15-Jan-20 19

Crocs, Inc. (CROX)

ICR Conference

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CORPORATE PARTICIPANTS

Jonathan R. Komp
Analyst, Robert W. Baird & Co., Inc.

Anne Mehlman
Chief Financial Officer & Executive Vice President, Crocs, Inc.

Andrew Rees
President, Chief Executive Officer and Director, Crocs, Inc.

MANAGEMENT DISCUSSION SECTION

<<Jonathan Komp, Analyst, Robert W. Baird & Co.>>

Okay, everyone, let's get started with the next session here. I'm John Komp, the analyst covering footwear and apparel stocks for Baird. I'm very pleased to welcome the next company, Crocs, which many of you may know, but is one of the larger casual shoe companies and brands really across the globe, selling in more than 90 countries, approaching 60 million pairs annually that are sold, and really, over the last few years has gone through a very dramatic transformation from a company and brand perspective.

So, there's a very good story for the team to tell today. And joining us is President and CEO, Andrew Rees; and CFO, Anne Mehlman. So, I will turn it over to the team.

<<Andrew Rees, President, CEO and Director>>

Thank you, Jon. Good afternoon, everybody. And also here from Crocs is – I just want to make sure everybody is aware - is Marisa Jacobs sitting here on the front row, our Head of Investor Relations. So, please feel free afterwards to ask any questions that you have.

So, 2018 has been a fantastic year for Crocs. We made enormous progress on our strategies, culminating late in the year with the collaboration that you can see on the screen here, where we collaborated with Post Malone and we did a drop in November and another one in December that were both hugely successful, both sold out in under 10 minutes.

So, obviously, a forward-looking statement, I will skip through that.

What we really want to talk about today is how the company is positioned for growth in the future – and I'm going to take you through that and then Anne will take you through the Q4 guidance that we released yesterday and our broader financial picture and then touch on our investment considerations.

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So, as you think about Crocs, for those of you that are not familiar with us, Crocs is a powerful brand positioned for global growth. So, a few key statistics: we are one of the top-10 global non-athletic brands at over $1 billion in revenue. A core part of our product and a big part of our sales is our iconic clog. Clogs' represent over 50% of our overall revenues. We're a very democratic brand. We sell to men, women and children, and we sell to a very broad range of socioeconomic groups across the globe.

So, it gives us a very large addressable population. We have incredible global brand recognition, with 65% aided brand awareness around the globe. As for our global reach, we sell today in over 90 countries, and a lot of our growth comes from scaling our business, not necessarily penetrating new markets, which is obviously far more profitable. And, we have a world-class management team. I think one of the biggest things that's changed at Crocs over the last several years is the quality of the team and the ability of the team to manage this brand and take it forward in the future.

So we're well positioned for global growth. And if you think about where we've come from, at this time last year, this is what we talked about: we talked about three key pillars that were going to drive the business. Three key pillars that are going to drive the business. The first of which is, simplify the business to reduce cost; the second of which is, improve the quality of revenues and enhance gross margins; and the third of which was grow – drive sustainable, profitable growth in the future.

As we sit here today, the first two, both simplifying the business to reduce costs and improving the quality of revenues, are frankly largely behind us. The SG&A reduction plan that we put into place two years ago to save between $75 million and $85 million of SG&A, we have achieved that successfully. And the store closings along with the sales of smaller markets to distributors, those have all been completed. So, our gross margins, if we think about improving the quality of our revenues, have improved by over 400 basis points over the last three years.

So today, we're really focused squarely on growing the top line, and that's really what I want to take you through today. So, how are we going to grow the business? We think about that in three dimensions. First is product. And within product, we're really focused – and we've talked about this pretty extensively – we're focused on clogs and sandals and we're focused on bringing to market new visible comfort technology. So I'm going to take you through each of those. And I think that's an important framework to drive our overall product story and drive growth across all of our channels.

From a channel perspective, we're incredibly digitally focused. We're focused on our e-commerce business, which has grown successfully at double-digit rates; and we're also focused on our wholesale business, which gives us tremendous operating leverage. And we've been a wholesale business – one thing I would point out is that half of our wholesale business is to e-tailers and distributors, so not to traditional brick-and-mortar retailers.

And from a retail perspective, we rationalized our retail fleet very successfully. A lot of those closings have been full price stores and we are left with a fleet which is now a majority outlet stores. It's performing very well, and we believe that there is incremental growth, certainly in profitability, but also in terms of stores and revenues from our outlet fleet.

