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PRESENTATION

Operator

Welcome to Fossil Group 2018 First Quarter Earnings 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 Jeff Boyer, CFO. Mr. Boyer?

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

Thanks, Adrienne, and good afternoon, everybody. As many of you are aware, an unauthorized third-party released our earnings report prior to the market close. We're extremely disappointed this occurred, and we'll conduct a thorough review to ensure this won't occur in the future. Early indications are that a financial news organization accessed a nonpublic staging area of our website and scraped this information for their benefit. Upon learning of this incident, we immediately published our earnings release through our normal distribution channel. We apologize for any confusion due to this incident and are taking steps to ensure it won't happen in the future.

Now I'll turn the call over to Allison to read our Safe Harbor statement. Allison?

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

Thank you. Good afternoon, everyone. Thank you for joining us, and welcome to Fossil Group's First 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 projected 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 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 us today. 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.

We are reporting today that our first quarter results have surpassed the high end of our guidance. As we stated on our February call, our posture for fiscal 2018 was to plan prudently but operate aggressively in the marketplace. This approach drove better-than-expected results, despite continuing disruption in key categories and distribution channels. As we look ahead, we will continue our prudent planning posture, but take every opportunity to actively pursue accretive sales opportunity, as we focus on becoming a more profitable company.

In the first quarter, we had stronger sales performance versus our expectations in 3 key areas. First, our retail comps in our direct channel, which includes our stores and our own e-commerce business, were up 5% globally in constant currency. The Americas region led the way with retail comps in watches up 12%, driven by our Fossil brand wearables.

The second, our smartwatch category across our entire brand portfolio grew substantially in the quarter, up 97% on a constant currency basis. This growth was well balanced with all 3 of our regions nearly doubling their connected sales versus last year.

With this growth, nearly 20% of our sales was in smartwatches. And third, our direct e-commerce business continued to build nicely. Sales in the channel were up nearly 50% in the quarter versus last year.

In addition to the first quarter sales upside, we managed other key elements of the business well. Gross margin was 50.5% in the quarter, about in the middle of our guidance range and was about 70 basis points better than last year.

Our SG&A expense, including restructuring expenses of $21 million, was also in the midpoint of our guidance range. Our adjusted operating income, excluding restructuring actions, improved significantly versus the first quarter of last year.

Although we are encouraged by our first quarter performance, we recognize we are operating in an environment going through significant change. This is due to a number of trends, including the ongoing shift away from traditional retail channels to direct channels, such as our own retail stores, our e-commerce sites and third-party e-commerce partners.

Strong growth in wearables in the overall wrist market will continue to shift spending from our traditional watch business. We're working hard to gain our fair share of this fast-growing smartwatch category, while focusing on innovation to improve traditional watch trends.

And consumers will continue to engage with products in an increasingly digital and mobile manner, and we are building our capabilities to operate in that environment. We also recognize that, despite these challenges and changes, we have a number of opportunities available to us as we navigate through this period of transition.

On our last earnings call, we outlined 4 overarching objectives that drive our strategies and initiatives for the year. First is to improve our overall profitability. Second is to innovate our product offerings. Third is to expand our e-commerce and digital marketing, and fourth is to transform our business model. First, we will talk about improving our profitability.

In fiscal 2018, we expect to become a smaller but more profitable business. Total sales will contract as we exit unprofitable stores and businesses and product lines. Connected watches continue to demonstrate strong growth, but the absolute dollar decline in traditional watches in our wholesale channel will be greater in the near term.

Though overall sales will decrease as a result, our operating income is expected to improve. A portion of this improvement will come from exiting unprofitable stores and product lines, but the most significant improvement in profitability is the result of our New World Fossil initiative, which we kicked off in late 2016.

Through a combination of category management programs, direct and indirect sourcing efforts and organizational efficiency initiatives, we are projecting to drive $200 million in gross margin expansion and efficiency savings through 2019. We've been extremely pleased with our organization's efforts under this program, and we are on track to reach this objective.

Our second overarching strategy is innovation and design, which has always been the cornerstone of our business model. Our outstanding design capabilities start with traditional watches, where we are ramping up innovation with differentiated new treatments and materials that are very unusual and eye-catching. In our experience, new ideas in watches has always been the catalyst for changing the direction of the business, and our teams are focused on quickly bringing these new ideas to market.

