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Q2 2018 Fossil Group Inc Earnings Call

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PRESENTATION

Operator

Welcome to the Q2 2018 Fossil Group Earnings Conference Call. My name is Adrienne, and I'll be your operator for today's call. (Operator Instructions) Please note, this conference is being recorded.

I'll now turn the call over to Allison Malkin. Allison Malkin, you may begin.

Allison C. Malkin ***ICR, LLC - Senior MD***

Thank you. Good afternoon, everyone. Thank you for joining us, and welcome to Fossil Group's Second Quarter 2018 Earnings Conference Call.

I would like to remind you that the information made available during this conference call contains forward-looking information, and actual results could differ materially from those that will be discussed during this call. Fossil Group's policy on forward-looking statements and additional information concerning a number of factors that could cause actual results to differ materially from such statements is readily available in our Form 8-K and 10-Q reports filed with the SEC.

In addition, the company assumes no obligation to publicly update or revise any forward-looking statements whether as a result of new information, future events or otherwise except as required by law. Please note that you can find a reconciliation and other information regarding non-GAAP financial measures discussed on this call in our earnings release filed on Form 8-K and in the Investors section of our website.

Please note that you may listen to a live webcast or replay of this call by visiting www.fossilgroup.com under the Investors section.

Now I would like to turn the call over to company's Chairman and CEO, Kosta Kartsotis.

Kosta N. Kartsotis ***Fossil Group, Inc. - Chairman & CEO***

Thank you, Allison. Good afternoon, everyone, and thanks for joining us this afternoon. I will begin with a few prepared remarks before turning the call over to Jeff Boyer, our CFO. Following Jeff's comments, we'll have Greg McKelvey, our Chief Strategy and Digital Officer, join us for the Q&A.

All my comments will be in constant currency. In the second quarter, the business performed better than our expectations, surpassing the high end of our guidance on sales, gross margin and operating expenses. In addition, we continue to make solid progress on several key goals as we reduced inventory and improved both working capital and cash generation.

As you may recall from our calls earlier this year, our posture for fiscal 2018 was to plan prudently but operate aggressively. This approach continues to drive better-than-expected results despite the ongoing disruption in our categories and our distribution channels. As we look ahead, we will continue to plan carefully but take every opportunity to aggressively pursue accretive sales opportunities as we focus on becoming a more profitable company.

In the second quarter, we had stronger sales performance versus our expectations on a number of dimensions. Across regions, the Americas and Asia solidly exceeded our sales plans. Asia grew 5% behind strong double-digit growth in both China and India. The rate of decline in our Americas region slowed to minus 3% and a solid improvement from the declines we experienced from most of last year.

Smartwatches grew 91%, driving growth across our entire brand portfolio and across all 3 of our regions. With this continued growth, smartwatches represent about 20% of our total watch sales, up from about 10% in the second quarter of last year.

Our direct e-commerce business continues to build nicely with sales up 25% in the second quarter versus Q2 last year. 2 of our 3 most significant brands delivered higher sales levels this year versus the second quarter of last year. Fossil brand sales were up modestly with low single-digit growth globally in watches, partially offset by Fossil jewelry softness.

Armani continued to demonstrate strong double-digit growth powered by the watch category. And while Michael Kors watch business remained down, it improved significantly on the strength of wearables to a decline in the low single-digit range.

In addition to the second quarter sales upside, we managed other key elements of the business well. Gross margin was 53.6% in the quarter, better than our expectations and above the high end of our guidance range, representing an improvement of 300 basis points versus last year.

SG&A expense, including restructuring costs of $15 million, was favorable when compared to the low end of our guidance range. In a few minutes, Jeff will cover our key financial performance metrics, but our adjusted operating income, excluding restructuring actions and impairments, improved significantly versus the second quarter of last year.

Although we are encouraged by our performance in the first half of the year, we are still operating in an environment that continues to experience significant change. Although growth has returned to high-end traditional watches, consumers' interest in midpriced fashion watches continues to shift from traditional products to connected ones. And they are engaging with products and direct channels in an increasingly digital and mobile manner at the expense of traditional wholesale channels.

As we mentioned on our last call, we have a number of opportunities, which will help us navigate through this period of transition, and we outlined 4-key objectives that drive our strategies and initiatives. First and foremost, we are very focused on improving our overall profitability. Our second objective is to increase innovation and differentiation across our product offerings. Third, we are pursuing initiatives to further expand our e-commerce and digital marketing capabilities. And lastly, we are reinventing our company and transforming our business model to improve our efficiency and reduce our cost structure.

First, we'll talk about improving profitability. As we stated earlier this year, due to structural and industry issues facing us, we expect to become a smaller but a more profitable business. Total sales will contract as we exit unprofitable stores, businesses and product lines.

