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PRESENTATION

Operator

Good day and welcome to the Fossil Group Q2 2016 earnings conference call. Today's call is being recorded. At this time, I'd like to turn the conference over to Eric Cerny, Investor Relations. Please go ahead, sir.

Eric Cerny ***Fossil Group, Inc. - IR***

Thank you. Good afternoon, everyone. Thank you for joining us and welcome to Fossil Group's second quarter 2016 earnings conference call.

I'd like to remind you that 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 10-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 may listen to a live webcast or replay of this call by visiting 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 Kartsotis ***Fossil Group, Inc. - Chairman & CEO***

Thank you, Eric, and good afternoon, everyone. I will begin with a few prepared remarks, before turning the call over to Dennis Secor, our Chief Financial Officer. Following his prepared remarks, Greg McKelvey, our Chief Strategy and Digital Officer, will join us for the Q&A.

Our financial results for the quarter, while below last year, were very much in line with our expectations from both the top and bottom line perspective. We're pleased that our sales trends, though still challenging, remain relatively stable, considering the disruptive environment. In fact, despite an overall decline in sales, there are several areas of the business that performed well, though they are being masked by continued weakness in the traditional Watch category, particularly among the licensed brands. We believe those areas of the business performing well are solid indicators that we are on the right track, have the right long-term strategy in place, and their performance reinforces our commitment to investing in these strategies to drive future growth.

Fossil and Skagen both grew during the quarter. Our Leathers assortment, particularly in women's handbags, continued to drive positive results. And even though it is a small portion of our overall business, our wearables product continues to resonate with customers and is driving growth. On that front, we are well on our way to launching connected accessories across more of the brands in our portfolio and are on track to deliver this product in the third quarter.

With the quarter playing out much like we expected, our team is continuing to work diligently on our key strategic growth priorities. First, a continued commitment to invest in Fossil and Skagen to fully exploit the full potential of these brands. Second, investing in digital and our omni channel capabilities to meet the customer wherever they shop. And third, driving future growth through wearable technology. And finally, while driving growth is critical to our success, we are also intently focused on managing our resources and investments tightly to improve the profitability of our core business.

With several quarters of tangible evidence that our investments in these strategic priorities are working and proving beneficial to the business, we will continue to direct our resources to the areas of greatest opportunity and redirect resources away from softer areas of the business. As we always do, we will continue to evaluate our infrastructure and investment needs, ensuring an efficient organizational structure and one that is well equipped to compete in the current retail environment, with ample resources to support our future growth initiatives. It's our ability to remain nimble and redeploy our resources that enable us to properly invest in these growth initiatives, providing the fuel to drive future growth.

Let's briefly expand on these priorities before Dennis reviews our quarter performance. First, investing in and growing Fossil and Skagen. As I mentioned, during the quarter we drove growth in both Fossil and Skagen. Given our investments in strategic marketing and brand building, we are encouraged by their growth, particularly in today's challenging retail environment. We will continue to invest in our own brands and are pleased with the progress we made during the quarter.

With 7% constant currency growth in Skagen, led by a solid performance in watches, we continue to believe this brand will be a driver of growth in the future and is a great complement to our Fossil brand. The international appeal of the brand is validated by continued growth in our international markets during the quarter. Fossil grew 2% during the quarter, delivering growth in both Asia and Europe, with a strong leathers business and growth in watches driving the results.

Continued strength in our women's handbags is also very encouraging, particularly on the heels of a strong first quarter performance. The product is resonating with consumers and we will continuously work to improve the assortment, adding new designs and features.

Our CRM initiatives are driving customer engagement, and we're delivering a unique store experience that starts with our associates and is further enhanced with our ability to personalize products. This is creating a deeper emotional connection to the brand, and we're receiving great feedback from our customers.

Second, leading in digital through e-commerce and expanding our omni channel capabilities. The investments we are making in our omni channel roadmap continue to benefit the business and drove another quarter of strong double digit growth in the e-commerce channel, a trend that goes back to last year. With consumers' shopping patterns continuing to evolve, as reflected in weaker wholesale channel trends recently, it is important that our digital capabilities and omni channel platform are best in class.

This initiative has been a priority for us over the last couple of years, and our ability to carefully manage our resources and infrastructure has enabled us to relaunch our branded websites, invest in our CRM initiatives, and expand our omni channel capabilities, all of which further enhance our customer's interaction with our brands.

And third, driving growth with the launch of connected accessories. Technology continues to be the top of mind for consumers and is currently the most exciting form of innovation in the Watch space. Consumers are driving the trend and seeking out incremental functionality in their accessories. We continue to believe our ability to provide that functionality in great looking accessories across desirable lifestyle brands that consumers identify with is clearly a strategic advantage for us. We are uniquely positioned to lead the convergence of style and technology, given our design, production and global distribution capabilities, and are on track to bring this category to our licensed brands later this year.

We are excited about the launch of connected devices in eight of our brands, six of which will be new to the category, later this year, and we're getting behind these launches with solid marketing support. Our brands are preparing their product launches and are very excited to be participating in the space, given the high demand from customers. Our wholesale partners are equally as excited to have the product in their stores later this year to provide their customers with the latest innovation in watches and accessories.

And finally, we're working on improving the profitability of our traditional watch business. While the traditional watch category remains under pressure, there continue to be long-term opportunities for us to gain share, especially in international markets, where our share remains relatively low and where we believe the demographics skew in our favor.