From a regional perspective, we are a global company and as I talked about earlier, a lot of our growth is going to come from scaling where we're distributed. Asia will be our largest long-term growth potential and we have highly developed markets in China, Korea and Japan, but also a large distributor market in Southeast Asia. And Americas is seeing really strong momentum today based on a lot of our key marketing activities, and we'll continue to accentuate that momentum.

So, I'll dive into each of those growth areas and give you a little bit of flavor of what's going on. First is clogs. Clogs are a $4 billion global category. Crocs is the market leader by a significant margin in the clog business. And what we're focused on in clogs is growing clog relevance. We're focused on growing the category, growing the relevance of that category, and then obviously benefiting from that ourselves. Clogs grew in 2018 by about 13% and represent 55% of our overall sales. And I would point out that Clogs are our highest margin product category as well.

So, how have we grown clogs? There are a few things that we've done very successfully over the last few years and I think those strategies are repeatable and will grow the category in the future. The first is collaborations, the most recent of which I mentioned which was Post Malone, but we've executed a series of collaborations from fashion brands, to street wear retailers from 2017-2018. And I think with the impact that these collaborations have had on the brand and the kind of PR and the buzz they're getting, I can also tell you that we're getting a lot of interest; interest from other celebrities and other performers who wish to collaborate with us, interest from brands, interest from other retailers. So, we have a pipeline of collaborations which we will execute through 2019 and 2020 and beyond.

The second is – it might seem simple, but really, it's optimizing the color portfolio. When you sell an iconic product like the clog in many different colors, getting the colors right, getting them seasonally relevant and adding graphics and interest has been incredibly impactful.

And then the last thing that's been really important is that we transitioned what was historically a children's add-on. So the Jibbitz charm, which is a little character that you put through the hole in the clogs was originally a child-orientated device. We transitioned that to being an opportunity to personalize; so adding numbers, adding colors, adding emojis, adding popular phrases. We see a huge trend with teenagers, and frankly all age groups personalizing their product. Personalization is a global megatrend and this is our vehicle to allow our consumers to personalize their product and it's been really impactful. So, with 55% of our business growing at 13%, we feel really good about the opportunities for clogs.

Next, we turn to sandals. Sandals are a bit of a different story. This is a large market. Our estimate of our addressable market is about $23 billion globally. That's our estimate of the casual sandal market, excluding portions of the market which we don't think are addressable by Crocs. We're at a fraction of 1% market share in that marketplace today.

We've grown the sandal business at very strong rates. We grew at 18% during 2018; it now represents about 23% of our total footwear sales. And that grew on top of a 26% growth rate in 2017. The opportunities to grow sandals is really all about driving sandal awareness. So, unlike clogs where we are – obviously, our brand is synonymous with the clog. One of the phrases or one of the comments we often hear from consumers is, "I didn't know Crocs made that".

So, this is all about growing sandal awareness and letting a broader range of consumers know about the compelling product we bring to the table. We've seen clear adoption of sandals within our core consumer. Two-thirds of the sandal market that we're focused on is purchased by women and we believe it's also an effective gateway to bring new customers into the market. And it's really a very broad space. We can play in – as exemplified on the right hand side of the chart, we can play in an everyday basic.

We can play in an outdoor-orientated product, and we can play in a more dressy silhouette. We can play in the ladies closet for a number of different ways and get a lot of different wearing occasions. So, we think that sandals represent a very significant long-term growth opportunity that allows the Crocs brand to scale beyond where it's been in the past.

The last thing we've done is really bring visible technology to the table. So in 2018, we introduced a technology called LiteRide. That's the picture on the top. So LiteRide is a premium positioning; so this is a premium product for us. It has more modern and up-to-date styling and the footbed looks like it is comfortable, it is very soft to the touch. We've had an incredible reaction to LiteRide where we were chasing suppliers for that product all last year. And as we look into 2019, it will be dramatically bigger than it was in 2018.

And in 2019, we'll be adding kids products. We never did kids product before. We kept this focused on adults. And if you notice, from a silhouette perspective, it was all focused on clogs and sandals.

In 2019, we will introduce Reviva. So, Reviva has a different positioning. It's, again, visible comfort. When you pick up the product, you can understand where the comfort comes from immediately. If you have to take more than a single line or a couple of words to explain to the consumer why it's a relevant product for them, you kind of lost the battle.