Connected watches will continue to demonstrate strong growth but will not offset the decline in traditional watches in the near term. [Though] overall sales will decrease as a result, our operating income is expected to improve. A portion of this improvement in operating income will come from exiting unprofitable stores and product lines. However, the most significant improvement in profitability is the result of our New World Fossil initiative. Through a combination of category management programs, direct and indirect sourcing efforts and organizational efficiency initiatives, we continue to forecast $200 million of annual run rate savings from gross margin expansion and operational efficiency benefits by 2019.

We've been pleased with our efforts since we began the program late in 2016, and we remain on track to achieve our New World Fossil objectives. Last year, we improved operating income by $80 million. And so far this year, we've added almost $40 million of benefits to our operating results, driven by a combination of both gross margin expansion and SG&A efficiencies.

Our second key objective is to be a leader in innovation and design. Our outstanding design capabilities start with traditional watches, where we combine key consumer insights with our creative product engine to innovate in materials, colors and designs. Iconic styles with bold design elements coupled with innovative marketing strategies will lead our storytelling in the upcoming fall and holiday season.

We are also launching 3 new display watch platforms for fall and holiday across our own brands as well as our licensed businesses. Ranging in size from 40 to 44 millimeters, these 3 new platforms include the features that customers want most, heart rate, GPS, NFC for payments and rapid charging. Our goal is to bring fashion, branding and style to the connected watch business with exciting new products tailored to each of our brands' unique point of view. These great new offerings are expected to support continued growth in our wearables business, which nearly doubled this quarter on a global basis.

Overall, smartwatches continue to have a positive impact on the sales trend for a number of our key brands. Wearables were nearly 20% of our total watch sales for the quarter, up from 10% in Q2 of last year and even higher in the U.S. Though our total watch business contracted in the quarter, the growth in wearables improved the overall sales performance in watches by 10 full percentage points, up from 9 percentage points benefit in Q1.

Given our design and innovation capabilities, we will continue to be an industry leader in both traditional watches and in smartwatches. To leverage our capabilities, we are pursuing a number of additional brands to incorporate them into our portfolio of licensed businesses.

In the first quarter, we announced the addition of PUMA, one of the world's leading sports brands, to our portfolio. Recently, we have also added BMW to our licensed business portfolio. These are 2 great brands that will enable us to tap into their unique communities of consumers with innovative product and differentiated marketing and distribution. We are looking forward to getting started with these brands and will begin shipping early next year.

Our third key strategy is to continue to build upon investments in digital marketing and to expand our efforts in e-commerce. We continue to shift our media mix to digital and now have more than 90% of our marketing invested in digital channels, including social media, digital media and paid search. We are diversifying and broadening our consumer targeting and social content initiatives to further improve engagement.

We will continue our initiatives with celebrity influencers such as Mandy Moore and others as well as hundreds of additional brand ambassadors and activation partners to expand our reach through segmented engagement-driven storytelling. We have been moving quickly on the digital front with increasing investments that are driving strong results.

Our unique visitors to our sites increased at a double-digit rate, and our own e-commerce platforms across the globe continue to drive growth, expanding 17% in the quarter with sales growth of 18% in the U.S., 13% in Europe and 82% in Asia.

To further improve and enhance our customer omnichannel experience, we have expanded our buy online, pick up in store capabilities, enabled ship from store options and will begin investing in the implementation of an integrated e-commerce sales and marketing cloud platform in the second half of this year. You may have recently seen Gartner's L2 rankings of digital IQ, where Fossil was recognized in the top 10 among all specialty retail brands in the U.S. We are making a lot of progress digitally, and we are pushing to move even faster.

Our fourth key initiative for fiscal 2018 will be to continue the transformation work under our New World Fossil initiative. This is our ongoing comprehensive program to reinvent the company to address changing consumer trends, drive efficiencies and speed throughout the organization, streamline the way we work, enhance our margins and ultimately drive significant economics to the bottom line. We've made a lot of progress on the initial transformation of the company, which is projected to drive $200 million in gross margin and efficiency benefits by 2019. And we expect to deliver $140 million of these annual run rate savings by the end of this year, driven by a combination of both gross margin expansion and operating and expense efficiencies.

We are working aggressively on the next phase of this project, New World Fossil 2.0, which will build on the foundation of our successful initial phase. Broadly, we will focus the organization on prioritized consumer market and channel opportunities, create long-term process and system enhancements to maintain productivity and pursue key opportunities in the areas of speed to market, strategic sourcing, indirect procurement and revenue optimization.

We're excited to continue our transformation efforts and to enter this next phase of our multiyear project. It is expected to position us for the future success across our key categories as well as in expanding digital channels. An important focus will remain on delivering gross margin and productivity savings similar to New World Fossil 1.0. We also expect to further improve our digital capabilities not only for marketing and e-commerce but also for additional consumer insights and advanced analytics.