Maintaining our advantage to attract the best fashion brands is integral to our success and we are pleased with the success that we are seeing with some of the newer brands in the portfolio. Both Tory Burch and Kate Spade New York drove growth and performed well during the quarter, despite being a smaller portion of the overall portfolio at the moment. Both of these brands are now fully benefiting from our competitive and strategic advantages of design, product development and global distribution, and we are excited about expanding the potential for both of these premium brands. We continue to believe that we can drive growth with brand building and innovation through design, fashion, new materials and ultimately, introducing new technology and functionality into our accessories.

Our team continues to focus on both controlling our expenses and redeploying resources to support our most compelling opportunities. Our goal this year is to drive more than a 20% increase in investments supporting our strategic initiatives, Fossil and Skagen, omni channel, and wearables, while at the same time significantly cutting infrastructure and other spending to hold our overall spending flat for the year. Improving our financial performance is a priority for our team, and we're continuously looking at multiple levers to create value.

As we look to the remainder of the year, not much has changed regarding our outlook or our strategy for the business since we last spoke in May. Our focus remains on the long term and executing against our strategic priorities. We believe these priorities support our overarching goal of delivering long-term sustainable growth and improving profitability to drive value for our shareholders. We anticipate that the traditional watch category will remain challenged in the near term. It has proven to be the case so far this year and will likely persist until newness and technology can potentially change the trajectory of the category.

We also expect the challenging retail environment to persist. Weaker performance in our wholesale channel, particularly in the US, where the business is most challenged, is likely to continue; however, we believe innovative product launching later in the year can begin to re-energize the channel.

We will continue to drive innovation with new designs and styles for our licensed brand partners. We anticipate that our portfolio of licensed brands will continue to evolve over time, as well. As we near the end of our contract with Adidas, we are not planning for that relationship to continue beyond the existing 2017 agreement. Instead, we will redirect those resources to other brands in the portfolio, areas that generate higher returns and, as we always do, continue to evaluate the opportunity to bring additional brands into the portfolio.

For all of the brands in our portfolio, innovation is central to driving their growth, and we will continue to focus on that. Technology innovation and new functionality is on the way. The solid performance of our own Fossil Q assortment is a strong leading indicator that our lifestyle brand-oriented customer eagerly awaits the launch of connected accessories across our licensed brands.

While our business is more challenging at the moment than it has been historically, we continue to believe that our competitive and strategic advantages of creativity, scale, and our portfolio brands, combined with our technology platform, put us in position to disrupt the watch market as the line blurs between traditional watches and connected accessories.

We are moving very quickly as a company to position ourselves for long-term sustainable growth in this rapidly changing market. We look forward to updating you on our progress in the category in November, when we will have delivered a lot of exciting new products into the market. And now I'd like to turn the call over to Dennis for more detail.

Dennis Secor ***Fossil Group, Inc. - CFO***

Thank you, Kosta, and good afternoon, everyone. Our second quarter performance was generally in line with our overall expectations, as we delivered on both our sales and earnings goals. Given the continued pressures facing the traditional watch category, we relied slightly more on promotions and off-price channels to achieve our sales plans, yielding a slightly lower gross margin; however, we managed to offset some of that with cost reductions and deferrals.

Overall, second quarter reported net sales decreased 7%, to $685 million, and on a constant currency basis declined 6%. Constant dollar sales declined in the Americas and Europe, while Asia was flat. Fossil and Skagen continued to show strength, with each brand increasing during the quarter, driven by growth in Europe and Asia. In constant currency, Fossil increased 2%, while Skagen grew 7%. Each brand delivered solid growth, particularly since we were anniversarying a strong second quarter in 2015, where Fossil increased 6% and Skagen grew 21%.

For the quarter, diluted earnings per share were $0.12. This compares to $1.12 in last year's second quarter. The decline from last year was largely driven by lower sales, given the pressures facing the traditional watch category.

In addition to the ongoing currency headwinds affecting our gross margins, our margins were lower, given outlet promotions to drive sales, and we also shipped more through our off-price channels as we manage our inventory levels. Non-operating gains were also much lower this year, given a relatively more stable, though still challenging, currency environment and last year's large interest rate hedge gain.

From a sales perspective, Fossil grew 2% compared to last year in constant dollars. Similar to the first quarter, our Leathers category, particularly women's handbags, drove the increase in the brand. Our Fossil watch business also grew slightly, while jewelry declined. Sales growth in Europe and Asia was partially offset by a slight decline in the Americas.

Globally, our full-price retail stores delivered positive comps, with Fossil Q continuing to sell well and drive traffic to our stores, and our women's handbags also performed very well. Our outlet stores remained more challenging, as traffic declines are pressuring the business and our promotions have not been able to offset the traffic headwind. Across all of our retail stores, overall comps declined 3% in the second quarter.

Skagen sales grew 7% in constant dollars, with growth across all three categories, led by watches, as well as growth in Europe and Asia partially offset by a decline in the Americas. In constant dollars, our multi-brand watch portfolio declined 9% compared to last year, with one brand driving the vast majority of this decline. Our wholesale channel continue to be the most challenged, as the traditional watch category feels pressure from technology-enabled products and an overall weaker demand for traditional watches. We continued to benefit from newer brands, such as Kate Spade New York and Tory Burch; however, the majority of the brands in the portfolio declined compared to last year.

In the Americas, second quarter reported sales decreased 11%, to $345 million, a 10% constant dollar decrease. Traditional watches drove the overall decline. Across brands, both Kate Spade New York and Tory Burch delivered solid increases during the quarter that were offset by declines in nearly all of the other brands in the portfolio.