And our strength and innovation in design has expanded into wearables. In 2018, across both owned and licensed brands, we will launch 3 new formats of smartwatches. This year's launches will again have a number of improvements and additional features that we feel will resonate strongly with consumers. Some of these features address the increasingly important macro trend of consumer interest in health and wellness. We look forward to sharing more with you about these products when they're launched in late summer.

Our objective remains to bring fashion, branding and style to the rapidly growing connected watch business, with these products tailored to each of our brands' unique point of view. These great new offerings are expected to continue to support significant growth in the connected product category as demonstrated by the strong Q1 growth in the first quarter, which nearly doubled on a global basis.

And wearables continue to have a positive impact on the sales trend for a number of our key brands and our overall watch sales. Wearables were nearly 20% of our total watch sales for the quarter, up from 8% in Q1 of last year and even higher in the United States. Though our total watch business contracted in the quarter, the growth in wearables improved the overall growth in watches by 900 basis points.

Given our design and innovation capabilities, we will continue to maintain our size and scale advantage over our competitors, which provides us the resources and the ability to be an industry leader in both traditional watches and in smartwatches.

To fully utilize our size and scale advantage, we continue to pursue a number of additional brands to incorporate them into our portfolio of licensed businesses. As a result of these efforts and due to our capabilities across both traditional and smartwatches, we recently signed a licensing agreement with Puma. As one of the world's leading sports brands, Puma is a strong complement to our current portfolio and enables us to provide world-class design and distribution to this athletic apparel and footwear company. We look forward to working with our new brand partner to fully develop their watch potential on a global basis.

Our third key strategy is to continue to build upon our investments in digital marketing and to expand our efforts in e-commerce. Based on our successful programs in 2017, our 2018 plan called for further strengthening of our digital marketing and social media efforts, while leveraging celebrity and influencer partnerships to drive increased engagement. Given our success with these programs in Q1 where unique visitors to our sites and our social media followers both increased double digits, we're feeling even more strongly about our plans to expand our digital programs for the balance of the year.

In addition, we will expand buy online, pick up and store capabilities to more of our global markets, enable ship from store options and increase our collaboration with wholesale partners to optimize online performance. We will be increasing our overall investments in digital marketing and optimizing our marketing mix to achieve the most efficient path to purchase for our consumers.

As a result of these programs, our own e-commerce platforms across the globe continue to drive significant growth, expanding 49% globally in the quarter with sales growth of 47% in the United States, 19% in Europe and 147% in Asia.

In the first quarter, we also continue to grow our business with pure-play online retailers in the United States and all over the world. Our business with this critical group of online retailers grew by 51% in the quarter.

Our final overarching strategy for fiscal 2018 will be to continue the transformation work we began in 2017 as part of New World Fossil. 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.

As I've mentioned, we have made significant progress on the initial transformation of the company, which is projected to drive $200 million in gross margin and efficiency benefits through 2019. Our first quarter benefited from nearly $20 million in margin benefits and cost savings.

We are working aggressively on the next phase of New World Fossil, which we began with a deep dive into insights on what the traditional and connected watch business will look like over the next 5 years. Our initial research work indicates that the mid-tier watch category, defined as traditional watches plus connected watches under $1,000, will continue to show robust growth over the next 3 to 5 years, increasing between 5% and 7% annually. Much of this growth will come from the acceleration of smartwatches around the world, but we're also expecting continued growth in traditional fashion watches, especially in the expanding middle class found in emerging markets, such as China and India, a growth pattern we are seeing this year.

The watch market is changing, and we are now in position to compete in both traditional and connected watches. How the consumer shops is also changing quickly. The vast majority now engage in an omnichannel journey, mixing online, retail and wholesale channels as they consider a watch purchase. As a result, we must continue to reinvent the company to significantly improve all of our customer touch points, particularly in our own retail and e-commerce channel.

We expect this next phase of New World Fossil to position us for future success in digital channels as well as delivering margin and cost savings similar to the first phase. We expect to improve our digital capabilities, not only for marketing and e-commerce, but also for additional consumer insights and advanced analytics.

