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Q4 2018 Fossil Group Inc Earnings Call

EVENT DATE/TIME: FEBRUARY 13, 2019 / 10:00PM GMT

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PRESENTATION

Operator

Welcome to the Fourth Quarter and Fiscal Year 2018 Fossil Group, Inc. Earnings Conference Call. My name is Adrian 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 Fourth 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. In addition, 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 the company's Chairman and CEO, Kosta Kartsotis.

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

Thanks, Allison. Good afternoon, everyone, and thanks for joining our call today. I will begin with a few comments regarding last year and 2019, and then turn the call over to Jeff Boyer, our CFO, to cover our Q4 financial performance and financial outlook for next year. Following Jeff's comments, we'll have Greg McKelvey, our Chief Strategy and Digital Officer, join us for the Q&A.

Note that our sales comments today will be based on constant currency unless noted otherwise. As you know, we are on a multiyear journey to transform our company. The watch and accessory business is changing at a rapid pace around the globe. Consumer preferences and shopping patterns continue to shift. Product innovation in watches has expanded the category overall, but has caused a move away from traditional watches towards connected product. Marketing product information and consumer research on watches and fashion accessories are shifting from our traditional brick and mortar channels to online ones. To address these structural shifts and improve the long-term health of our business, we identified a number of key priorities for 2018.

Our most important priority this past year was to improve our profitability and our financial condition. Due to fundamental structural changes in the watch and accessory categories, we recognize the need to be highly focused on improving our financial condition to provide us the flexibility to make the necessary changes to our overall business model. One critical element was to improve our overall profitability, which meant at times walking away from less profitable parts of our business, such as unprofitable stores and businesses and product lines.

This year our sales decreased but our actions did drive dramatic improvements in profitability as adjusted operating income increased significantly versus last year reaching $115 million, which is nearly 4x higher than last year's $31 million. And our adjusted operating income margin expanded to 4.5%, up from roughly 1% in 2017. In addition to improving our profitability, we were also focused on strengthening our capital structure. Our teams did an outstanding job in improving the efficiency of all elements of our working capital with particular focus on inventory productivity and turnover. The improved profitability along with much better working capital efficiency generated $250 million of cash from operations. As a result, we ended the year with 0 net debt.

Our second key priority was to drive product innovation and we continue to focus most of our efforts on connected and traditional watches. In traditional watches, we saw traction in new products with bold colors and differentiated designs that captures the consumers' attention, and we will be expanding on these in 2019. In the connected watch segment, our new Gen 4 product with heart rate, GPS and Google Pay sold at higher rates than the Gen 3 product in both our direct and indirect channels. Our new Fossil Sport offering generated strong sales on limited availability. This watch has the latest Qualcomm 3100 chipset, which has improved battery life and faster processing.

Our third key priority was to invest in digital marketing and expand our efforts in e-commerce, particularly for our Fossil brand. We continue to focus our medium mix on digital, investing in digital media, social media and page search. Although our global digital media spend was flat for Fossil in the fourth quarter, we improved the overall effectiveness and efficiency of these efforts. We continue to enhance our consumer targeting and social content initiatives to further improve engagement, while driving product sales through search, affiliates and retargeting efforts.

Our fourth priority this year was to continue the transformation of our business model. As we mentioned previously, a portion of our improvement in operating income comes from exiting unprofitable stores and product lines. In addition to these rationalization programs, we have a number of other initiatives underway. One of the most important goals was to improve our working capital efficiency and convert inventory to cash. This liquidation initiative started in earnest in the fourth quarter of 2017 and continued for most of this past year. We also continue to work on optimizing our promotional programs. In the fourth quarter, we were significantly less promotional in our direct channels, and with a number of our wholesale partners, which affected our top line sales but improved the overall health of owned and licensed brands.

Our New World Fossil initiative continues to contribute significantly to our profit improvement efforts and includes operational efficiencies, revenue management, product sourcing and design-to-value elements. We remain on track to achieve our New World Fossil objective of $200 million in run rate savings by the end of 2019.