In closing, we still have significant work to do on our transformation initiatives to address the ongoing changes occurring in our categories and channels. That said, we are seeing encouraging signs, and our current focus on near-term profitability has provided stability in a challenging environment. This affords us the opportunity to develop and execute longer-term initiatives that will ultimately deliver strong and sustainable growth for our business.

We continue to be extremely focused on delivering improved profitability and continue to forecast our top line conservatively to put pressure on the things we have the most control over, our gross margin structure and our expenses. We're being very active in the marketplace with new ideas and innovations and products, brands and marketing as we position the company for sustainable growth. We remain focused on stabilizing and growing our core watch business, on bringing more innovation to connected products with new features and functions and driving efficiency throughout the company while investing in our e-commerce and digital marketing opportunities.

We continue to believe that after top line contraction in 2018, our initiatives should begin to stabilize our core sales levels in 2019 with sales growth returning by 2020. And with our New World Fossil transformation initiatives, we are targeting a double-digit operating margin over the long term.

Now I'd like to turn the call over to Jeff Boyer for a review of our financial performance and guidance for the remainder of the year.

Jeffrey N. Boyer ***Fossil Group, Inc. - Executive VP, CFO & Treasurer***

Thanks, Kosta, and good afternoon, everyone. Now turning to our financial results. Our reported net sales for the second quarter decreased 3% to $577 million, while second quarter constant currency net sales decreased 6%. Overall, sales exceeded expectations, driven by stronger performances in the Americas and Asia, partially offset by softness in Europe.

Our wholesale business, while continuing to contract, improved to a moderate single-digit decline in the Americas as compared to a double-digit decline in the first quarter as better inventory management resulted in reduced wholesale markdowns and returns and U.S. retailers tempered weeks of supply reductions during the quarter.

Store closures negatively impacted total direct channel year-over-year sales comparisons by roughly 500 basis points. We have closed 69 stores since the second quarter of last year and ended the quarter with 497 stores.

Excluding store closures, our direct channel posted a 4% gain with flat retail comps and solid increases in our online business, driven by growth in connected sales despite a 200 basis point negative impact due to Easter shifting to Q1 this year. Flat retail comps were driven by positive comps in watches, offset by negative comps in jewelry and leathers.

Our reported loss of $0.16 per share included New World Fossil restructuring charges of $0.23 and noncash intangible asset impairment charges of $0.10 per diluted share.

Last year, our second quarter EPS was a loss of $7.11 and included noncash intangible asset impairment charges of $6.50 and a restructuring charge of $0.13 per diluted share. Excluding these items, our adjusted EPS was $0.17 this year as compared to a loss of $0.48 last year.

Currencies. Both the translation impact on operating earnings and the impact of foreign currency hedging contract favorably impacted our EPS comparison in the second quarter by $0.13. Our watch business declined 4% in constant currency for the quarter. Sales on our traditional watch business, while still challenging, performed within our overall expectations. Sales trends of our traditional watches improve modestly in the Americas, while we experienced continued softness in Europe, mainly driven by weakening sell-through trends combined with certain European wholesale partners reducing inventory levels.

We continue to grow our connected watch business, delivering $93 million in sales, representing 20% of total watch sales for the quarter and 91% higher when compared to the second quarter of last year. We're continuing to see strong sell-throughs in all regions, especially in our own stores where we control the customer experience.

Total Fossil brand sales were flat in constant dollars compared to last year as growth in watches were offset by weakness in our jewelry and leathers categories. Fossil watch sales increased 4% in constant dollars, including positive comparable retail sales.

Smartwatches positively impacted the watch category growth rate by 17 points. Our marketing efforts, store experience and celebrity influencer campaigns continue to yield strong results for our Fossil watch brand.

In our retail channel, comp sales for our Fossil and Watch Station businesses were flat despite a 200 basis point negative impact due to Easter sales shifting to the first quarter this year as compared to the second quarter last year. Our global direct e-commerce sales continued double-digit growth, and the Americas posted positive comparable retail sales in the quarter.

Michael Kors brand sales declined 10%, largely driven by the jewelry category in anticipation of repositioning the jewelry line this fall. Kors watch sales declined 4% for the quarter with smartwatches positively impacting the rate by 13 percentage points.

In the Americas, second quarter sales decreased 3% on a constant currency basis to $279 million with declines in all 3 product categories, driven primarily by softness in the wholesale channel and retail store closures.

Our Americas wholesale business sell-in improved as some retailers begin to moderate weeks of supply reductions, while our traditional watch sell-outs remained down double digits in the second quarter. Additionally, off-price sales increased during the quarter as we continue to manage inventory levels. Our overall retail performance in the Americas declined low single digits as strong e-comm and positive low single-digit store comps were more than offset by the negative impacts on sales from closing unproductive stores and the shifted Easter into the first quarter this year as compared to the second quarter of last year.