In closing, we are making progress, but we still have significant work to do on our transformation initiatives to address the fundamental changes that are ongoing in the marketplace. Importantly, we are seeing encouraging signs and our current focus on near-term profitability has provided stability in the challenging environment. This affords us the opportunity to develop and execute initiatives that will ultimately deliver strong and sustainable growth for our business.

In the near term, we are extremely focused on delivering improved profitability. We have continued to forecast our top line conservatively to put pressure on the things that we have more control over, our gross margin structure and our expenses that we are planning prudently. We will continue to be very active in the marketplace 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 function and driving speed and efficiency throughout the company, while investing in our e-commerce and digital marketing capabilities.

As we said on our last call, our longer-term view is that after top line contraction in 2018, our initiatives should begin to stabilize sales levels in 2019, with sales growth returning in 2020 and continuing to grow annually thereafter. 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 for additional color on our financial performance.

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

Thanks, Kosta, and good afternoon, everyone. Turning to our financial results. Our reported net sales for the first quarter decreased 2% to $569 million, while first quarter constant currency net sales decreased 7%. Overall, sales exceeded expectations, driven by stronger performances in our direct channel.

And while our wholesale business continues to contract in the low double digits, our off-price sales in the wholesale channel were modestly higher than expected as we continue to focus on improving our inventory position.

Store closures negatively impacted total direct channel sales by over 200 basis points. We have closed 81 stores since the first quarter of last year and ended the quarter with 512 stories, which was slightly higher than originally contemplated when we provided our Q1 outlook in February. Excluding store closures, our direct channel posted a 5% gain with flat store comps and solid increases in our online business, driven by growth in connected sales.

Our reported loss of $0.99 per share included $0.35 of New World Fossil restructuring charges. Excluding these items, our adjusted EPS loss was $0.64. Last year, our first quarter EPS loss was $1 and included $0.35 impact from restructuring charges. EPS was relatively flat this year compared to last year, despite the lower sales volume as we continue to deliver on our New World Fossil initiatives with improved gross margins and lower operating expenses.

These operational improvements were offset by higher interest expense and an unfavorable effective tax rate due to valuation allowances and negative impacts from the December tax legislation. Currencies, including both the translation impact on operating earnings and the impact of foreign currency hedging contracts, favorably affected the EPS comparison in the first quarter by $0.02.

Our watch business declined 6% in constant currency for the quarter. Sales in our traditional watch business, while still challenging, performed within our overall expectations with higher volumes of off-price sales. Sell-through trends of our traditional watches remained fairly stable in the Americas, while in Europe, we experienced some signs of softening sell-through performance at certain wholesale partners, mainly driven by consumer shopping pattern shifting towards online channels.

We continue to grow our connected watch business, delivering $80 million in sales for the quarter, 97% higher when compared to the first quarter of last year. We're continuing to see strong sell-throughs in all regions, especially in our own stores where we better control the customer experience.

Total Fossil brand sales declined 2% in constant dollars compared to last year, which is consistent with our Q4 sales performance. The decline in Fossil brand was driven by weakness in our leathers and jewelry categories. Leathers declined overall due to continued wholesale channel softness, but performed better in our e-comm and store channels with improved assortments.

Fossil brand watch sales increased in the quarter, up 4% in constant dollars with smartwatches, both display and hybrid, positively impacting the category growth rate by 16 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 increased 5%, building on our Q4 positive comp despite ongoing retail traffic declines. Our watch performance for these businesses, both online and in our stores, was encouraging with comps up 8%, further demonstrating the impact that wearables is having on the category.

Our direct e-commerce sales, which are included in comp sales, increased almost 50% for the quarter. We're also continuing to see some stabilization in the trajectory for Michael Kors, where watch sales declines slowed to 4% for the quarter, with smartwatches positively impacting the rate by 7 percentage points.

In the Americas, first quarter sales decreased 11% on a constant currency basis to $249 million with declines in all 3 product categories, driven primarily by softness in the wholesale channel. Watches declined at a slightly better rate than the overall Americas region as continued softness in traditional watches were 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 5%, driven by connected performance across all channels.