Overall, we are pleased with the progress we made this year on these priorities and on the overall profitability and financial condition. While our business benefited from these efforts, it's important to note that our top line sales performance for the year was impacted by these critical actions. We are exiting unprofitable stores and businesses. We reduced the amount of promotional discount in price matching in the marketplace, especially in the U.S., and as a result, sales to more promotional retailers were reduced. The improvements we have made to our overall inventory levels means we have more current inventory and less product available for the off-price sales channel. These critical actions constrained sales in the fourth quarter and the impacts are expected to continue into the first quarter of 2019. Jeff will provide more specifics in his financial review and guidance in a few minutes.

Though we've experienced headwinds, we are excited about the opportunities in the watch and accessory category over the long term and believe that our strategies and initiatives will strengthen our position in this evolving category, and will transform our company to support long-term profitable growth. As we look at 2019, our focus and priorities will remain consistent with the past year and we will pivot appropriately to address the changing landscape. One overarching priority that will not change is our focus on improving our profitability as well as strengthening our financial position to ensure the long-term success of Fossil Group.

Our category continues to evolve at a rapid rate. Connected watches are growing in the U.S. and Europe, while traditional products are strong in high-growth emerging markets in Asia. The consumer is shifting channels and we are shifting as well. In the Fossil brand globally, nearly 60% of our sales now are in the direct channel with a growing presence in e-commerce. As the shift continues, we are improving our revenue management capabilities to price and position our products optimally and to promote most effectively. And we will continue to exit unprofitable stores and businesses and product lines to improve our bottom line health. Our New World Fossil initiative continues to proceed on plan.

Secondly, product innovation and differentiation are more important than ever and we are ramping up our efforts on this topic. Creativity and innovation are our strengths and the core of what drives our business. Our teams are focused on differentiation this year, and there are a lot of new exciting products and merchandising ideas in the pipeline. In wearables, our objective remains to bring fashion, branding and style to this business with new products tailored to each of our brands' unique point of view. This past year, we added heart rate, enhanced fitness and Google Pay to our smartwatch offerings. We have great technology partners in Google, Qualcomm and Citizen, and an outstanding platform of brands to continue to create excitement and growth in our connected business. As a result of these partnerships and our efforts, we will continue to innovate in the connected watch space, and we'll introduce enhanced display and hybrid product in 2019 and in the years ahead. The product will continue to get better and better.

In traditional watches, we are expanding our efforts in design and innovation, focused on differentiation, to bring bold and exciting new product to market. We have identified a number of trend opportunities and have seen strong results when we introduce new product ideas, combined with integrated marketing programs across our ecosystem. We will continue to use our increasing marketing abilities to build momentum and awareness in our traditional business.

Our third priority this year is to maximize sales growth across multiple channels. Where and how our customer shops is also changing rapidly. We have adapted and will continue to adapt to these changes. Our digital marketing programs are focused on driving awareness and purchase intent on a broad omni-channel basis. The new integrated e-commerce and marketing platforms we are rolling out this year will provide better support to both our wholesale and direct channels. We will expand buy online and pick-up-in-store to more of our global markets, enable ship from store capabilities and increase our collaboration with wholesale partners to optimize online performance on our partners' websites. We are excited about our e-commerce expansion opportunities, including expanding a number of markets in which we have direct e-commerce. And by further developing our analytics and revenue management capabilities, we'll be able to optimize pricing, product placement and promotions to generate optimal levels of profitable sales across multiple channels.

And fourth, we need to further transform our business model. Our organization has done an outstanding job of adjusting to the new realities of our business over the past few years. We are smaller, leaner and more efficient. Since 2015, we have reduced our expense structure by over $200 million, while also investing in critical areas such as wearables, e-commerce, digital marketing and analytics. We've entered into technology partnerships to be more efficient and also to better support innovation and new product introductions, but we recognize we still have much more to do. Our vertically integrated manufacturing and supply chain are strategic advantages that we must make the most of. We have initiatives underway to strengthen our supply chain this year, which will improve our speed to market, improve our on-time delivery rates and reduce our costs.

We are also undertaking a comprehensive assessment of our global operating model, using a zero-base budgeting approach to enable us to allocate resources to the most critical parts of our business, while becoming as efficient as possible in other areas. We expect that our revenue management, supply chain transformation, indirect procurement and zero-base budgeting initiatives, along with store closing and business exit projects, will deliver savings and efficiencies similar to our New World Fossil program. Note that part of our transformation has already taken place in our connected business.