And so I think this is immediately obvious to the consumer and appealing. It gives you a massage under your foot. And this is a different positioning. This is more of a volume price point positioning. And we're introducing this technology in its first season

exclusively in sandals. So we're really excited by the potential introduction – or the introduction of Reviva in 2019. So that's our product platform: clogs, sandals, and visible technology. I think it's done well over the last couple years and we feel very optimistic about its potential in the future.

So then, if we transition to channels of distribution and where we would sell those products. First is digital commerce – so e-commerce, and we kind of think about that in two levels. If you look historically, we've grown our e-commerce business at a compound annual growth rate of 15% over the past five years and we feel very optimistic that we'll continue to grow at that rate in the future.

And that's been driven by our own sites, so those are the 11 sites that we operate around the world in our major markets. Obviously, we are benefiting from the shift of consumer purchasing out of bricks-and-mortar into the digital commerce or e-commerce environment. And we've been investing both in people and technologies and a backbone behind that that will allow us to continue to grow and become more sophisticated in these markets in the future. So, we feel we've got a track record here. And we think that's a very solid growth platform we can continue to invest in.

In 2018, we also started to venture into global marketplaces, and this is marketplaces from a direct selling perspective. So, in 2018, we opened up five sites, and here, we're focused on the large global marketplaces. We're focused on Tmall, Rakuten, Coupang, Zalando, where we can sell directly. We're taking control of our brand on those environments and we are managing those environments directly. And we see the opportunity to grow and open additional marketplaces in 2019 and scale the marketplaces we've opened.

We think this is incredibly important. As marketplaces build a tremendous traction with their consumers, by selling on those marketplaces, we're not spending money and time and effort trying to drive consumers to our own sites. We're taking advantage of the platforms that other companies have built, and we believe are particularly important for the brand to allow us to reach our broad consumer base. And so, we have tremendous confidence in digital commerce and e-commerce go forward.

From a wholesale perspective, and I think many of you probably look at the wholesale business and say, well, you're not concerned about your wholesale business with brick-and-mortar largely shrinking, as you look at a lot of recent announcements, with major chains shrinking.

There are a couple of reasons that we are not concerned, and we think we can drive continued wholesale growth. The first is 50% of our wholesale business comes from both e-tailers and distributors. So e-tailers obviously, Amazon, et cetera, and this is where we're selling at wholesale to an e-tailer and then they are reselling the product. Many of those e-tailers around the globe are again Amazon, Zalando, Wildberries in Russia, Tmall, they are growing very rapidly. And we have built, we believe, a capability and a relationship with a lot of these sites that allows us to be very successful in this

environment. We're focused on elevating the brand presentation, making sure we have clear segmentation of product between our competing channels and have a very compelling proposition.

In addition to our e-tail business, distributors sell in the – what I describe as the under-penetrated portions of our market, where we are relatively small from a brand perspective. So, by definition, they are under-penetrated, a lot in Southeast Asia, a lot in the Middle East and Africa, and a lot in Latin America. And we've spent the last two years or three years renovating our distributor portfolio, so those who represent us in those markets. We feel like we're well-positioned with a lot of the leading distributors in these markets and we're investing with them to grow our penetration in these marketplaces.

The remainder of our wholesale distribution is more traditional brick-and-mortar. And from a brick-and-mortar perspective, on a global basis we typically focus on family footwear or the equivalent, depending what that is in the relevant market; so multi-brand family footwear and sporting goods. We have downplayed successfully, and continue to downplay, the department store channel.

Then lastly, that brings us to our own retail environment. And our own retail environment, these days, obviously – a big part of our SG&A reduction program has been closing a significant number of stores. So, we shrunk our store base from I think a high of around 580 stores, 590 stores, down to just shy of 400 stores. And you can see by the graphic on the right, the predominance of closings have been in the non-outlet full-price or kiosk business and we've largely maintained our outlet base. Outlet stores are very profitable, very successful.

We transitioned our merchandising strategies in our outlets to be more built for outlet, to give our consumers a better experience and allow us to drive more sustainable profitable growth. And as we look at our outlet portfolio, we don't see a lot of additional openings here in North America, but we do see some openings in the EMEA region, which will principally be in leading outlet centers in Europe and we see some much more interesting growth opportunities in terms of growing the fleet, both in China and Japan. So, we see comp growth opportunities within our outlet business and some store openings in China and Japan.