Most other brands posted sales declines in the quarter. Our Americas wholesale business sell-in and sell-outs remained down double digits in the first quarter. Note that a third of the sell-in decline is due to our Burberry and Adidas termination and our reposition of the Kors jewelry business. Partially mitigating this wholesale performance, off-price sales were up and stronger than expected.

Our retail business in the Americas was significantly stronger than wholesale, posting growth for the quarter and exceeding expectations as some store closures are shifting into later quarters. Strong e-comm and positive high single-digit store comps more than offset the negative impacts on sales from closing unproductive stores.

In Europe, reported sales increased 3% to $202 million, while on a constant dollar basis, sales declined 8%. Sales declined across all product categories in our more significant channels, particularly wholesale.

Similar to our Americas region, our Europe wholesale business is also affected by the Burberry and Adidas license terminations in Kors jewelry repositioning as well as our decision to exit our Europe wholesale leather business.

In addition, we see wholesale customers in certain European countries experience declines in traditional watch sell-throughs as the European customer increases their adoption of online channels. Our e-comm growth was stronger in the quarter, and our outlet comps have delivered moderate positive comps, while our full price concepts with higher conversion cannot overcome store traffic declines.

Fossil watch sales in Europe were modestly negative due to declines in traditional watch sales that were not entirely offset by the growth in connected sales. Connected sales positively impacted the category growth rate by 15 points.

Within our watch portfolio, Michael Kors, Emporio Armani, Armani Exchange and Diesel were relatively flat, while Skagen declined. As I mentioned previously, the exit of Burberry and adidas licenses are also negatively impacting sales comparisons to last year in Europe. Across the Eurozone, sales were down in most major markets, including France and U.K.

In Asia, we reported growth of 9% on $118 million of sales. And on a constant currency basis, sales increased 3%. Positive performance across all channels were driven by strong Chinese New Year results, effective celebrity marketing campaigns and enhanced outlet promotions, combined with improved stock availability of best sellers and early shipments of new product offerings. Our Fossil brand increase in Asia, driven by almost 20% growth in watches, partially offset by a decline in men's leathers.

And Emporio Armani, our second largest brand in Asia, posted even stronger growth, driven by both traditional and connected watches. Most other brands were flat to slightly down in sales dollars for the quarter.

Strong growth momentum continued in India and China, primarily driven by e-comm. Hong Kong and Malaysia posted positive results with improving trends in most other markets though Japan and our distributor markets continue to be our most challenging during the quarter.

Gross profit was about flat with last year at $288 million and gross margin increased 70 basis points to 50.5%. Favorable currency impacts, combined with the benefits for our New World Fossil initiatives and lower markdown levels, totaled about 300 basis points, but were offset by unfavorable factory cost absorption on lower sales volumes, increases in sales mix towards connected products and higher volumes of off-price sales as we remain focused on rightsizing our inventory position.

First quarter operating expenses were $316 million on a reported basis, 6% or $19 million lower than the first quarter of last year. Excluding the impacts of currency, operating expenses decreased $33 million or 10% as compared to last year. Expenses included $21 million in restructuring charges, while 2017 first quarter expenses included $26 million in restructuring costs.

The lower expenses in the first 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 first quarter operating loss was $28 million, an improvement of $17 million compared to a year ago. First quarter other expense of $2 million was unfavorable to last year, mainly due to net foreign currency contract losses compared to net gains recognized in the first quarter of last year.

Interest expense increased $2 million to $11 million, primarily due to higher interest rates on our amended credit facility. Income tax expenses were approximately $7 million in the first quarter on pretax losses of $41 million, resulting in a negative 16% effective tax rate compared to a positive 2.5% rate in the first quarter of last year.

The first quarter negative effective tax rate was driven mainly by 2 items. One, the recognition of deferred tax asset valuation allowances; and two, an unfavorable impact from the GILTI provision of the Tax Cuts and Jobs Act that was signed into law this past December.

First, the valuation allowance impact. 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. As Kosta highlighted, we are focused on our transformation initiatives to address the continued changes and challenges in our markets and deliver improved profitability.

As we generate taxable income, in the future, these deferred tax assets are expected to be realized. However, due to continuing losses in the near term in the U.S. and certain international subsidiaries, we are required to record valuation allowances on deferred tax assets related to these losses, thereby, increasing our effective tax rate.