During the third quarter, we announced a strategic partnership with Citizen watch company to grow and expand the hybrid smartwatch category and innovative product in our connected watch portfolio. Under a licensing agreement, Fossil Group provides Citizen with our proprietary hybrid technology for use in both their brands and in third-party watch brands. This past month, we announced an agreement to transfer intellectual property to Google for technology that is expected to improve upon our existing platform for smartwatches and unlock future growth and wearables. Both of these agreements are expected to drive innovation and reduce cost in our wearables business.

In closing, we still have a lot of work to do, but we have made significant progress and are focused on the opportunities in front of us. As we enter 2019, we will continue to forecast our top line conservatively to put pressure on the elements we have the most control over, our gross margin structure and our expenses. We remain focused on energizing our core watch business and on bringing more innovation to connected products with new features and functions. We will continue to invest in innovation and in our digital and analytic capabilities while increasing our productivity and efficiency throughout the company. In closing out the year, we'd like to express our sincere thanks to our spirited Fossil team members all over the world for their relentless efforts this past year.

And now, I'd like to turn the call over to Jeff.

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

Thanks, Kosta, and good afternoon, everyone. Overall, we're pleased with our progress this quarter as we continue to navigate a challenging environment. Every quarter this year, we've improved our profitability and this continued in the fourth quarter.

During the fourth quarter, we expanded gross margin to 53%, reduced expenses by $47 million and delivered a much stronger balance sheet. We reported net income of $48 million compared to a net loss of $80 million last year. Our reported earnings of $0.94 per diluted share included New World Fossil restructuring charges of $0.07 per diluted share. Last year, our fourth quarter EPS was a loss of $1.65 and included tax-related charges of $2.20 per diluted share, mainly for the impact of the December 2017 tax legislation combined with valuation allowances established on deferred tax assets and a restructuring charge of $0.09 per diluted share.

Excluding these items, our adjusted EPS was $1.01 this year as compared to $0.64 last year. Currencies, including both the translation impact and operating earnings and the impact of foreign currency hedging contracts, unfavorably impacted our EPS comparison in the fourth quarter by $0.09.

Sales decreased 15% to $787 million and decreased 13% on a constant currency basis. While store closures unfavorably impacted sales comparisons during the quarter, profitability in our direct business improved significantly as we exited unprofitable stores and we're less promotional overall in our retail concepts. Store closures negatively impacted total year-over-year sales comparisons by 170 basis points. We have closed 67 stores since the fourth quarter of last year and ended the quarter with 484 stores. Licensed brand and business exits unfavorably impacted total sales by 310 basis points. Excluding these items, underlying core sales decreased 8% in the quarter. Our fourth quarter underlying core sales results were negatively impacted by lower promotional levels, less off-price sales and a display watch supply or delivery delay.

Our watch business declined 11% in constant currency for the quarter with decreases in both traditional and connected products. Sales in our traditional watch business, while still challenging, generally performed within our overall expectations with continued weakness in the Americas and Europe, flat sales performance in Asia and the unfavorable impact of licensed brand exits. While our next-generation smartwatches are resonating well with consumers, connected sales decreased modestly during the quarter, largely due to delays in inventory receipts, the impact of store closures and reduced liquidation levels as compared to last year. Our connected watch business delivered $134 million in sales, representing 21% of total watch sale for the quarter, up from 20% last year.

Total Fossil brand sales decreased 11% in constant dollars compared to last year with declines across all product categories. Fossil Watch sales decreased 10% in constant dollars, with more than half of the decline driven by the closure of underperforming stores. Excluding business exits and store closures, direct channel sales increased single digits in the Americas and were flat in Asia, while sales declined single digits in Europe, largely driven by the challenging macroeconomic environment. Sales decreases in our retail stores, driven by a reduction in promotional activity to increase profitability, combined with store closures, drove an overall 11% decrease in our total direct channel.

