sure our key styles are mapped, and so they are not promoted on an ongoing basis. And then we give the retailers, I think, five holidays a year, throughout the year, which is frankly, pretty typical. I would say most brands follow that cadence and give them an opportunity to drive some promotion. Those are all at key promotional periods when the consumer is expecting promotion. And we think that is a very sensible strategy to maintain majority full price sell through plus also give our wholesale partners an opportunity to drive lesser business at key times and compete with other brands. I would highlight, particularly for Crocs, that's been in place for some period of time, that is driving a very high overall achieve gross margin rate, and a great deal of profitability for the brand. And then so then, you want to ask you a question associated with Amazon cleanup?

Samuel Mark Poser
Yeah. I mean, I understand but if you have a brand that appears as strong as both your brands are, and you have a strong map policy, wouldn't the consumer start waiting for the sale periods over time versus just control it? So I understand promoting stuff you need to clear but if you have core colors that you're going to promote, I mean, it just--I don't understand it.

Andrew Rees

Yeah. I would say, Sam, there's not all the evidence for that, right? We see our core products, core colors, core products sell week in, week out, right? So there's really not a lot of evidence that they're waiting for the map periods. And I would say the map brakes on the cause are pretty light. And I would say, look, we're doing a ton of other things with scarcity, right? So we do multiple call outs a week to drive scarcity and drive consumer interest in the brand, and a reason to buy. We have huge amounts of kind of seasonal product that's in and out. And if you think about the core classic clog, a whole range of seasonal colors that don't get replenished. And so the consumer knows if they don't buy them, they're not available later. So I think the balance of colabs, marketing activity consumer activation, it's kind of working really well, to be honest, in terms of driving the overall trajectory of the brand, as well as the sales and gross margin achievement.

Samuel Mark Poser
And then, apply that to Hey Dude, including the Amazon question?

Andrew Rees
Yeah. We're transitioning to a similar strategy for Hey Dude. Right? So we've rapidly expanded the distribution of the brand, essentially, to the same partners that have Crocs. We're following kind of a similar pricing approach. But I would say, we are seeing quite a lot of pressure in terms of Amazon gray market, and we're working really hard to close that down, I think we've highlighted that we think a lot of that product is coming from the distributors that we closed internationally. So the amount of product that they have available is finite and will run out and really is running out. And so it's a disruption, temporary disruption to the business, but I think we're very clear about what it is and how we deal with it.

Samuel Mark Poser
Thank you very much.

Andrew Rees
Okay. Thanks, Sam.

Operator
The next question comes from Jeff Lick from B. Riley. Please go ahead.

Jeff Lick
Good morning, guys. Congrats on a great second quarter. Andrew or Anne, I was wondering, your Q2 presentation that you put out on June 7th, the implication is you take the Hey Dude guidance from mid 20s, down to the 14 to 18. The implication is things were probably on track at that point, given how you go about your IR efforts and your communications. I'm just wondering if you could walk us through some color as to what happened from June 7th on to today, in terms of how would you get the feedback, any color on how things deteriorated a little bit and changed?

Andrew Rees
Yeah. Look, I think the biggest thing, Jeff, is what I highlighted to an earlier question, right, which was, as we look at our--there's really two big pieces. One is wholesale. The other is sort of our efforts to clean up the gray market. The biggest probably is the wholesale, and we look at our bookings for the fourth quarter, they were more conservative than we thought they were gonna be. That's really the biggest change. And the reasons we think that we've been told, and the reasons that we understand for that is number one, the majority of the wholesale channel has been pretty cautious about the back half of this year. They have some inventory overhang

from some other brands that they need to work through, so they're open to buy dollars that are a little bit more constrained than they'd like to be.

Now, you could argue that they should invest in the performing brands and then deal with the overstock brands separately. We've certainly made that argument, and we'll continue to make that argument. And they don't have strong history on Hey Due, right? So unlike Crocs, with their years and years of history, and can see exactly how it performs in the back of the the year, they don't have the same history and confidence in Hey Dude, and they're pushing a bit of the responsibility back on us in terms of at once, but we don't have the ability to deal with that to the degree they'd like us to. So we just felt at this point, it was prudent to lower expectations for the back half of the year, so that's really what changed. As we look beyond the back half of this year, we see lots of growth opportunities for the brand, both from a territory perspective, from a customer perspective and also from a silhouette and new product introduction perspective.

Jeff Lick
And just a quick follow up on the direct-to-consumer Hey Dude, 29.7, I'm curious, is that a relative to the 40.6 in Q1? On a two year, are those comparable? It seems like that probably decelerated a little bit. And then I was wondering, as you guys measure the gray market impact, how much of an impact in terms of percentage points might that have on that DTC revenue percentage?