Regarding GILTI. Though we don't expect to incur payments under this provision, it appears that 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. We are continuing to monitor regulatory guidance and interpretations of the new legislation and are evaluating certain tax elections and operational strategies to mitigate this adverse GILTI impact on our overall tax rate. 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 approximately $6 million. We also recorded tax expense for discrete items during the first quarter, mostly due to a $3 million adjustment in the onetime repatriation tax estimate required for the December tax legislation.

As we previously reported, accounting for income tax effects of the repatriation tax requires significant judgments and estimates in the interpretation and calculations of its provisions. Although we made reasonable estimates and recorded provisional amounts in our 2017 financial statements, as required under accounting rules, we expect to make additional changes to the estimates during the year as we refine our tax calculations and implement future expected guidance and regulations from the Department of Treasury and the IRS.

We improved our net debt position by $63 million compared to a year ago. We ended the quarter with $230 million of cash compared to $320 million last year, and debt of $463 million compared to $616 million a year ago.

During the quarter, we invested $4 million in CapEx and had additional net borrowings of $22 million. Our adjusted EBITDA for the quarter was $19 million, a slight increase compared to last year, resulting in trailing 12-month adjusted EBITDA of $204 million. Our first quarter leverage ratio was 2.3x, well within our 4.5x bank leverage ratio covenant limits.

Comparable inventory levels at the end of the quarter were down 2% 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 5% to roughly $234 million and wholesale DSOs were relatively flat. Depreciation and amortization expense totaled $16 million for the quarter.

Now let's move to our 2018 outlook. As we outlined in our February call and Kosta mentioned earlier, we're focused on 4 key objectives that drive our strategies and initiatives for 2018. One, improving our overall profitability; two, innovating our product offering; three, expanding e-commerce and digital marketing; and four, transforming our business model.

Q1 was an important first step on this journey where our smaller, but more profitable focus was demonstrated as we delivered improved operating margins on a lower sales base. Looking ahead to the balance of 2018, we remain focused on our key strategies as we pursue our consumers through innovation and unique experiences, which coupled with transforming our business model, will ultimately drive improved profitability.

During the first quarter, we had some encouraging trends emerge. Our retail comps, which includes stores and e-commerce, were up 5% globally. This performance demonstrates to us the strength of our core watch and wearables business when we get our assortment, marketing and store presentation and associate training all working in a consistent and synergistic matter. In addition to our strong performance in our direct channel, several of our own and licensed brands demonstrated continuing growth. While we exceeded our plans for the first quarter, had a number of improving trends, and we're excited about the innovation we have in the pipeline, the overall environment within our traditional channels and categories remains challenging. Our direct business has been stronger over the last several quarters, but we know that most important quarters for 2018 are still to come.

Given these factors, we continue to plan our traditional business prudently. The higher end of our guidance assumes 2017 and Q1 2018 traditional category trends continue through the balance of 2018, while the lower end of guidance assumes further disruption for traditional categories, particularly within the wholesale channel.

Wearables performance in Q1 demonstrated once again the significant opportunity we have in this category. The wearables market continues to grow rapidly, and we expect the innovation and design we're bringing into the market will continue to drive top line growth. We have a number of exciting technology innovations in the pipeline and look forward to sharing those with you as products reach their launch dates.

As we move through 2018, while wearables will continue to deliver growth, we do expect wearables growth rates to moderate somewhat, given the successful sell-in we delivered in the back half of 2017. In addition to these business drivers, Q1's reported sales benefited by over 500 basis points due to currency rate favorability. Our guidance is based on roughly prevailing rates with the euro and British pound, 2 of the currencies most impactful to our results, at approximately $1.20 and $1.35, respectfully (sic) [respectively].

Based on these FX rates embedded in our guidance, currency will continue to be a tailwind throughout 2018, though the magnitude of that benefit will diminish as we move through the year. Given these factors, we're narrowing our full year sales range to reflect our Q1 results, and we now expect full year sales to range from minus 5% to minus 12%. For the second quarter, we expect sales to range from minus 4% to minus 11%.

Though we currently expect sales to contract in the near term, we'll continue to operate aggressively with our entire organization focused on driving consumer excitement with our products and leveraging our strategic advantages to drive profitability.