Michael Kors brand sales declined 14% in constant dollars with decreases in both watches and jewelry. Kors watch sales declined 8% for the quarter as liquidation sales that occurred last year, mainly in older-generation connected product, were not repeated. Regionally, Kors watches decreased in the Americas and Europe, and increased modestly in Asia. The jewelry category continue to be negatively impacted by the repositioning of the line as we transitioned into a higher-price assortment. We began expanding distribution of the new jewelry assortment in the fourth quarter and will continue into 2019.

We saw increasing consumer interest in the new jewelry assortment during the fall season and increased sales in the December gifting season. In the Americas, fourth quarter sales decreased 14% on a constant currency basis to $379 million with declines in our 3 main product categories, driven primarily by softness in the wholesale channel, retail store closures and reduced promotions as well as license brand terminations.

Watch sales were slightly better than the overall Americas region sales trend, despite continued softness in traditional watches and connected inventory delays negatively impacting selling. Wholesale sellout trends remain down double digits to last year. Our overall retail performance in the Americas declined as double-digit e-com growth was more than offset by negative store comps, driven by lower promotions especially in our outlets, the negative impact on sales from closing unproductive stores and delays in connected inventory receipts. While retail sales declined, profitability increased solidly. In Europe, reported sales decreased 19% to $272 million. On a constant dollar basis, sales declined 17%, representing decreases across all product categories. During the fourth quarter, soft sales trends continued across all channels, reflective of the challenging macroeconomic environment and the general softness in the European markets.

Retail comps were modestly negative with negative comps across all concepts including e-commerce. Fossil watch sales in Europe were negative with declines in traditional watch sales, partially offset by modest growth in connected sales. Within our watch portfolio, sales declined across most brands. Across the eurozone, sales were down in most major markets with the greatest declines in the U.K., France and Germany.

In Asia, we reported a sales decline of 5% and $136 million of sales and on a constant currency basis, sales decreased 1%. Decreased retail sales driven by the negative impact of nonproductive store closures were partially offset by strong e-commerce growth and a modest sales increase in wholesale channel during the fourth quarter. Excluding store closures and business exits, our underlying core sales growth in Asia was positive 5%.

Fossil brand decreased modestly in Asia, driven by softening sales trends in leathers and traditional watches, due in part to fewer promotions in the retail channel. Both Emporio Armani, our second largest brand in Asia, and Diesel posted strong double-digit growth driven by traditional watches. This growth was partially offset by brand exits. Most other brands in our license portfolio were relatively flat to modestly down in sales dollars for the quarter. Strong growth momentum continued in India across all channels and in China, primarily driven by the third-party e-com and wholesale channels. Hong Kong delivered modest sales growth, while most other countries were down during the fourth quarter with the greatest declines in Japan, Australia and Taiwan.

Gross profit increased to $417 million and gross margin increased 430 basis points to 53.0%. This gross margin expansion was partly driven by favorable comparison over last year when we recorded additional inventory valuation reserves for excess levels of older-generation connected products. Gross margin also benefited from our New World Fossil initiatives, higher outlet margins from lower promotions and improved off-price margins, partially offset by an unfavorable currency impact of approximately 60 basis points.

Fourth quarter operating expenses were $350 million, including $5 million in restructuring cost. Last year, operating expenses were $397 million and included $6 million in restructuring costs. Excluding restructuring charges, operating expenses decreased $47 million in the fourth quarter as compared to prior year and included a $6 million favorable currency impact. The lower expense in the fourth quarter resulted from our store-closure program, lower variable marketing expenses and infrastructure reductions driven by our New World Fossil initiatives along with the currency effects of a stronger dollar.

Our fourth quarter operating income increased by $16 million to $67 million and improved to 8.6% of sales as compared to operating income of $51 million a year ago. Excluding restructuring charges, operating margin was 9.1%, a 280 basis point improvement from the 6.3% recorded last year. Interest expense remains flat at $11 million. And fourth quarter other income of $5 million was favorable to last year, mainly due to increased net foreign currency gains.