Anne Mehlman
Yeah. So Jeff, the 40%, that was just March. If you remember, that was direct-to-consumer call for March because we didn't own the business before that. The 29.7% of total growth for direct to consumer, which is ecommerce, and we have a small amount of retail type of clearance stores, so that's the 29.7% growth. So you're comparing kind of three months to one month when we kind of own the business. So I'm not sure it's a totally fair comparison, but we felt pretty good about a 30% direct-to-consumer growth.

I'm not sure if we can actually, or we're ready to kind of talk about how much the gray market has hurt from a growth perspective, but I would say, actually, on both brands, it's not insignificant. It's actually pressured ASPs and also, obviously, we lose the (inaudible) and being able to sell directly to the consumer. So we've been very aggressive and attacking that. We talked about, we've launched a market cleanup kind of program, and obviously, canceled a pretty significant distributor. And we will continue to be very focused on making sure that our product ends up where it should be.

Jeff Lick
Great. Thanks very much.

Anne Mehlman
Thank you, Jeff.

Operator
The next question comes from Jim Duffy from Stifel. Please go ahead.

Jim Duffy
Thank you. Good morning. First, Andrew--hey, I'm hoping you can speak to development of the China marketplace and opportunity, if not, to build. Maybe to start, just can you size the baseline. A lot of moving parts with COVID. Give us a sense for the size of that business now, and then maybe speak to the current channel mix. And then with that background, if you could

speak to the different avenues for growth, will digital be the principal channel or do you plan to open more stores in China as well?

Andrew Rees
Yeah. Let me talk about the strategy about what we're going to do in China, and I'll have come in at the end and talk to you about the size of the base and give you some perspective there, right? So from a strategy perspective, the way to think about it, and we've talked about this historically through the cleanup. So the way to think about it, in China, today, we have a large digital business. We've definitely invested very heavily in digital. It's probably our most important channel within China. And then secondly, we have a small footprint of company owned stores. Those company own stores are in the major cities and in the best malls, which are sort of quite expensive for your distributors, or your distribution partners in country to invest in. They're super important because they showcase all of our latest products. They drive authenticity with the consumer. And then we have outlet stores that we also own directly ourselves. Important because they are highly profitable and also, they allow you to keep your inventories clean.

And then the third component of the strategy is the franchise or partner model branded stores. So as we look at growth, we think growth will principally come from two things. We think our digital business will continue to grow, and that's diversified across the platform. So that's (inaudible) that's JD (ph), but also increasingly Chinese TikTok, where we do a lot of social selling in China. And so the growth will come from digital and will also come from partner operated stores. And so if we look at the partner portfolio, they will continue to grow their store footprint, probably quite aggressively. The stores that are operating for Crocs are performing extremely well. They're making a lot of money from those and they're really commercial animals. If they're making money and they can see an opportunity to open more stores, they will, and obviously, we'll encourage that. So really, the partner operated stores and the digital will drive the business in the future.

Anne Mehlman
Yeah. So I think historically, from a size perspective, we said China was about 5% of the Crocs revenue base. And obviously, our longer term growth for that as we expect it to grow up to be about 10%, which would be a $500 million kind of base. And roughly, if you do the math, historically when we said it, it would have been more like a $60 million business. So we obviously are growing very quickly. So it's outgrowing so it is taking share and really on track with that long-term trajectory. So we're pretty pleased overall with how China's growing and that it's on track.

Jim Duffy
And Anne, is that a margin accretive business?

Anne Mehlman
So we're investing quite heavily in it right now. Right? So we're investing outside marketing into that business, but long-term, obviously, you leverage that and the gross margins in that business are incredibly strong.

Jim Duffy
Great. Then last question for me, Anne, is just on (inaudible) SG&A. I'm curious if you've at all adjusted it for the type of revenue view?

Anne Mehlman
I'm sorry, can you say that again? What was the last part of your question?

Jim Duffy
The Hey Dude SG&A. I'm curious if you've adjusted your planned SG&A investment in the Hey Dude brand for the tempered revenue view?

Anne Mehlman
Oh, understand. No, actually, we continue to accelerate investments into Hey Dude in line with our original plans, because again, this is not a consumer takeaway issue, and so we feel very strongly that we need to invest in our brands. And luckily, we can still generate 27.5% operating margins, to the benefit of having a portfolio and also with the benefit of having one brand spin off so much profitability. So we will continue to invest in Hey Dude. SG&A throughout the year at the same pace.

Jim Duffy
Excellent. Thank you.

Anne Mehlman
Thank you.

Operator
The next question comes from Laura Champine from Loop. Please go ahead.

Laura Champine
Thanks for taking my question. So I hear that the shift from expecting Hey Dude to grow in the mid 20s, to more like high teens this year, is because of wholesale customer orders coming in conservatively. Does that impact your own internal thoughts about the growth rate for Hey Dude for next year and beyond?