Watch trends were slightly better than the overall Americas region sales trends as continued softness in traditional watches was partially offset by connected watch sales, with our best sales performance continuing to come from Fossil, which did grow in the region for the quarter, up 15%, driven by connected performance. Most other brands posted sales declines in the quarter.

In Europe, reported sales decreased 10% to $176 million. On a constant dollar basis, sales declined 15%, representing decreases across all product categories. Underlying sell-out weakened across channels and geographies, negatively impacting sell-in and driving retailers to be more cautious with inventory purchases. E-comm growth was stronger in the quarter, while our retail stores were down as a result of decreased traffic despite higher conversion rates.

Fossil watch sales in Europe were negative due to declines in traditional watch sales, partially offset by growth in connected sales. Connected sales positively impacted the category growth rate by 10 points.

Within our watch portfolio, sales declined across most brands. Across the Eurozone, sales were down in most major markets, including Germany and France. In Asia, we reported growth of 7% on $122 million of sales. On a constant currency basis, sales increased 5%, driven by the wholesale channel. Retail sales decreased modestly as strong e-commerce growth was more than offset by the negative impact of nonproductive store closures. Effective celebrity marketing campaigns and improved stock availability of bestsellers favorably impacted sales.

Our Fossil brand increased in Asia, driven by 18% growth in watches. Emporio Armani, our second largest brand in Asia, posted the strong double-digit growth, driven by both traditional and connected watches. Most other brands in our portfolio were relatively flat to modestly down in sales for the second quarter.

Strong growth momentum continued in India and China, primarily driven by e-comm. Hong Kong and Korea posted positive results, while Japan and our distributor markets continue to be down double digits during the quarter. Gross profit increased to $309 million and gross margin increased 310 basis points to 53.6%.

Favorable currency impacts of about 220 basis points, along with benefits from our New world Fossil initiatives and lower markdown and promotional discounts, were partially offset by increases in sales mix towards connected products, unfavorable factory cost absorption on lower sales volumes and higher volumes of off-price sales as we remain focused on rightsizing our inventory position.

On a reported basis, second quarter operating expenses were $308 million, including $15 million in restructuring costs and $6 million of noncash intangible asset impairment charges.

2017 second quarter operating expenses were $731 million and included $407 million of noncash intangible asset impairment charges related to goodwill and trade names and $10 million in restructuring costs. Excluding the intangible asset impairment and restructuring charges, operating expenses decreased $27 million in the second quarter as compared to the prior year and included $8 million unfavorable currency impact. Excluding intangible asset impairment charges and restructuring, the lower expenses in the second quarter resulted from corporate and regional infrastructure reductions as well as lower store expenses given the significant number of stores we've closed since last year.

Our second quarter operating income was $1 million as compared to an operating loss of $430 million a year ago. Excluding noncash intangible asset impairment charges and restructuring, operating income improved $35 million this year.

Second quarter other expense of $1 million was unfavorable to last year, mainly due to net foreign currency losses compared to net gains recognized in the second quarter of last year.

Income taxes in the second quarter were a $3 million benefit on pretax losses of $11 million, resulting in a 31.8% effective tax rate compared to a 21.9% rate in the second quarter of last year. The second quarter effective tax rate was driven mainly by a discrete item, reflecting a $10 million income tax benefit related to a change in the method of accounting for inventory valuation reserves for our 2017 income tax return that will lower the taxable income from previous estimates.

This favorable impact was partially offset by the recognition of deferred tax asset valuation allowances and an unfavorable impact from the GILTI provision of the Tax Cuts and Jobs Act that was signed into law last December. We continue to establish valuation allowances on our deferred tax assets in the U.S. and certain international subsidiaries given our recent operating losses in these jurisdictions, thereby increasing our effective tax rate.

Regarding GILTI, though we don't expect to incur payments under this provision, it appears that the current GILTI calculation is having an unintended consequence unique to our particular earnings profile. As written, the GILTI provision appears to effectively result in double taxes on some of our foreign income. Until this provision of the new tax legislation is corrected or alternative strategies are implemented, we are reflecting the double taxation impact in our financial statements. We estimate this full year impact could total between $5 million and $10 million.

We improved our net debt position by $172 million compared to a year ago. We ended the quarter with $242 million of cash compared to $320 million last year and debt of $396 million compared to $646 million a year ago.

During the quarter, we invested $2 million in CapEx and made net debt payments of $67 million. Our adjusted EBITDA for the quarter was $47 million, a $21 million increase compared to last year, resulting in a trailing 12-month adjusted EBITDA of $227 million. Our second quarter leverage ratio was 1.8x.

Comparable inventory levels at the end of the quarter were down 14% versus a year ago. We're making progress on our inventory reduction efforts and have significantly reduced our inventories of traditional watches. We remain focused on clearing previous generation connected products over the next few quarters.