As a reminder, these sales estimates are inclusive of the negative impact of store closures, business exits and licensing termination discussed during our February earnings call, which we estimate to be approximately 500 basis points for the full year. The impact of these changes in our business was approximately 400 basis points in the first quarter and will expand as we move into the second and third quarters.

We are maintaining our full year gross margin expectations of 51% to 53%. Our guidance implies approximately 200 to 400 basis points of gross margin expansion from 2017, driven by our New World Fossil initiatives, improved connected margins and the positive impact from a weaker U.S. dollar.

Our design to value focus within New World Fossil continues to deliver material improvements to our margins, and we're challenging our team to continue to accelerate any opportunities to further improve our margins. We expect Q2 gross margins to range from 51.5% to 53.5%. We expect operating expenses for the year to range from 48.5% to 50.5% of sales, including an expected $55 million of restructuring charges related to our New World Fossil initiatives. For the second quarter, we expect operating expenses to range from 55.5% to 58%, including $18 million of restructuring charges.

Therefore for the full year, we expect operating income margin in the range of 0.5% to 4.5%. And for the second quarter, we expect operating income margin in the range of negative 6.5% to negative 2.0%.

We're also maintaining our net interest expense guidance of $50 million for the full year with Q2 interest expense of approximately $13 million. Other income and expense, which is primarily related to hedge contract gains and losses, was a benefit in 2017. Looking at the balance of 2018, based on the foreign exchange rate used in our guidance assumptions, other income would turn to a negative or expense in 2018, 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 approximately $10 million for the year and is expected to be roughly consistent across quarters.

As I discussed earlier, given the increased clarity of the impact of tax reform, based on the profile of our geographical earnings including the tax laws in U.S. companies, we now expect tax expense to range from $30 million to $40 million for the year and $6 million to $8 million for the second quarter.

We're planning diluted share count at approximately 49 million shares. For 2018, we expect adjusted EBITDA in the range of $175 million to $225 million, and we're planning to invest approximately $25 million in capital expenditures.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our first question comes from Omar Saad from Evercore ISI.

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

Good progress on your plan. You know with wearables really starting to become a much more significant part of the mix, it feels like -- it sounds like you guys are much more confident in the trajectory in that category and your position in the category. Is that a fair characterization? And then as a follow on to that, if you look at the current offering, the offering you've had over the holiday and you have now in the wearables, what are some of the opportunities to improve that offering? What are some of the feedbacks from your consumers? What they like about it? What they don't like about it? And anything you can give us on that front from the product perspective, that would be helpful.

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

Thanks, Omar. As you can see, we're getting good traction on wearables overall. Our first quarter sell-throughs are pretty good. We seem to be getting somewhat of a viral impact where the more people wear them, the more they tell their friends about them and we're seeing pretty good sell-throughs on that. So from our perspective, we've got some great new products coming the back half of the year. A lot of it is more health and wellness oriented. Great new technology, new software, the products getting better and better. So we think we're in a good position for that. In addition to that, our situation with traditional watches, we saw sequential improvement in sell-through during the first quarter that is kind of compelling to us. And you also have noticed that the Swiss watch business is getting better. So there could be some incidental activity going on in just the interest in overall watches. In our experience, when the upper end of the business gets good, we have a follow-on effect from that. And watches, just like any other cyclical business, is not good until it is. And we're putting a lot of innovation and differentiation into the marketplace as much as possible, telling new stories. So now we're in a position with both traditional watches with ramping up our innovation and differentiation. And also with wearables, we're bringing new products to market. Our addressable market is actually much larger, and wearables last year was an $18 billion business growing to $33 billion in 3 years. So we're in a position with the 2, wearables and traditional watches, a great global distribution platform, including our own digital plus increasing e-comm and digital capabilities. In addition to that, we have CE distribution globally. So we feel like we're in a pretty good place to follow the customer wherever they go, whether it's traditional or wearables, and we're in a good position.