Within the regions, our full price stores performed relatively well, driven by strong performance in women's handbags and wearables. Modest growth in Canada was offset by a decline in the United States. As US department stores business continues to appear soft, the wholesale channel proved to be the largest driver of our decline during the quarter, though sales trends were relatively stable and generally consistent with our first quarter trend.

In Europe, reported sales decreased 5%, to $216 million, with minimal impact from currencies. A decline in watches and jewelry was partially offset by an increase in leathers. Within the region, growth in Fossil and Skagen was offset by a decline in nearly all of the brands in the licensed portfolio. Modest growth in France and Germany was offset by declines in the UK, the Middle East and Russia, and we did experience a modest decline in sell-throughs in some markets. The retail channel delivered another quarter of growth, including positive comps in our full-price stores, despite a slight decline in the overall comp store performance for the region.

In Asia, reported sales decreased 1%, to $124 million, while constant dollar sales were flat. A decline in watches was offset by growth in leathers and jewelry. Growth in India, Malaysia, Singapore, Australia and China was offset by declines in Japan, Macau and Hong Kong.

Growth in Fossil and Skagen was offset by declines in nearly all of the brands in the portfolio. Comp stores sales increased in the region in both our full-price and outlet stores.

In the quarter, gross profit decreased to $356 million and gross margin declined 340 basis points to 51.9%, with 90 basis points related to changes in currencies. Our gross margin rate was lower than we expected coming into the quarter, as we increased promotional activity to drive our outlet business and we leveraged our off-price partners to manage our inventory levels.

Second quarter operating expenses were in line with last year, at $340 million. A reduction in store expenses and the impact of last year's restructuring charge were offset by an increase in expenses associated with wearables, which includes $6 million in Misfit purchase accounting costs and an increase in strategic omni channel investments. Our second quarter reported operating expense rate was 49.7%, compared to 45.8%.

Operating income decreased to $16 million, including an $8 million unfavorable currency impact, and operating margin decreased to 2.3%, including a 110 -basis point headwind from currencies.

Second quarter other income decreased $12 million to $3 million, due to lower gains on foreign currency contracts compared to the prior year and the settlement of an interest rate hedge that benefited the prior year.

Our effective income tax rate for the quarter was 30.2%, compared to last year's 28.7%.

Second quarter net income decreased to $6 million, due to lower operating income given the decline in sales and gross margin, as well as a reduction in other income due to the prior year benefit from hedging activity and an interest rate hedge settlement.

Now turning to our cash flows and balance sheet, for the quarter we generated operating cash flow of $37 million and reduced borrowings on our revolver by $88 million. We invested $20 million in CapEx and $1 million in our share repurchase program. We ended the quarter with roughly $232 million in cash, compared to $250 million last year, and debt of $735 million, compared to $691 million a year ago.

We ended the quarter with inventory of $661 million, down 1% from last year. Accounts receivable increased by 1% to $257 million, and wholesale DSOs increased 5 days compared to the prior year, mainly driven by later sales in the quarter this year. Depreciation and amortization expense totaled $25 million for the second quarter.

We also announced this morning that we have amended our existing credit agreement. The amendment extends through May, 2018 and provides an increase in our allowable leverage ratio, which gives us additional liquidity and increased debt capacity, ultimately providing greater operational flexibility. Among other things, based on this amendment, we will not be re-engaging our share repurchase program during the term of the updated agreement.

Let's move now to an update of our outlook for the year and share some of the key elements of our second half operating plans and how those plans will impact our financial results. First, our full-year outlook, where relatively little has changed since May, given our Q2 that aligned with expectation. While the traditional watch category remained soft, sales trends were relatively stable. We did rely slightly more on promotions and off-price channels to achieve our sales plans, yielding a slightly lower gross margin than we expected. We were able to offset some of that with cost reductions and deferrals. Overall, that resulted in sales performance at the top of our guidance range, while EPS did not quite reach the top.

As we think about our traditional watch business for the balance of this year, we've updated our outlook to assume that the second quarter traditional watch dynamics continue for the balance of the year. Our team is still focused on delivering the upper end of our sales guidance, which assumes no further significant trending erosion, though we expect that it will require modest additional investments in margin to achieve those same sales. We've also identified further expense reductions for the balance of the year.

With respect to wearables, we remain very encouraged by Fossil Q's performance, though our wearables rollout thus far has been relatively small. We still plan to release over 100 new wearable SKUs across a total of eight brands by the end of this year. We and our license partners are very excited about these amazing new products, and we're devoting significant marketing investments to support their launches.

These are generally the operational assumptions that support the upper end of our guidance. For the balance of the year, we see three principal earnings risks, though obviously there are others that could materialize. First is a further softening of the traditional watch demand, where visibility remains challenging. Many factors seem to be affecting consumers in general and certainly our category, economic and political uncertainty, continued shift in shopping patterns, along with foreign currency, and these and other factors could impact demand even more.

Second, given the state of the consumer, we may need to invest in further promotions to drive sales. And finally, while we are focused on delivering our wearables products on time, there is a lot to get done at the most critical time of the year and delivery timelines are tight. These are new categories for us, with different supply chain and distribution challenges. These are the principal risks that we have reflected in the lower end of our guidance range.