Accounts receivable decreased by 15% to roughly $205 million, and wholesale DSOs decreased 6 days as compared to the prior year as a result of increased collections, primarily in the Americas department store channel. Depreciation and amortization expense totaled $15 million for the quarter.

Now let's move to our 2018 outlook. As Kosta mentioned, we remain focused on our 4 key objectives to drive our strategies. Improving overall profitability remains our #1 financial priority, which we delivered on in the first half of the year as we exceeded our initial sales plan, and our New World Fossil initiatives improved profitability even on an overall lower sales base.

Looking to the back half of the year, we're excited about the innovation we have in the pipeline in both our wearables and traditional categories. Wearables performance in the first half continued to demonstrate the significant opportunity we have in this category. The outsized growth in the wearables category and the exciting new features and functions that we'll bring to market will continue to drive growth in the back half, but we do expect growth rates to moderate some given the overall size of this business.

Our direct business, retail and e-commerce, has also been stronger over the last 2 quarters. But we know the most important quarters of 2018, fall and holiday, are still ahead of us. And while it seems some trends improved in the first half, the overall environment within our traditional channels and categories remains challenging. We continue to plan our business prudently to reflect the ongoing disruption in the marketplace while acting aggressively to change [in] these trends.

The higher end of our guidance assumes the trends we've seen in the first half continue for the balance of the year in the traditional category, while the lower end of the guidance assumes further disruption within the wholesale channel.

In addition to these factors, the U.S. dollar has strengthened since we provided guidance in May, which will negatively impact reported results for the back half of the year. We've updated our guidance based on roughly prevailing rates with the euro and British pound, 2 of the currencies most impactful to our results, at approximately $1.16 and $1.32, respectively.

Using our updated exchange rates, currencies will have relatively little impact in the back half compared to last year's performance, though when compared to our previous guidance, updated exchange rates will negatively impact reported sales in the second half by about 200 basis points versus last year with the resulting $15 million negative impact on operating profits versus our prior guidance.

It's important to note that sales trends in the first half of 2017 were more challenging, while sales trends in the second half of 2017, while still negative, did improve versus the first half trends. Therefore, the relative sales comparisons in Q3 and Q4 of 2018 will be more challenging.

Our guidance assumes a fairly consistent trend across quarters in 2018 on a 2-year stack constant currency basis.

In addition, as we've said on our previous earnings calls, our 2018 guidance includes the negative impact of store closures, business exits and licensing terminations, which we estimate to be approximately 500 basis points for the full year. The impact of these business changes was approximately 500 basis points in Q2 and expected to be roughly 600 basis points in Q3 and 500 basis points in Q4.

Given these items and the completion of the second quarter, we are narrowing our full year sales guidance range to minus 10% to minus 6%. We expect Q3 to range from minus 16% to minus 10% and expect Q4 to range from minus 14% to minus 8%. Compared to our previous guidance, the full year sales range includes 100 basis points negative impact from changes in foreign currency rates.

Our updated full year gross margin guidance ranges from 51% to 52% and reflects approximately 50 basis points of negative foreign exchange impact from our previous guidance. Our guidance implies approximately 250 to 350 basis points of gross margin expansion from 2017, primarily driven by currency, our New World Fossil initiatives and improved connected margins as we do not expect to repeat connected liquidation reserves recorded in 2017.

We expect Q3 gross margins to range from 50% to 52%. In Q4, our gross margins will range from 50% to 52% as well.

We expect operating expense for the year to range from $1.25 billion to $1.3 billion, including an expected $50 million of restructuring charges related to our New World Fossil initiatives. For the third quarter, we expect operating expenses to range from $300 million to $320 million, including approximately $7 million of restructuring charges. Fourth quarter operating expenses are estimated to be $330 million to $350 million, inclusive of $8 million of restructuring expenses.

Therefore, for the full year, we expect operating income in the range of 1% to 3%, which reflects an approximate 50 basis point negative impact due to currency rate changes from our previous guidance. Operating income margin for the third quarter is expected to range from minus 1% to 1% with Q4 operating margin of 8% to 10%. We expect net interest expense of $45 million for the full year, and we expect Q3 and Q4 interest expense to be approximately $12 million per quarter.

Other income and expense, which is primarily related to hedge contract gains and losses, was a benefit in 2017 and has been a negative or expense in both the first and second quarters. Based on the foreign exchange rates used in our guidance assumptions, other income will be a loss of approximately $2 million in Q3 and then turn to a slight positive in Q4, though this will vary as exchange rates move.

Based on the foreign exchange rates assumed in our model, net other expense is expected to be a loss of approximately $4 million for the year. As I discussed earlier, given Q2's tax expense and the increased clarity of the impact of tax reform, based on a profile of our geographical earnings including a tax loss in our U.S. companies, we now expect tax expense to range from $15 million to $20 million for the full year and $0 to $3 million for the third quarter and $12 million to $14 million in Q4.