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

I'll just add, I think there's 3 takeaways on wearables, specifically. The first is as we mentioned in Q4, the wearables business model has taken us a lot of heavy lifting over the last 2 years now in place and scaling. So it's dramatic improvement in product. The advantage supply chain we implemented largely last year is now unlocking substantially lower cost of goods sold and increasing margins. And then our teams are just executing really, really well across the business. So that's first takeaway. Second is we are delivering yet again another significant step-up in product and innovation. As Kosta mentioned, this year, the most dramatic improvement is going to be on fitness and health and wellness features that will be -- we had a couple of SKUs last year in Q4. We'll be very broad now in implementation of those across our products suite, which will bring us to parity in -- against the market leaders in the wearables space. It also allows us to tap into a whole another set of consumers that without those features, we have not been able to reach successfully. And then the third, which is very recent news, is both Google and Qualcomm are significantly stepping up their investment volume and category in the support of the ecosystem. Google, in particular, launched rebranded from Android Wear to Wear OS by Google, which is giving us 2 things. It's a significant improvement in investment in the software experience, particularly on an iPhone. But also rebranding, so that using the Google name instead of Android, which is a much better brand association for the iPhone user. And then Qualcomm today also announced the next-generation chipset. I can't speak to too many specifics around it, but it's going to be a significant step-up also in product and user experience and battery life and other features.

Operator

And the next question comes from Ed Yruma from KeyBanc Capital Markets.

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

Just to follow up on Omar's question. I know that you guys have dramatically changed the launch cadence this year. I guess, when will we expect to see products that will ship for the third and fourth quarter? And in terms of thinking about your factory capacity and your ability to meet some of those demands, I guess relative to last year, how would you score kind of your factory availability or your ability to flex kind of close-in demand?

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

Yes, so timing will be about a month earlier than last year. So think, see it in broad scale across our formats and channels in August with some early limited edition launches a couple of weeks earlier than that. Staying sort of annual significant technology upgrade around that fall time line is the key there. That should be on an ongoing basis, the cadence that you see. And then we'll be adding brands this year as well, so you'll see more breadth of our offering to go along with that launch timing. In terms of capacity, we are, I think going to be in a much better position this year even in better managing supply and demand and then -- at launch. And then also have plenty of capacity to flex up and respond to the demand in the back half of the year if we see an even better-than-expected result. Now that we're 2 to 3 years in on the supply chain side, I think we'll just continue to do better.

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

Great. And one follow-up, if I may. I know that the hybrid is clearly a competitive advantage for you guys, but maybe a little tougher for the consumer to understand versus the display screen watch. I guess kind of what progress have you made in educating the consumer on hybrid and how should we think about that longer-term opportunity?

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

Well, as we said before in our own environment, in our own stores and e-comm, we continue to see hybrid is doing well and increasing as a percentage of the total, so we know that the product -- consumers love it. And then we also see some viral impact of more people wear it and more people want to know about it, and then we sell more. So we do have a number of initiatives in place where over the next several months and years, we want to expand this with new products and ideas, more compelling ways of communicating it. One good thing is that over 50% of our wearables sales are actually online, so it opens us up to being able to communicate with videos and other things. So we do think that long term is -- it's very a significant opportunity that could transform the entire watch business, and that's one of the things that we're putting initiatives in place to really make sure that we're making progress towards that goal.

Operator

And the next question comes from Anna Andreeva from Oppenheimer.

Anna A. Andreeva ***Oppenheimer & Co. Inc., Research Division - Executive Director and Senior Analyst***

Two quick ones. First on SG&A, I think came in a little lower than your guidance. Any timing shift we should be aware of? And what's driving, I guess, the big step-up in the second quarter? And as a follow-up, you mentioned off-price sales were a bit higher during the quarter versus plan. How should we think about off-price penetration as we go through the year? And should off price channel be normalized when you guys think about sales stabilization in '19?

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

On the sales side first on the off-price, it's still [off] price in terms of our total enterprise sales is under 10%. It had good growth in that channel overall for us, but it wasn't overly strong. I think you'll see that continue. It continues to be a good liquidation channel for us, a good sales channel. So we'll continue to have that in 2018 from a plan standpoint, probably a little too soon to say about 2019. Haven't really gotten to what that plan looks like on '19. From an SG&A perspective, we did have good performance in the first quarter on controlling cost, proven true where we thought would be at. We continue to have good benefits from our New World Fossil initiative, both on the margin side as well as on the cost side. That will continue as we go into the second through fourth quarters at roughly the same rate overall. So really no fundamental changes. Really getting the same kind of leverage that we saw in the first quarter through the rest of the year because of our cost savings initiatives, both from New World Fossil and just general belt tightening.