So, as we think about our regions, we see Asia as our highest growth region. It's probably our most underpenetrated as we have three major owned markets in Asia where we directly operate, China, Japan and Korea, and then also a Southeast Asian distributor market, and also India, which is growing extremely rapidly. So the long-term growth for the Crocs brand will come from Asia.

Today, we're seeing really impressive momentum in the North American market, driven by penetration of the Classic clog into the teen category, driven by a lot of those collaborations that I talked about. So, that's really exciting, and we will look to make sure

that we capitalize on that. And EMEA is a much more diverse region which will have some growth opportunities, but probably not to the scale of the other two regions.

So, in summary what I would say is that this is really a very important pivot point for Crocs and for the brand. We've moved from repositioning the Company and the brand. We've moved from reducing SG&A and improving the quality of revenues to really driving growth. We have an emerging track record for growth as you can see in our most recent quarters that we have announced. And we feel very strongly that we have the product platform, we have the marketing credentials, and we have the distribution strategy that will allow us to be successful in the future. So we're incredibly optimistic.

And with that, I'm going to pass you over to Anne who's going to take you through our financial information. Thank you.

<<Anne Mehlman, Executive Vice President and Chief Financial Officer>>

All right, good afternoon. So to recap our financial information which Andrew touched briefly on, 2018 was a very successful year. We had robust revenue growth. We had 6% revenue growth. We had growth in all four quarters of the year, and that 6% revenue growth includes tailwinds from – or headwinds from both store closures and currencies, so absent that, we would have been up around 10%. We improved the quality of our revenues. We improved the quality of our revenues by less promotions, less liquidation and cleaner inventory. And that is part of our strategy to get our margins at our interim target to be in the low 50s.

We've also simplified the business to reduce costs. As Andrew mentioned earlier, we took out $75 million to $85 million. We announced that in 2016, through closures of our fleet and restructuring, and we will hit that in 2019, and that will go towards our target of taking SG&A to the low 40s.

And we've strengthened our balance sheet. We've strengthened our free cash flow. Our inventories are now going to turn at 4 times. We've increased our borrowing capacity on a revolver from $100 million to $250 million, which in part let us redo our cap structure, and we removed an expensive part of our cap structure. We took out the preferred shares that Blackstone had invested in, in 2014. We did a forced conversion of that and we bought back half of those preferred shares. And then half are locked up into August. That essentially eliminates a $12 million a year annual dividend and additional dilution for the average common shareholders. We're very excited about that this year.

In addition to that, we repurchased 3.6 million common shares at an average share price well below where the market is today, at $17.42. And that still leaves us additional board authorization if we choose to continue to buy back shares. And we've laid out an interim EBIT target of double-digit EBIT, and we've made a lot of progress towards that. We will improve EBIT up to 400 basis points year-over-year.

So, that takes us to our Q4 2018 guidance. We recently announced that we're revising our revenue guidance of $195 million to $205 million to $211 million to $214 million. And that includes $10 million of fleet reductions in stores and also a currency challenge of $6 million. Excluding that, we would have been up double digits. Our gross margin is expected to be 80 basis points to 100 basis points better in Q4 and our SG&A is expected to be at 54% of revenues compared to approximately 60% in Q4 of 2017.

And then our revenues for the full year, as I just mentioned, we now expect to be up 6% for the full year and we expect our gross margin to be up 100 basis points over 2017, and as Andrew mentioned earlier, well over where we were two years ago. Our SG&A is going to be at approximately 46% of revenues, which is down 280 basis points to 2017, and we've increased our expectation for income from operations to be over $60 million versus $17.3 million in 2017.

So looking ahead to 2019 and what we've laid out for 2019, we set out a growth target for 2019 revenues. We think we'll be up mid-single digits over 2018. And that does include some headwinds of currency of $15 million at current currency rates and store closures of $25 million. Absent those changes, we expect to be up high-single digits. And we will give full guidance on our Q4 earnings call at the end of February.

So to recap, why Crocs and what is there to talk about Crocs. So we have an unmistakable icon in the plastic clog that's recognized around the world. We're a democratic brand. We appeal to a broad based consumer. We have a management team with deep talent. And we are one of the world's largest non-athletic footwear brands. And we drove a successful business transformation, which will drive further increases in shareholder value.

We've grown revenue and gross margins this year, while reducing SG&A and setting out a sustainable business model. And we have a clear path to a double-digit EBIT margin and a very strong balance sheet and we're a strong free cash flow generator. Thank you.