Therefore, for the full year, we continue to expect sales to decline in the range between 1.5% and 5%. This includes roughly a 1 percentage point headwind due to currencies. We now expect operating margin in the range between 5% and 6.5%, which includes roughly a 1% point decline from currencies, and EPS in the range between $1.80 and $2.65 per share. Our guidance assumes relevant currencies remain roughly at their prevailing rates and a tax rate of about 30% for each remaining quarter and for the full year. Our guidance assumes higher interest expenses, given debt levels, significantly fewer currency contract gains compared to last year, and virtually no further share repurchases.

We expect full-year gross margins will decline, given the weaker currencies, greater reliance on off-price channels and promotions to drive business in our outlets, and the impact from wearables, which carry slightly lower margins.

Regarding expenses, our team continues to focus on reducing overhead and infrastructure expenses to improve the profitability of our core business. Based on our current plans, we expect overall operating expenses will be roughly flat to slightly down this year. Within that, however, our current plans will significantly increase our investments in our key strategic growth priorities, marketing initiatives to support Fossil and Skagen, omni channel development, and wearables. Based on our current plans, these investments will be offset by significantly lower infrastructure costs, as well as the anniversarying effect of last year's restructuring, impairment and acquisition charges. Given the full year sales trajectory, this would result in a higher overall expense rate.

Now let me give a little more color on our plans by quarter and how our activities will likely affect our financial results for both remaining quarters. Our new wearables rollout should begin during the latter part of the third quarter and then accelerate into the fourth. Assuming no further significant erosion in traditional watches, wearables should start to offset, though not completely, the sales headwinds in the third quarter.

We anticipate third quarter gross margins will decline compared to the prior year, but we don't expect a headwind as large as we experienced in Q2. Given our current inventory position, which we feel is quite healthy, we're planning on less of an off-price impact. We've also been working on several supply chain efficiency initiatives, the favorable impact of which should finally start to work their way through margins in Q3. Currencies and wearables will also negatively impact year-over-year gross margin.

Third quarter expenses will be higher compared to last year for several reasons. This year, we plan to step up our marketing investments in the third quarter, while last year our biggest increase came in the fourth. These investments will help support the launch of our wearables products and help create the buzz around these exciting new products. We're also now carrying infrastructure cost to support wearables and some of those development costs, given product cycle timing, will tend to peal in the third quarter. We're also carrying purchase accounting and contingent equity costs from our Misfit acquisition and those expenses will more than offset the favorable impact from last year's Q3 restructuring charges. For the rest of our cost base, third quarter expenses should decline.

Based on these assumptions and our assessment of risk, we are expecting third quarter sales to decline between 2% and 6%, which includes roughly a 1 percentage point currency headwind, and we're planning operating margin in the range between 2.5 % and 4.5% and EPS in the range of $0.15 to $0.40. This includes a significant tax headwind, given last year's low third quarter tax rates, and non-operating earnings headwinds from both interest expense and currency hedges.

As we accelerate our wearables rollout into the fourth quarter with more brands and the opportunity for holiday replenishments, our goal is to finally see an inflection point in our sales and drive overall quarter growth. We could see further sequential abatement of gross margin headwinds later in the year, as currency comparisons become easier and as we anniversary some promotional acceleration that occurred last holiday. By the fourth quarter, even as we continue to invest in marketing, omni channel and wearables, we do expect to operate with a lower expense base, given reductions to our base infrastructure, as well as lapping last year's impairment and acquisition expenses. And finally, we now expect CapEx for the full year to be in the range of $70 million to $80 million.

So now we'll open the call up to your questions. And to be fair to everyone, please ask only single-part questions. If you have more questions, please requeue after others have asked theirs.

QUESTIONS AND ANSWERS

Operator

(Operator instructions)

Omar Saad, Evercore.

Omar Saad ***Evercore ISI - Analyst***

Thank you. Good afternoon. I guess my one question is, a lot of conversation around wearables coming this fall, third quarter. I didn't hear you really talk a lot about Misfit and what's been happening with that acquisition and that business, not only as a standalone brand with product and services, but also the opportunity to integrate that into some of the traditional watch brands that you guys are managing. Thank you.

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

Thank you, Omar. Our investment thesis and our goals for the Misfit acquisition are playing out pretty much exactly as we had hoped. We bet our internal integration goals. And we're on track now for pretty much all of our product delivery expectations over the next several months.

The next three months are really going to amount to what's an unprecedented launch in wearables. So we will have eight brands across three product categories, 100 SKUs, 40 countries, 20 languages, all launching in the next three months. You'll see that in two waves. The first wave will be Fossil and Michael Kors smart watches on Google's Android Wear platform. Those will hit the market at the very end of August and early September. Coming this Friday, actually, you will be able to pre order Fossil's products on our website. There will be nearly 30 SKUs across five different product platforms across those two brands, which that will amount to the most fashion forward smart watches on the market today, with the styling of those two brands, customized straps, and a significant amount of customization in the style of the watch faces that are truly branded. So we're really excited about that.

Our wave two comes later in September and in October, some early November. And what we'll see there is hybrid smart watches and trackers across eight brands. So Fossil, Michael Kors, Kate Spade New York, Armani, Diesel, Misfit and Chaps by Ralph Lauren. And what we're doing there is with hybrid smart watches, we're adding the Misfit technology into traditional watches that people love today. So you'll see a whole host of new features added to products that are from brands that people love and in styles that we sell 30 million of today.