Operator

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

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

So I'll focus on the wearable categories as well. Jeff, in the back half of last year, I think you took some inventory reserves on some slow-moving inventory that, I think, you expected to sell earlier this fiscal year. Can you maybe just help us understand how much of the wearable revenue growth in Q1 was driven by liquidating this carryover inventory versus what the go-forward wearable category growth rate was? And then I think on the last call, I think that you talked about a 20% to 25% wearable growth rate for this year. Is that still the plan? Or is that -- is there any change to that outlook? Or how should we think about the growth rates for the year?

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

I'd tell you the growth rate probably trending a little bit more towards the top end of that range. We had 20 -- we said 20 to 25 and we're probably about in the middle, but we'll probably trend a little bit more towards the top end of the range from a growth [view] overall. From a liquidation standpoint, we are moving through that. I will tell you in the first quarter, we didn't have a substantial amount. We had -- we continue to move through at a pretty good price point overall on it. We're really going to go through more of the liquidation phase as we get into the second quarter and really the third quarter is really our big liquidation. If you think about it, our volume picks up significantly and we're trying to manage the margin realization on that product. We could have moved through more of it through some channels but we took the opportunity to move through it at a more modest pace as we went throughout the first quarter. And so we'll continue to sell through it in the second and third quarter. So I wouldn't say it's an overly measurable number in Q1 that really drove the wearables number. That's really the underlying base business doing well.

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

Okay. And you feel comfortable with the inventory? You don't think there's any other -- any more reserves that need to be taken on that inventory?

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

No, we feel very comfortable with the reserve we took last year.

Operator

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

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

As you think about the wearables business and the margin on wearables and given that you're distinguishing whether it's a sports watch category, whichever type, is there a difference in the margin profile? And where do you expect the business to go in terms of percentage of sales on wearables?

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

I think we're on record of saying that we think the smartwatch display category at a sustainable level should be 45% plus gross margins. I don't think we've given guidance this year on where we're going to be. And then hybrids should be over time more like a traditional watch margin. So that's the way to think directionally where we're headed. We feel like we've got line of sight to that, and I think are executing pretty well.

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

And then as you think about the percentage of the business becoming wearables over time, how do you see that?

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

Well, we're going to find out. We're in a position now with great capabilities for both traditional and wearables. It's interesting that there's significant demand out there for wearables. The business is growing extremely quickly. It's an aspirational female customer largely, which is our customer. They're very interested in the whole idea of connectivity and new innovation. So the potential is very significant. We have something like a 5% or 6% share globally of the watch business. If we get that above what's expected to be in wearables of $33 billion business in 3 years, it could be a very significant business for us. So we'll play it out, and we'll see what happens. We're in a position where we're going to do as much as we can with innovation, design and execution on both the traditional and wearables. We've got great new product ideas coming out, and we'll follow the customer wherever they take us.

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

Dana, your mix question, it's always a little bit difficult to forecast because it relies on your forecasting, not only in the growth in wearables, but also what happens in traditional watches on it. You can tell in the past 2 or 3 years, we've grown to almost 20% of our mix is wearables product on it. So if you think about that, that's 5% to 10% mix growth or shift over the past 3 years. So just extrapolating that, you can do it about as well as we can. It's probably a similar amount of mix shift between 5% and 10% over the next 3 years. So you go from 20% to 25%, 30% to 30%, 35%. So it's going to kind of build and grow. It'll be a 1/3 of our business. It's going to maybe 40% of our business. The tough call is going to be exactly when. When will you get to those higher penetration points.

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

And I would just add too, our mission here is to get to a net growth business in watches in total, which is traditional and wearables. And that the margin profile in wearables, even for display although lower on a percent basis, is a much higher average unit retail. So your gross margin dollars per unit are actually equal to or higher than traditional watch here in the not-to-distant future. So we're not as concerned about a unit shift.

Operator

I will now turn the call back over to management for final remarks.

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

Okay. I want to thank everybody for joining us today. We look forward to speaking with you when we report our Q2 results in August. Thanks, again.

Operator

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