Income tax expenses were approximately $14 million in the fourth quarter and a pretax income of $62 million, resulting in a 22% effective tax rate. Income tax expenses in the prior year were $121 million and included $107 million combined impact from the Tax Cuts and Jobs Act that was signed into law in December and the recognition of deferred tax asset valuation allowances. 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 those jurisdictions, thereby increasing our effective tax rate. We improved our net debt position by $222 million compared to a year ago. We ended the quarter with $403 million of cash compared to $231 million last year and debt of $396 million compared to $446 million a year ago. Given our strong year-end cash position, we accelerated our March 2019 term loan payment and pay-down debt by $125 million shortly after year-end in January.

During the quarter we invested $8 million in CapEx bringing full year CapEx to $18 million. Our adjusted EBITDA for the quarter was $102 million, resulting in full year trailing adjusted EBITDA of $221 million. Our fourth quarter year-end bank leverage ratio was 1.8x. Comparable inventory levels at the end of the year were down 35% versus a year ago, driven by reducing slower moving traditional inventories and clearing our previous-generation connected products. Accounts receivable decreased by 11% to roughly $328 million and wholesale DSOs decreased to 1 day as compared to the prior year.

Depreciation and amortization expense totaled $17 million for the quarter and $64 million for the year. As we move into 2019, we recognize our industry continues to experience significant disruption given evolving consumer preferences across product categories and channels. While we're working extremely hard to change sales trends and drive improved profitability, given the limited visibility, it remains prudent for us to continue to plan our financials conservatively. This conservative posture allows us to appropriately control our costs, our margin structure and our inventories, while maximizing our ability to respond to opportunities as they develop.

We continue to see long-term growth opportunities in our categories, but top line growth in 2019 will be challenged by a number of factors. Those factors include negative currency impacts, store closures and business exits, fewer inventory liquidation programs and a constrained supply of connected product in the early part of this year.

For the full year, we expect total reported sales to range from negative 12% to negative 7%. The upper end of the sales range reflects additional opportunities in connected, owned and third-party e-commerce, while the lower end reflects a potential change in sales trends given macro factors and further disruption. It's important to note, our full year sales guidance includes approximately 250 basis points of headwinds related to store closures and business exits as well as 150 basis points of headwinds from changes in foreign exchange rates. Excluding the unfavorable impact of currency, exits and closures, 2019 midpoint core sales performance on a constant currency basis is forecasted to be approximately minus 6%, generally consistent with this past year and includes the impact of lower liquidation sales.

Turning to gross margin. We're continuing to focus on improving product costing and our overall gross margin. In addition, we're seeing regional and channel mix benefits and our connected products are delivering higher gross margins in 2019, all of which will further improve margins. These factors are expected to deliver roughly 100 basis points improvement in our gross margin rate. However, the negative impact of foreign exchange rates will offset a significant portion of the underlying improvements we expect to achieve. Overall, we forecast gross margin for the year of 51.5% to 53.5%. Within our operating expense structure, New World Fossil continues to deliver savings as we move into 2019, both from run rate actions executed in 2018 as well as incremental efficiency actions that will be delivered in 2019.

We'll also continue to refine our store base to focus on the most profitable opportunities with an expected net reduction in store count of approximately 30 stores in 2019. We planned restructuring charges at a level similar to 2018 with full year restructuring plan at $50 million. For the full year, we expect operating expenses of $1.14 billion to $1.20 billion, inclusive of planned restructuring charges. Therefore, for the full year, we expect operating margin of 0.5% to 3%, excluding the impact of a restructuring program adjusted operating margin is forecast to range from 2.5% to 5%. The unfavorable currency fluctuation this year is expected to have a $20 million negative impact on our operating income metrics. In constant currency, the midpoint of our guidance reflects adjusted operating income consistent with 2018. And considering the quarterly earnings pacing for 2019, it's important to remember that 2018 reported sales were stronger in the first half and weaker in the second half, primarily due to currency fluctuations as well as higher liquidation levels early last year. Therefore, looking at 2019 on a sequential quarterly basis, reported sales are expected to improve throughout the year given the tougher comparisons in the first 2 quarters. For the year, we are using the current prevailing rates for the euro and the British pound of

$1.14 and $1.27 respectively.