We're also taking, I think, technology across a similar number of brands in the tracker space, where we see a new category developing for us. We're able to take a lot of the basic activity tracking functionality that people buy millions of units of today and just put a much more branded and style assortment together. So huge, unprecedented launch, the next three -- obviously, as you can imagine, our teams are furiously at work on this. But all systems are go, and we're just thrilled with how things are progressing there.

On the Misfit brand, we are also equally excited. As a start-up business for a brand that we acquired, but we are now bringing all pf Fossil Group's capabilities to bear. So we're focusing on an expanded assortment, so new styles from straps, bands, new color waves. You'll also be seen a hybrid smart watch, and ultimately then a smart watch we'll be bringing to market. So doubling down on wearables and style and fashion-oriented design. We've got into our global sales team, so they're expanding distribution as we're expanding and getting the assortment right. And then we're putting some emerging emphasis here on the back half around marketing and awareness, including a new Disney partnership that we recently locked in. So also a ton of great movement on the brand itself.

Operator

(Operator Instructions)

Oliver Chen, Cowen and Company.

Oliver Chen *Cowen and Company - Analyst*

Hello. Thanks a lot. We had a question about the status of the inventories. It sounded like you were relatively elevated, just given that you had to use promotions in the off-price channel. How do they look? And as we do think about your new guidance, can you just help us dimensionalize for fourth quarter what percentage of the revs will be connected accessories? What needs to happen in that business for the achievability of full-year guidance? And it would be great to get your sense of how this manifests in the department store channel versus direct to consumer, given that this is one of the biggest launches maybe you've ever done, if that's correct, in terms of sales training and what linear cabinets that occupies. Thank you.

Dennis Secor *Fossil Group, Inc. - CFO*

I'll start with the inventory question. The trends were fairly stable that we saw throughout the channel for the quarter, and so sell-in pretty much was consistent with sell-through, so the inventories in the channel seem pretty healthy for us right now.

I think the best way to think about wearables from the back half of the year is that if you look at the first half of the year, that, for the most part, you've got to factor out currency, but that establishes roughly the overall trend of the traditional business. There's a little bit of wearables that's helped the first and second quarter, but that really establishes the trend. We've assumed that that general trend that runs through. If you think about the top end of our guidance, that general trend runs through for the rest of the year. Where you see the impact of wearables is there is the delta between that and what we're guiding to. So it starts, as Greg said, we're starting with rollouts here late August and early September, and then that will accelerate across the total of those eight brands by the rest of the year. So that really represents the change in trajectory is the sell-in and the opportunity for additional sell-in and preorders in the fourth quarter on wearables.

Operator

Ike Boruchow, Wells Fargo.

Ike Boruchow *Wells Fargo Securities - Analyst*

Hello, everyone. Good afternoon. Just a quick question. I think you spoke about one large brand driving the decline in the licensed portfolio this quarter. You've said that for a while. As you think about the right size of what that brand may be, are we getting close to that point or would you expect maybe another 12 or 18 months of pressure from that brand on your licensed portfolio? Just trying to think about holistically when you take a look at it, are we near the right sizing of that business or is it still going to take some more time? Thank you.

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

Obviously, we're up against some very tough comparisons, just for the sheer size of that business. Obviously, in the market we're in right now, the watch business, in addition is very tough and traffic is challenged anyway. It's really hard to say, except that we're coming up against easier comparisons.

The other thing is as we said, we're launching more innovation and change in the product and change in the point of sale than we've ever done before. A lot of that is happening in the next couple of months. We think that's going to be a lot of impact on that. In addition, the wearables launch we're doing there is one of the biggest launches we've ever done. There's going to be huge amount of awareness, PR, advertising, celebrity input, social media, digital, video. It's going to be very significant, and we're expecting that could change the direction pretty quickly. In addition, we still have big opportunities there in men's and in jewelry. The brand is still very productive on a sales per foot or inventory turn basis and we're still putting shop-in-shops globally. Asia, for example, is also a relatively small market, so there's long-term growth there. So I think we're looking at this brand as something that we can turn around. And to say exactly when, we're not sure, but we think we can get it going.

Operator

Simeon Siegel, Nomura Securities.

Simeon Siegel ***Nomura Securities Intl - Analyst***

Good afternoon, guys. Sorry if I missed it, but did you quantify how much the wearables revenues are embedded in the high-end and low-end of the full year and Q3 guidance? And then from your early learnings, do you have an ideas where it will resonate most, maybe which customer demographic, and maybe parlaying that, which of your owned or licensed brands do you see the greatest opportunities there? Thank you.

Dennis Secor ***Fossil Group, Inc. - CFO***

The first part, we didn't specifically quantify, but it really represents the change in trajectory from the first half on sales. That's probably the best way to dimensionalize it.

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

As Dennis mentioned earlier, we've got a lot of launches going in, a lot of PR, a lot of point-of-sale activity. You'll see more differentiation at point-of-sale, as we've been encouraging all the stores that we sell to globally to turn their departments from watch departments into wearable departments. We will know at the end of the year when we see sales in December, we'll be able to give you better size on how big this market is, what percent of our sales it is, and how we're going forward. But we're positioning it as a game changer. There's a lot of stuff going on. We do have the capability potentially of reordering for holiday, and that could change the direction for next year, as well. So we've got a lot of things going on.