For 2018, we expect adjusted EBITDA in the range of $185 million to $220 million. We expect Q3 adjusted EBITDA in the range of $22 million and $34 million. And we expect Q4 adjusted EBITDA in the range of $95 million to $120 million. We're planning to invest approximately $25 million in capital expenditures and expect diluted share count to be approximately 49 million shares.

Now I'd like to open up the call for your questions. Thank you.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our first question comes from Edward Yruma from KeyBanc.

Edward James Yruma ***KeyBanc Capital Markets Inc., Research Division - MD & Senior Research Analyst***

I guess first, some positive commentary on destocking or maybe a little bit of a slowdown in destocking in the U.S. wholesale channel. I guess are retailers finally just hitting equilibrium with inventory levels? Or are they taking maybe a more offensive position and trying to build inventory in some of the wearables and maybe some of the new fashion watches? So any insight there will be helpful. And then second, I know a lot of moving parts to the FX. The adjustment in the high end of the EBITDA guide for the year, was that solely related to FX? Or were there other pieces moving as well?

Kosta N. Kartsotis ***Fossil Group, Inc. - Chairman & CEO***

On the destocking issue in the United States, I would say our stores, our wholesale partners are prepared for the holiday season in a prudent manner. I think our inventories are in line with the sales trends. We do have a lot of new products hitting in the next couple of months. Not just our new wearables, but also there's a lot of new initiatives on the traditional watch side. There's a lot of new things, new ideas, new materials. We've identified a couple of new trends. So those are going in place. But I would say on balance, the inventories are in line with the trend. Where we have seen some destocking is Europe is in a very difficult situation. A lot of disruption there. Business has been tough. Traffic has been off. And we've seen that our retail partners over there, a lot of them are smaller retailers, as you know, have been very conservative on the inventory. So there is some destocking going on there. But in the United States, I think we're in a pretty good position.

Jeffrey N. Boyer ***Fossil Group, Inc. - Executive VP, CFO & Treasurer***

Excuse me, Ed, this is Jeff on the guidance range and the adjustment that we made. You've got to think about it this way, that we flow through Q2 favorability pretty much intact on that. We also flow through some additional sales benefit as well that we had in the second half we're forecasting. But the biggest impact has been currency. The currency did impact the top line a couple hundred basis points, and those flowed through. So that does impact the bottom line on a reported basis because of the currency impact on it. We also narrowed the range a little bit as we got further through the year and looked at the ranges. We had also narrowed it. From a sales standpoint, that narrowing actually increased the [net] midpoint overall. But because of the net flow-through on the profitability, our reported numbers were slightly different because of the currency impact. So hope that helps.

Operator

And our next question should come from Simeon Siegel from Nomura.

Simeon Avram Siegel ***Nomura Securities Co. Ltd., Research Division - Senior Analyst of U.S. Specialty Retail Equity***

I think you mentioned overall growth in 2020. Could you speak to the time line you expect for that growth in watches, Americas and Michael Kors? And then I don't know if you said, how were watch units and pricing within that constant currency decline this quarter?

Kosta N. Kartsotis ***Fossil Group, Inc. - Chairman & CEO***

Well, let's go to the first question and we'll come back to the second question on how that -- I was [getting hung up on] because you were asking about watch revenue returning in 2020. As we look at the long-range plans out here, we can see some stabilization in the traditional level as we get through 2019. I really see continued growth in the direct channel as well as the connected business. What happens is both of those businesses get large enough, our direct channels as well as our connected business, that, that growth starts to overcome any weakness we have in traditional. So that's the basic math we're seeing on that. I'm going to have to ask you to ask the second question again on your pricing question that you had. You had a number of pieces in that. So if you could ask that second question, that would be great.

Simeon Avram Siegel ***Nomura Securities Co. Ltd., Research Division - Senior Analyst of U.S. Specialty Retail Equity***

Sure. So the second one was just how was ASP versus -- how are units versus pricing within this quarter's constant currency decline. And I guess the other part was just thinking through when Michael Kors turns to -- you expect that to inflect.

Jeffrey N. Boyer ***Fossil Group, Inc. - Executive VP, CFO & Treasurer***

So I would say over the last several quarters, if you look at traditional watches, the average unit retail has come down slightly. So I think that's a global situation, probably not so much in Asia but especially in Europe and the U.S. We are seeing -- obviously, if you look at the whole mix, because wearables is a much higher retail, I would say probably as a company, our average unit retail holds steady. And I would say that might be the case. We do have -- we have been improving our business with Kors largely through the increase in wearables. And we have a lot of new things going in that market, too. We are expecting, at some point, traditional watches to level off. Don't have a lot of visibility when this is happening, but you've seen a lot of more interest in the watch business on the upper end and Swiss, et cetera. So there is some indication that there is a lot of interest in watches that hasn't been there in the last couple of years. So the combination of being in a position to grow our wearables business as the traditional watch business levels off, I think, is a good thing. And we're pushing that as fast as we can.