First quarter will be the most impacted by currencies with an expected 400 basis points negative impact with the impact diminishing in Q2 and Q3 and turning relatively neutral in Q4. In addition, business exits and store closures will be a larger headwind in Q1, representing a 350 basis point headwind and then the impact will also diminish as we move through the year. Based on these factors, for the first quarter, we expect sales in the range from negative 22% to negative 16%, which includes approximately 350 basis points impact from store closures and business exits and 400 basis points of unfavorable currency rates. In addition, first quarter sales will be negatively impacted by lower liquidation in off-price sales as well as constrained sales of display watches until inventory levels normalize in Q2. We expect gross margin improvement to be the largest in the first quarter and then to moderate as we move through the year, given the larger impact of currency in Q2 and Q3, and channel mix benefits moderating as we move into the second half. For the first quarter, we expect gross margin of 51% to 53%. Operating expenses for the first quarter are expected to be $273 million to $286 million, which includes $10 million of expected restructuring charges. Therefore, we expect first quarter operating margin of negative 10% to negative 7%. Given that we enter 2019 with lower debt levels, we expect interest expense to decline in 2019 with full year net interest expense expected to be $35 million.

Interest expense is expected to be relatively flat sequentially throughout the year. Other income and expense, which is primarily related to hedge contract gains and losses, is expected to be flat to a modest positive each quarter, using the foreign exchange rates embedded in our plan and assumptions. It's important to note, however, that under the new hedge accounting pronouncement, which takes effect at the end of our first quarter. A portion of the hedge contract gains and losses will be recorded in the cost of sales rather than in other income. Further, as you'll recall, in January, we announced an agreement to sell intellectual property, related to a smartwatch technology we developed, to Google for $40 million. The transaction closed in January and therefore in Q1, we will recognize a gain in other income related to this transaction. We have not yet finalized the analysis necessary to record the accounting related to this transaction, but based on our initial estimates, we expect to record a gain of $20 million to $25 million in other income.

We will update you on the final gain related to this transaction when we release our Q1 results. Therefore, we expect full year earnings before tax of approximately 0 to $60 million, and we expect first quarter earnings before tax of approximately negative $30 million to negative $18 million, which includes an assumed $20 million gain from the Google transaction. Based on the profile of our geographical earnings including our tax loss in our U.S. companies, we expect the tax expense to range from $20 million to $30 million. And we expect first quarter tax expense to be approximately $6 million. We're planning to invest approximately $30 million in capital expenditures in 2019.

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

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***

A couple of questions on wearables. I know you mentioned product delays or shipment delays. Help me just try to understand kind of what the longer-term growth looks around wearables? Maybe give a little bit of color on some of these delays and kind of what would wearable performance have been potentially without some of those issues that you had?

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

This is Greg. I'll talk about the supply shortage and then maybe pass it off to Jeff to talk about how we, sort of, view growth. Unfortunately, this is the first time in 4 years we've had a supply chain issue or a shortage, so it hasn't -- fortunately it hasn't happened a lot, but it was unfortunately material this time. The key issue was a supplier in one of our subassembly processes. So it's a little bit deep in the supply chain where we had a single source of a component that caused the issue. We have already actually moved to 3 suppliers, so we have diversified away, have the problem solved, but it was material in Q4 and will continue to be material in Q1. We're confident it will be fully caught up though by the second quarter. Maybe pass it off to Jeff to talk about materiality and growth projections.

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

Ye, Ed, Jeff here. In the fourth quarter, we estimate the amount of constrained or loss sales at probably about 200 basis points to the total company, so it's about $15 million or so. Obviously, because the connected business is a smaller piece overall because of a bigger impact on the growth, so that would slip it from a slight decline to a growth for -- in connected. But the other thing that you should be aware of is we are going through -- we're going to start lapping some of our liquidation from last year, kind of an abnormal event to clear through, a fair amount of inventory in connected, really started in earnest in the fourth quarter of '18 on it, [we are on '17,] and as we left it in '18 because of some drag, that's going to continue on in the first and second quarter. When we strip out the liquidation piece and the supply chain piece of it, we are looking at the underlying display program, that connected display product, to be up about 20%. So the display product, excluding some of this liquidation, should be strong going into 2019.