In terms of what we're seeing in the market, obviously the watch business is very difficult out there, and we think it's clearly because of this interest in technology. So our number one mission as a company is to continue to gain share in the traditional watch business. So forgetting the technology, we are launching all types of new materials and ideas and differentiation and point-of-sale. We're expanding some of our newer brands to new markets. So we're doing everything we can to change the direction of the traditional watch business. Keep in mind also that when the watch business gets tough, we gain share. So we're being very aggressive in the marketplace.

In addition to that, we do think, and it just so happens, the best way to change our direction in the watch business is through technology. So our objectives of launching multiple brands, three different types of wearables, we think is a game changer for the market. So we're launching hybrids, which are traditional watches that look like regular analog watches that have connectivity, measuring health and fitness, sleep, notification et cetera, at not a lot of additional price. Those hybrid watches, we think is a game changer for the watch business and we think that someday every watch we make will have some type of connectivity in it.

In addition to that, and what we know already, is that it is bringing a younger customer into the business. Millennials largely have not worn watches, because they grew up with smartphones. There's lot more interest in technology-driven watches than there are in traditional watches. So we think we can impact the traditional watch business by putting more technology in there, getting more interest, bringing the younger customer in there. And all of our customer globally are on board with that.

We also have a rather significant opportunity in the wearables business. So looking at Android display watches and also trackers, by bringing fashion and our resources and our distribution to the market, we think is a very significant opportunity. So there's two objectives, one is to infuse technology into the traditional watch business and gain share and excite that business, and secondarily is to bring a fashion to the wearables business. We think that the wearables market in 2019, according to research, is a $45 billion business, the watch business is $65 billion. It has the potential of making our addressable market much larger and puts a much better long-term sustainable growth track for the Company.

Operator

Ed Yruma, KeyBanc Capital Markets.

Ed Yruma ***KeyBanc Capital Markets - Analyst***

Hello, guys. Thanks very much for taking my question. In terms of wearables, have you been able to get where you had wearables placement in maybe nontraditional watch stores, electronic stores, and in terms of the sell-in process for your traditional wholesale partners, are they accepting them on very similar terms as you would a traditional fashion watch or are there changes that may make this cadence a little lumpier? Thank you.

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

We are actually, the entire consumer market, as you know, is changing very quickly. And our channels are changing, as well, especially with the impact of wearables. We are doing testing globally in certain consumer electronics channels, CE channels, and additional websites that we had not sold before. So we are gaining additional distribution. And there's huge amount of interest, on those distribution points part, on the interest they have in not just wearable technology, but hybrid watches. A lot of those CE channels have a millennial customer walking in there and they're buying wearables and phones and other devices, and there's an interest there on the hybrid watch, as well. So we think that we're going to gain additional distribution for that.

Operator

Erinn Murphy, Piper Jaffray.

Erinn Murphy ***Piper Jaffray & Co. - Analyst***

Great. Thank you. Good afternoon. Maybe just following up on something, Dennis, you mentioned earlier. You highlighted one of the risks of your guidance was the supply chain and the complexity of the wearables launches, given the scale and the breadth of what you're looking for this holiday. Could you just remind us, what are the lead times in that business? And then what are retailers' expectations for the timeline of deliveries? Do you have firm orders on hand, similar to what you would typically in the holiday season or is there more at once? Thank you.

Greg McKelvey ***Fossil Group, Inc. - Chief Strategy Officer & Chief Digital Officer***

I'll answer. This is Greg. In terms of timelines, first, we do have firm orders. Our sell-in process has been very robust. We secured the capacity much earlier this year than you would normally in a traditional watch business to make sure that we got component supply and manufacturing capacity, and we're pretty much hitting our ramp-ups as we would've expected. So we're going to be able to meet the firm orders that we have in place.

Lead times, I don't know that we'll say specifically what those are, but I will say that our early launches with Kors and Fossil, we'll have opportunities for replenishment and we'll be able to respond to those. We'll then learn a lot on the very back half of the year to plan next year and really continue to scale up the opportunity, based on the demand we see.

Operator

Betty Chen, Mizuho Securities.

Betty Chen ***Mizuho Securities - Analyst***

Thank you. Good afternoon. I was hoping you can talk a little bit about the supply chain efficiencies I think you mentioned earlier. Can you quantify what they are, what are the sources, and should we expect that to occur on a quarterly basis going forward? Thank you.

Dennis Secor ***Fossil Group, Inc. - CFO***

Sure. This is Dennis. The whole organization has been looking at opportunities to reduce costs in the supply chain across a number of different initiatives. We've been working on that really all year, with pretty good line of sight on it, but just because of the timing of when inventories roll through, it takes a little while for it to work its way through the financial statement. So that's what we're expecting to see start to hit in the third quarter and then even accelerate perhaps a little bit in the fourth quarter. We didn't quite say how big it was, but it should be reasonably impactful to our margin. We'll still see headwinds in the margin. This is one of the levers that we're pulling to try to offset some of the existing headwinds in our margins.

Operator

Heather Balsky, Bank of America.

Heather Balsky ***BofA Merrill Lynch - Analyst***

Hello. Thank you for taking my question. First, just a follow-up regarding the question on orders for holiday. So does your guidance for the fourth quarter reflect current orders for wearables or is it baking in some upside? Is there upside from your guidance if there's reorders during the quarter? And then I just wanted to clarify that for outside of Kors and Fossil, that the wearables that you're launching in 4Q are hybrid, just curious when some of those other brands are interested in getting into the smart watch product?