Simeon Avram Siegel ***Nomura Securities Co. Ltd., Research Division - Senior Analyst of U.S. Specialty Retail Equity***

Great. And then if I can just -- one other one since it's topical. Obviously, still a lot of moving pieces, but any color you can share on what you expect from the potential tariffs impacts?

Kosta N. Kartsotis ***Fossil Group, Inc. - Chairman & CEO***

Yes, at this point, Simeon, it's uncertain as to exactly what the impact is going to be. The final form hasn't been decided yet. It would affect just 2 parts of our business, the leathers part and the smartwatches. So the largest part of our business, traditional watches, is not impacted by the proposed tariffs. We're working hard with legislators and with lobbyists to influence the position on that. Hopefully, it's just a threat at this point, but we are anticipating there could be some impacts. And with that, we're working hard on all the levers we can pull from manufacturing, sourcing, across our supply chain, both in locations, working with our partners on it as well as what we can do with our wholesale partners as well as if we need [to] price on us. We've got many different levers we're pulling on. At this point, again, it's a bit too soon to say exactly with precision how much that might impact us. We'll have a better idea in the back half of the year. Important to recognize that from a buying cycle for us, largely we'll walk through most of the end of the year and there will be very little impact of inventory running through with higher tariffs. This will really be an FY '19 issue, so we've got some time to address our purchase cycles, our sourcing, our manufacturing and our supply chain and pricing. More to come on that.

Operator

(Operator Instructions) Our next question comes from Ike Boruchow from Wells Fargo.

Irwin Bernard Boruchow ***Wells Fargo Securities, LLC, Research Division - MD and Senior Specialty Retail Analyst***

Jeff, I'm sorry if I missed this. Could you update us on your wearable growth plan that's embedded in your guidance? I think in the last call, you had said mid-20% growth. Is there an update you can give us?

Jeffrey N. Boyer ***Fossil Group, Inc. - Executive VP, CFO & Treasurer***

Yes, yes. As you can appreciate, we had some strong growth in the second quarter on it, and we have taken that guidance [up]. We haven't explicitly called it out, so it's a good question, Ike. It was -- 20% to 30% was our previous guidance. Roughly 25% was a good -- a good midpoint. Now we're ranging really in the 30s -- into the high 30s, pushing close to 40. So think about 30% to 40% growth for the full year. A lot of that hasn't been achieved in the back half. We did mention on our comments some moderation on it, so we don't know we'll be at that. In the first half of the year, we were at 80%, 90% growth rate overall. So you will see some moderation in the second half. Still good solid growth on a very healthy base. So we really love the way the connected product is performing. But we have a big hill to climb covering next -- the second half growth that we had last year, but the full year will be 30% to 40% growth on that. So well over $400 million for us in the connected business.

Irwin Bernard Boruchow ***Wells Fargo Securities, LLC, Research Division - MD and Senior Specialty Retail Analyst***

And I mean, I guess I don't mean to nitpick. I mean, is there a level of conservatism that's built into that? Because, I mean, that would imply, I think, negative wearable revenue in the back half. So I'm just trying to understand if there is some...

Jeffrey N. Boyer ***Fossil Group, Inc. - Executive VP, CFO & Treasurer***

Yes, it [doesn't] imply negative. It's still growth. It's still strong double-digit growth in there. I would tell you the challenge we have is obviously we had great response to our Gen 3 product last year and we're introducing the Gen 4 product. We're just hitting right now on it. We love the product. We love the features, heart rate, GPS, near-field communications. We improved all the features it has. And so we're just trying to be appropriately cautious until we cycle through kind of what the response is going to be. Again, more we'll know after we get through to the third quarter on it. We still have double-digit growth in the back half of the year on smartwatches.

Operator

And our next question comes from Omar Saad from Evercore.

Warren Cheng ***Evercore ISI Institutional Equities, Research Division - Associate***

This is Warren Cheng on the line for Omar. I just wanted to clarify Gen 4 versus the Gen 3. I think if I remember correctly, heart rate and NFC payment capabilities, those are both new for Gen 4, right? And also, just what other differences in either functionality or form factor can we see from the Gen 4 versus Gen 3?

Gregory A. McKelvey ***Fossil Group, Inc. - Executive VP and Chief Strategy & Digital Officer***

Yes. Thanks. This is Greg. You mentioned payments, for sure, and then the [broad] fitness features. So we have heart rate in GPS, untethered GPS integrated as well. Additional features that the teams have worked hard to engineer is swimproof and then a rapid charge capability. So pretty rich feature improvement versus prior year. In addition, it's also thinner. So the teams have done a nice job continuing to improve the fashion elements. And we have many more brand and a lot of material innovation as well. So broadly, the offering this year is particularly strong. And while -- I'll add one other thing. In addition to adding features, we've been able to engineer cost down as well. So we're getting much better product at lower product cost at the same time. So really, really proud of our teams and what they've accomplished this year.