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

I'd just add one other point on growth, Ed. And we had a tremendous success, albeit short in supply on the launch of our Fossil Sport product. And really that indicates a drive -- still to continue with the fashion product with more traditional fashion materials, but more use of silicon and more brands targeted at the sports segment, which is where a lot of the growth in the category consumption is today. So you'll see that extended as a part of our program this year.

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

Great. And one follow-up, if I may. Obviously, lots of moving pieces in the traditional watch business. I know you were impacted by comp against the liquidations, and that particularly within the Kors business. How do we think about the trajectory of the traditional watch business? When do you think that you could start to see some leveling off, if at all? And how should we think about kind of opportunities to continue to kind of rationalize the brand portfolio?

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

As you know, traditional watch has been tough for some time, and we don't have a lot of visibility on the turnaround in there. We do have -- I would say, this year, we have identified a number of opportunities, especially for the balance of this year. We have seen a response to some new trends we've put in the marketplace. And our teams are working diligently on as much differentiation as possible. And I would say, also, we do think at some point that a game changer for traditional watches is going to be adding technology. And part of our arrangement with Citizen is basically to do that as to get to critical mass and scale, and have great product at lower prices, which will create more awareness and to do as quick as possible. So that's what that project is about, but we do think through a lot of innovation and differentiation in some of the technology we'll be able to reach a point where we start growing again.

Operator

And our next mission comes from Simeon Siegel from Nomura.

Simeon Avram Siegel ***Nomura Securities Co. Ltd., Research Division - Executive Director & Senior Analyst***

Just within the Kors commentary, what is the connected versus traditional penetration kind of, I guess, similar to what you'd given for your -- for the total? And then on the total across the brands, what would you expect -- would you expect the connected watch penetration to end '19?

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

In terms of across the brand, it's actually relatively similar, it's not that different. Fossil and Kors are our 2 big brands. And they sit in fairly similar spots and it kind of sets with the basis for the entire company. In terms of where the penetration is going to be at, overall, it will be climbing probably not as quite a fast a pace as it has in the past couple of years. We'll have some modest growth in connected in 2019 mostly because we're up against the liquidation problem that we have. But with our traditional business being down, we'll gain a few share points within the penetration in connected, probably in the low 20s, I don't think it would get towards the 25% at this point, Simeon.

Simeon Avram Siegel ***Nomura Securities Co. Ltd., Research Division - Executive Director & Senior Analyst***

Great. And then obviously not material, did you say what -- the new corporate revenue line item. What was that?

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

The corporate revenue item, we actually have had that. It was embedded in the region, it wasn't material, but we decided to break that up separately to have our regions line up a little bit more cleanly, overall. So there's some factory income is the biggest thing with the factories that we have, so it's mostly the factory income at this point.

Operator

(Operator Instructions) And our next action is from Omar Saad from Evercore.

Omar Regis Saad ***Evercore ISI Institutional Equities, Research Division - Senior MD and Head of Softlines, Luxury & Department Stores Team***

I wanted to ask more about the wearables category and then try to understand why it's declining or not going fast. I know the underlying is that it's about plus 20%. But you've put so much innovation and newness across the brands into the holiday, little surprised it's not growing more. Can you help us understand if there is a channel issue? Is

(technical difficulty)

for the wearables category they are managing through? And also, I

(technical difficulty)

the ongoing declines in the fashion watch business, why do you think more of those consumers are transitioning or switching to the wearables category?

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

So yes, I'll start, Omar, this is Greg. A few different things. So overall, we -- the category is healthy in wearables, including what all the other competitors are doing, so category is growing. We see the rate of innovation increasing and have not changed our view on where the category is going to be in 2021, 2022. So category is healthy. Short term for us, the supply shortage was pretty material to us and also caused us to be a bit more conservative in our drive to increase the business in Q4 and Q1, so we pulled back a little bit, we're conservative of our inventory position. Another point is we've done a nice job, our brands are bringing fashion products, so I think metal and leather. However, a lot of the demand in the category is sport. So we're -- as we are now pivoting to more silicon, lighter-weight materials, think more like what we did with Fossil Sport and extending that across brands. We think that'll open up the number of consumers we're going to be able to segment and target, so we can increase our share of the category. And then we're working really hard on continuing to drive product costs down. So as we do that, we should see improved margins but we should also see sharper price points to drive volume up.