Dennis Secor ***Fossil Group, Inc. - CFO***

On the guidance, what we've tried to do in our range is to accommodate a risk of outcome. So we think on the higher side, we've got the ability to sell in. And then as Greg mentioned just a minute ago, there's an opportunity for some reorders. This is still, though, a new business for us. And times are tight. It's a pretty critical time of year. So we want the range of our guidance to reflect not fully executing on that plan. So we've got -- I think the way we've approached our guidance is that we expect to operate somewhere within that range.

Greg McKelvey ***Fossil Group, Inc. - Chief Strategy Officer & Chief Digital Officer***

Okay, and on the other half of your question. First, hybrids are the right place for us to start when you begin to push multi-brand and global. Because we're adding features to existing designs that can be merchandised in our stores with products that are coin cell battery-operated. It slots right into our business model, from design to manufacturing to distribution, and that's why we're starting there. We're going to be able to add features at a much higher average unit retail across all these brands that will bring energy to the category, that will resonate with customers, and that just simply fits our business model. So it's the right place for us to start.

On smart watches, there's a lot more scale that's required to get in that game. So we're focusing on Fossil and Michael Kors first, where we've got the broadest distribution, including direct to consumer, for both of those brands. There's a lot of demand and interest across other brands to be in the smart watch category, so those are in our roadmap. But we are first making sure that we can scale the opportunity globally with Fossil and Kors first.

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

One other thing to keep in mind is not only on display smart watches, but on hybrids and also trackers, is the technology is going to get better and better. It's going to get smaller, more efficient, better battery life. The display smart watches will get smaller, which will enable them to fit on a female brand. They're going to be untethered, at some point. A huge amount of innovation and technology is going to make these products even more compelling to more brands. And it's a very significant opportunity.

We do have a situation where every one of our brands in every store that we sell to is pounding the table for more and more right now. And it's a great situation to be in, where we have, in a very tough environment for consumer products in general and also in watches, that we have a huge amount of excitement going on in the marketplace and we're able to bring a lot of innovation and design and point-of-sale and excitement to the counter, bring in younger customer in there. And every one of our customers globally are very excited about it.

So having said all that, we have to get more selling and information through the next couple months, see what impact that has. One of the information points we have is that the smart watch business itself is even skewed heavier towards December sales. It could be up to 50% of sales for the year. So we're getting in a position to optimize that time period, both with all the ideas that we have, but also in inventory and distribution, point-of-sale, et cetera. A lot of activity going on getting ready for this, and we'll see how it plays out.

Operator

Anna Andreeva, Oppenheimer.

Anna Andreeva ***Oppenheimer Capital - Analyst***

Great. Thank you. Good afternoon and thank you for taking our question. I guess the question on the credit agreement amendment. Just making sure, if the leverage ratio improves, are you able to buy back stock again prior to May 2018? And with the cash burn, what kind of minimum cash cushion do you need to see on the balance sheet?

Dennis Secor ***Fossil Group, Inc. - CFO***

No, for the duration of this agreement, we would not be able to purchase shares. What we're trying to accomplish with this amendment is really to preserve our flexibility. In the last few years, there has been headwinds in the business that have impacted EBITDA, whether it's currency and category pressures and that's compressed that EBITDA, which limits our access to our existing revolver capacity. On top of that, we took on debt for the Misfit acquisition. So what we wanted to accomplish here was to restore our access to our existing revolver and maintain that level of liquidity. We still are generating strong cash flows, but a lot of that's generated overseas, which is accessible to us, but at a very high tax cost. So our goal is to preserve our overall liquidity at a cost effectively as possible, and this amendment accomplishes that for us.

Operator

Randy Konik, Jefferies.

Randy Konik ***Jefferies & Co. - Analyst***

Thanks a lot. Question here, it seems like the corporation has to -- it was always known for being a design driven corporation that leveraged that design skill and manufacturing marketing skill across these different brands, and now we're getting more towards a technology-driven organization. How do you think about resource allocation and how you try to pivot the company to get more towards that technological side of things versus the design and still embody that design ethos you've always had?

And then the other thing I'm trying to think about with the wearables and hybrid investment, how should we be thinking about resource and inventory allocation across the traditional piece of the business versus the more technological forefront of where everything is going in the market tied to the business. How should we be thinking about how the organization is allocating those resources? And lastly, when you add 100 SKU count, what do you take away from the business from, if anything, from the traditional SKUs? Just curious. Thank you.

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

On the first question about design, actually I think it's very interesting to watch this company be as nimble as it has and pivot in such a strong direction, where our entire organization, from design, branding, distribution, visual merchandising, sourcing, has pivoted towards adding this capability of adding technology, which is really innovation to the watch product. So our design teams, for example, on each brand have, with Misfit's engineering help and guidance, have developed the capability to incorporate into their design briefs the ability to put technology in there. And the design teams for each brand, in addition to if it's a license brand, the brand partners are very involved in building the apps. So a big part of this is the software and the customer experience and the engagement we're getting with consumers and the color and the storytelling that's involved in that. So this whole project has been really more of a creative experience than a technology experience, because we're enabling our customer to have a deeper connection and more relevant communication with a brand through the apps and the storytelling. So it actually right in our wheelhouse.

We are, as I said earlier, we're going to be able to bring, add technology into the watch business and that technology is not cold, hard technology. It has to do with community and branding and storytelling. It's very more emotional and human than you think of cold, hard technology.

And then on the smart watch side, on the display smart watch and in wearables, we're going to be able to bring fashion and color and engagement through the apps and through the experience and the design into that wearables business. So we think it's right in our warehouse. We sit right in the middle between technology and fashion. We're able to bridge both of them and bring more compelling products to consumers. It's a very exciting position that we're in.