Warren Cheng ***Evercore ISI Institutional Equities, Research Division - Associate***

Okay. And then just a follow-up I had to that was, how does the ASP compare year-over-year? If I were to compare as like-for-like as possible, how would the ASP compare?

Jeffrey N. Boyer ***Fossil Group, Inc. - Executive VP, CFO & Treasurer***

Yes, comparable. So this has been a strategy all along. Last year, we priced it appropriate before we thought consumer willingness to pay was based on our insights and analytics. We drove volume to get down the cost curve, and that's played out pretty much as expected. So we've held price and brought product cost down to expand margins.

Operator

And the next question comes from Dana Telsey from Telsey Advisory Group.

Dana Lauren Telsey ***Telsey Advisory Group LLC - CEO & Chief Research Officer***

As you think about PUMA and BMW coming into the mix, how does the volume and how are you planning that relative to the exit of adidas and Burberry? And how do you see that progressing? And then also on the wholesale business, Europe, the Americas, Asia, I think last time, there were some headwinds on European wholesale. What are you seeing now? And how are you seeing order trends in the different regions?

Kosta N. Kartsotis ***Fossil Group, Inc. - Chairman & CEO***

Okay. On the -- first on Puma and BMW, obviously, great opportunities for us, great brands. We're going to approach them somewhat asymmetrically in a different approach, largely digital. And we're going to get started on that and be shipping next year. So those businesses will start off small, as we typically do in new business, start off small and get the working model right before we expand it. So there is -- in this case, both those brands have strong followings, huge amounts of passionate fans for these brands, a lot of CRM capabilities, et cetera. So we think we can scale it quicker than maybe we have in the past. But in any case, we're going start off with those. We have seen in Europe there's a lot of disruption over there, traffic way off. There seems to be some systemic problems there with the market that we've seen maybe in the U.S. a couple of years ago. A lot of increase in e-comm. So we're seeing still some very difficult times over there. We've got a lot of activities in the market. We are growing e-comm there. And our own e-comm, we've got a lot more social and digital activities going in there to turn the trend. But in our forecast for the back half the year, we're not predicting that, that business is going to change its trend. There's still a lot of work to do, and we're working on it as fast as we can.

Jeffrey N. Boyer ***Fossil Group, Inc. - Executive VP, CFO & Treasurer***

Dana, just on -- you asked about the PUMA, BMW and adidas, Burberry impact. Think about it this way. The Burberry and adidas impacts, we largely will be through those this year. And the PUMA and BMW will hit next year. So really incurring all the pain with that departure this year of those businesses, and we'll get the growth in BMW and PUMA next year as those cycle and we get those products in the market.

Operator

And the next question comes from Laurent Vasilescu from Macquarie.

Laurent Andre Vasilescu ***Macquarie Research - Consumer Analyst***

For the second quarter gross margin, can you remind us how much of the liquidation provision you took last year, how much has flowed through into the second quarter gross margin?

Jeffrey N. Boyer ***Fossil Group, Inc. - Executive VP, CFO & Treasurer***

Yes. Really from a net economic standpoint, given the fact that we had compressed margins on the sell-through, there's really no net economic impact on it. It happened similarly in the first quarter and the second quarter, so those margins are basically doing what they should be doing as reflected through the net economics on it. So really don't have a net impact from any liquidation impacts overall.

Laurent Andre Vasilescu ***Macquarie Research - Consumer Analyst***

Okay. And then on the fourth quarter, the operating margin, take the midpoint of 9%, suggests meaningful improvement year-over-year on the SG&A. Can you walk us through the drivers of that, if that's marketing or if there's other components that we should consider?

Jeffrey N. Boyer ***Fossil Group, Inc. - Executive VP, CFO & Treasurer***

Yes. It's actually, a lot of pieces, Laurent, on that. It's some marketing spending on it. We were investing pretty heavily last year in some of the connected fixturing and marketing programs. That isn't at the same level this year. We have a good base out there. I would tell you, the continuation [will] happen with the store closures. So store closures continue to have savings on that year-over-year. That's going to be a benefit, and then our infrastructure savings as well. So it's really spread across all 3 of the major categories we have, marketing spend, our direct spend for mostly stores as well as our infrastructure. And all of those are favorable year-over-year fairly consistently.

Operator

We have no further questions. I'll turn the call back over for final remarks.

Kosta N. Kartsotis ***Fossil Group, Inc. - Chairman & CEO***

Okay. We thank everybody for joining us on the call today, and we look forward to speaking to you when we report our Q3 results in November. Thanks again.

Operator

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