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

And on your question on traditional watches. I mean it's clear to us that we're in a very disruptive watch market. The traditional watch business in our addressable market is about $35 billion. Smartwatches, last year, did about $15 million, it should grow to $30 million over the next several years. But just the sheer number of volume that's coming -- going into wearables or smartwatches right now. And we already know, it's largely health and wellness, it's largely female, it's a younger customer, it's really our traditional fashion watch customer that's largely buying these smartwatches. So now, we think we're putting ourselves in position with brands and styling and new technology, the product's going to get better, and we're going to accelerate it with our partnerships with Google and with Citizen, to put ourselves in position to capture this growing market and to balance out our efforts both in traditional and in smartwatches. So we're in a unique position as the market gets disrupted, we're with partners that we're working with, we're trying to do is -- we're trying to get better product, lower cost and do it faster. So we can create scale to create awareness to change the watch market and that's the situation we're in right now.

Omar Regis Saad ***Evercore ISI Institutional Equities, Research Division - Senior MD and Head of Softlines, Luxury & Department Stores Team***

That's really helpful color, guys. Could you also address the channel question? Is there something unique or different? Or what you're learning about which channels the wearables category will overlap as best?

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

Well, as we said before, wearables is skewing very heavily towards online. Probably about 50% of the total sales is done online, either through our websites or our retail partners' websites or pure play, so it's clearly that younger customer. There's a lot of, obviously, detail the customer has to learn about the product. They're doing that online rather than at a point of sale and they're purchasing there. We obviously have seen a big increase in buy online, pick-up-in-store in wearables as well. So the channel shift which is ongoing from retail to digital is actually putting us, our company, in a position where, as we're getting bigger in wearables, we're migrating more towards digital e-com.

Operator

And our next question comes from Ike Boruchow, Wells Fargo.

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

First question. So Jeff, I think I understand the headwinds that are impacting the connected category. Just curious, they were down about mid-single digits on a reported basis in dollars in Q4. Is that the kind of decline we should be expecting in Q1? Or should that worsen because the discounting compares are tougher. And then just curious should we expect a return to growth in your connected business on a reported basis once we get out of Q1 into Q2 and beyond?

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

Yes, probably in connected because of the liquidation issue, it's a couple of quarters, that will be Q1 and Q2, those will both be in the rough range of low single-digit softness, mostly because, again, of that liquidation piece. You get to the second half of the year and we move through most of liquidation and the growth will return again. What we like to take a look at is stripping out and looking at just the pure display product itself that's unaffected by the liquidation effects on it. That pure display product will be up in the low 20s, this is what our forecast is. But we do have some noise because of the excess liquidation we went through in 2018, that we're up against now in '19, particularly in the first half of the year.

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

So on a reported basis, small low single-digit declines in connected in the first half and then a reacceleration in the back half?

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

Right, right.

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

Okay. And then just a follow-up. Just making sure I heard right on the guidance, is the $20 million gain from the sale to Google, is that included in the Q1 other income line? And then the follow-up to that is just on the working capital, if you could address inventory, I mean you've taken -- you have done great job on working cap and taken inventory down in 2018. Is there more room to run there or does working cap now, maybe you have to start building up? Just kind of curious how we should about that?

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

On the Google gain, that is in other income, it is in the guidance. I would say that's -- there's a small amount that's hedging that's in there, but most of that gain is from the net gain from the Google transaction. On the working capital piece of it, we are still going to be very focused on inventory productivity on it. You will not see any kind of a sizable step down you saw this year. We're working on inventory turnover to flow the product on it and so we're not looking at adding significant amounts of inventory overall. So I think the working capital equation will be fairly similar in 2019 to where we ended '18 at. There's not a whole lot of opportunity on top of that, so no big changes there as we exit the year-end guidance in '19.

Operator

And this concludes the question-and-answer session. I'll now turn the call over to Jeff Boyer for closing remarks.

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

Yes, I want to thank everybody for joining us today. We look forward to speaking with you on our first quarter call in the future. Thanks.

Operator

Thank you, ladies and gentlemen. This concludes today's conference call. Thank you for your participation, and you may now disconnect.