In terms of resource and inventory allocation, and we are, we believe that obviously over the next several years, we're going to have more and more technology in our products. So we are actually on a mission to reduce SKUs and have less of our inventory that doesn't have the technology capabilities, so we're pivoting in that direction. We basically, everyone in the company, even on the supply side and our manufacturing, is getting education and knowledge. We have consultants working on how we can convert our manufacturing base to be able to incorporate the technology. But the entire company is pivoting, and it's pretty interesting that we've been able to do this without adding SG&A. We've been able to reduce expenses dramatically in some areas and put more resources on this project and incorporate everyone in the company to learn and have the knowledge and the capability to bring these to market. I think we've done a pretty good job of that.

The other, you asked about SKUs. One of the things that we're very interested in is we have a big initiative in place to reduce our SKU count. Wearable technology could be the methodology for us to do that. Because in that industry, as you know, there's relatively small numbers of SKUs that can do millions of units. And we're very interested in seeing what impact that has on our overall business and our supply chain and our inventory turns.

Operator

Laurent Vasilescu, Macquairie.

Laurent Vasilescu *Macquarie Research Equities - Analyst*

Good afternoon. Thank you very much for taking my question. What are your free cash flow expectations for the third quarter and full year? And then secondly, you mentioned cost deferrals in the prepared remarks. Can you quantify the amount in dollar terms and how long did you defer those costs to?

Dennis Secor *Fossil Group, Inc. - CFO*

We don't specifically guide to our cash flow for the year. With respect to expenses, we are constantly looking at our expense base, and some things move out quite naturally and others we'll be able to reduce. So again, we didn't quantify it. We were able to, as we went through the second quarter, reduce some of those costs in the second quarter, pull some costs down for the full year, as well, to help offset what we would anticipate would be slightly weaker gross margins for the rest of the year. So that's why you see us still with a vision toward delivering the top end of our sales guidance, but on slightly lower margin.

Operator

Oliver Chen, Cowen and Company.

Oliver Chen *Cowen and Company - Analyst*

Thanks a lot. Kosta, I just had a question regarding the sales and marketing infrastructure. So when you do conduct this launch, and there's really unique complexity across your multifaceted approach to connected, how will sales and marketing manifest, and service, just because you've had a really good history of offering very good service. Also, could you just share with us your biggest surprises in terms of Fossil Q and Misfit. What has surprised you to the upside or not in terms of your learnings? Because you've been, you were early to identifying battery life as a pressure point. And I'm just curious about what you're seeing and how that will translate into the products you're executing on. Thank you.

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

Our sales and marketing teams globally are, through education and information transfer from the design teams and from our Misfit technology team, all the engineers are selling these products into the stores. There's a lot of videos and instruction about how to do this. There's going to be a lot of point-of-sale activity. There's a lot of training for salespeople that we're embarking upon. So there's a whole integrated approach. It's done through our normal sales and marketing teams. The other thing I'd say about our sales and marketing team is they've picked up the Misfit brand and they're selling it to -- we're getting tests in almost every store we sell to globally. So we're getting the ability to leverage our distribution channel to put more Misfit products in there.

And then we do have somewhat of a new channel, with the CE channel. So our sales and marketing teams are also taking that on. We've added some additional resources for that and we've taken some people from Misfit to do that. So we kind of have a hybrid approach of going to the CE market and a lot of the new websites, et cetera, that we sell to.

The one thing that is an advantage for us, again in going after this wearables business, we do have infrastructure globally for repair and warranty work. So we have, it's a very big organization. We can basically repair a watch and get technical support in every country in the world. It's a very expensive thing that we built many, many years ago, and we're getting training and all our people in position in those operations globally to be prepared for handling the technology requests, et cetera, that are going to be coming with wearable technology. So that's a huge advantage in the marketplace that we've already got in place. Not to mention our distribution, we're already selling 30,000 point-of-sale. We also have the back up there.

I guess on the one of the biggest surprises, I think, was just the enthusiasm we've gotten from every customer in the world that they recognize this is a huge opportunity and they're willing to change the look of their departments and bring that customer in the store. I think we've had an incredible amount of support and excitement from the wholesale community and new distribution to really put these markets, these businesses in their stores in a pretty large way. You're going to see, as you go in stores starting September, October, and the balance of the year, you're going to see a lot of wearable technology departments that are built into watch departments. You're going to see a lot of point-of-sale activity, a lot of innovation and communication.

And I guess the other piece was just the huge amount of awareness and social media activity we've seen. We've gotten, from our launches -- and we haven't gotten to the big ones yet, they're coming in the fall -- we've got more response and page views on the internet than we've ever had as a company before. So sure, business is tough, but there's so much excitement around the products we're launching that you can't help but think that we're in a really good place.

Operator

Thank you. And t this time, I'd like to turn the conference back over to Mr. Dennis Secor for any additional or closing remarks.

Dennis Secor ***Fossil Group, Inc. - CFO***

So thank you all for joining us again today. We look forward to speaking with everybody again in November. One note, while we haven't yet confirmed the date for the third quarter release, we do plan to adjust the calendar so that it doesn't fall on November 8, which is the US Election Day. So we'll be sure to announce that a week or so in advance. So thanks again for participating.

Operator

Thank you. Ladies and gentlemen, once again, that does conclude today's conference. Thank you all again for your participation.