Andrew Rees
No, Laura. I think connected to (inaudible), to Jim's question, immediately prior, no, we see Hey Dude on essentially the same trajectory as we saw it when we bought the company, and since we've owned it. We still have very high expectations for the long-term growth of the brand. And we continue to make, I would say, the SG&A investments, the talent investments, and the marketing investments that we had anticipated making even before taking down this adjustment to our growth rate, and we will continue to do that. We're very confident in the long-term potential the brand and we're managing this brand for its ultimate potential, not it's kind of one year, sort of one quarter, or one half year performance.

Laura Champine
Understood. And then just a follow up on this sort of wild, wild west environment on Amazon, and the gray goods sold there. Has there been a change in your own policy for wholesale customers for Hey Dude to retail on Amazon? And if so, how much is that impacting that guide for this year?

Andrew Rees
Yeah, there has been a change, and we will make further changes. So what we did last year, and so that doesn't impact our guide for this year, just to be clear. What we did last year, is, we did terminate some customers that were operating, I would say, one or two stores, but buying goods principally to sell on Amazon. So we terminated several customers that were doing that. That was done last year. That's not this year. We also have made it very clear in our terms of

sale to all of our partners that they are not allowed to sell on Amazon. That doesn't mean that some don't, some do because they do, but that is our policy.

We will further, as we go through the back end of this year, constrict our wholesale customers rights to sell on their own dot coms as well. Right? So this is essentially moving Hey Dude to the same policy we have for Crocs, which is our large wholesale customers, so think Famous Footwear or Footlocker. They absolutely have the rights to sell on their own dot com. But the mom and pop retailers will not have the rights to sell on any web presence that they have. So we're in the process of the sort of continued reining in of digital sell.

Laura Champine
Got it. Thank you.

Andrew Rees
And just to emphasize, we're getting into the same place that Crocs is. We're not restricting further than that.

Laura Champine
Makes sense. And can you be specific on how much that has impacted the guide for 2023?

Andrew Rees
Look, it's probably had some impact and I say we can't break that out and be specific about that, but it probably is a factor.

Laura Champine
Understood. Thank you.

Operator
The next question comes from Rick Patel from Raymond James. Please go ahead.

Rick Patel
Good morning, everyone. Thank you for taking the question. Can you talk about the drivers of the Crocs brand in North America going forward? I'm just curious how we should think about the contribution of pricing versus volume in the back half. And also, if there's anything to call out in terms of the wholesale business, in light of the trends that you're seeing at Hey Dude.

Andrew Rees
Yeah. I mean, the drivers of Crocs, as we think--I think your question is kind of a multiperiod question. So we see new product introductions. We see strong marketing support. We see collaborations continuing to drive very high interest in the Crocs brand, and in fact, growing interest in the Crocs brand. We will capture that interest through continue to diversify clogs, and continue to grow our clog business, as well as the rapid acceleration of sandal and penetration of sandal categories, and also continued innovation within jibbitz. So we really see those core businesses towards the back end of this year, and we'll also continue to experiment with, I would say, kind of new and innovative silhouettes that we think the Crocs brand can be particularly relevant. So you'll continue to see us push the envelope in terms of experimentation. I think that's super important. And so pretty confident, as evidenced by a DTC growth and strong wholesale performance that we'll continue to drive kind of multiyear trajectory of the Crocs brand in North America.

Rick Patel

Can you also update us on where you are with addressing Hey Dude's ERP and capacity constraint issues? And I believe you touched on working through that next year, but I'm just curious if it's going to be a first half versus second half event. And when that does happen, what kind of change we can expect from Hey Dude from a go to market strategy perspective, in terms of potential to add new wholesale partners, or accelerate international efforts?

Andrew Rees
Yeah. We plan to transition to a new ERP and a warehouse, essentially at the end of the year. So that will be the transition period, and that will release a couple of important constraints. One is we're incurring a lot of extra costs to move goods around, double handle goods and have good stored in subscale places. So that will alleviate some expense, and also some flexibility and ability to react to the business. It will also give us the opportunity to have a much larger at once business in the following year. And it will also allow us a little bit more flexibility, some of the major wholesale partners with whom today we're really trying to do a lot of direct shipments, which can be efficient and cost effective, but also not very flexible. So it will give us a lot more flexibility. It will give us lower costs, flexibility and the opportunity for larger at once business.

Rick Patel
Thanks very much.

CONCLUSION

Operator
This concludes our question and answer session. I would like to turn the conference back over to Andrew Rees for any closing remarks.

Andrew Rees
So just to close, I think I'd like to just thank everybody for their continued interest in the business. Obviously, we had a phenomenal second quarter. And I think what you're also seeing is the real cash generating power of our portfolio and the ability to pay down debt very rapidly and give us a lot of balance sheet flexibility. So thank you for your interest and we'll talk to you again next quarter.

Operator
The conference has now concluded. Thank you for attending today's presentation. You may now disconnect.