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PRESENTATION

Operator

Welcome to the Q2 2017 Fossil Group Inc. Earnings Conference Call. My name is Ashley, and I'll be your operator for today's call. (Operator Instructions) Please note that this conference is being recorded. I will now turn the call over to Eric Cerny, Investor Relations. Mr. Cerny, you may begin.

Eric Cerny

Thank you. Good afternoon, everyone. Thank you for joining us, and welcome to Fossil Group's Second Quarter 2017 Earnings Conference Call. I would 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, 10-Q and 8-K 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 the call in our earnings release filed on Form 8-K and in the Investors section of our website. Please note that you may also listen to a live webcast or a 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 N. Kartsotis ***Fossil Group, Inc. - Chairman and CEO***

Thank you. Good afternoon, everyone. We appreciate you joining us today. 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.

Today, we announced that Dennis Secor has decided to relocate his family back to Southern California and, therefore, will be leaving the company. We also announced today that Jeff Boyer will become our new CFO and will join the company on October 16. Jeff has been a valued member of our Board of Directors for the last 10 years, and we're pleased to welcome him to this new role. And Dennis will be staying on to assist Jeff in the transition. We're grateful to Dennis for the contributions he's made over the past 5 years, and we wish him all the best in the future.

With the first half of 2017 now behind us, we believe that our traction in wearables, our significant progress in our supply chain evolution and our reduction in infrastructure cost show that we are pursuing strategies that can improve our profitability and return the company to solid growth over time. Even as we operate in a market and retail environment experiencing unprecedented disruption, we believe we are focusing on actions that can deliver solid results and returns to our shareholders over time.

In our traditional watch business, we are managing through uncertainty and low visibility by focusing on optimizing our deployment of resources and on innovation. We continue to advance our New World Fossil agenda and are offsetting some of the headwinds in our business with lower expenses and margin gains.

In the second quarter, the strength of our wearables product, particularly in key brands, once again demonstrated that wearables have the ability to help mitigate the ongoing softness in the traditional watch category and ultimately, we believe, turn current headwinds into tailwinds. We remain confident that technology in wrist wear is increasingly important for many consumers and the catalyst for stabilizing and growing our watch business over time.

We have a significant number of exciting new products hitting the market over the next few months that are much improved over our current models. This generation of wearables has increased functionality, slimmer cases, brighter screens, more brands and more robust software. We continue to believe we're in the best position to take advantage of the convergence of fashion and technology, given our capabilities and our portfolio of brands.

So let me spend the balance of my time focusing on our team's primary objectives for the remainder of this year: advancing our wearables initiative and executing New World Fossil to improve the profitability of our core traditional watch business.

First in advancing wearables. We are competing in a growing category that continues to show widespread acceptance from a broad consumer base and it is becoming increasingly evident to us that fashion and design matter in the category. In key brands, such as Fossil and Michael Kors, we're seeing wearables positively impact the watch category by more than 10 points. That represents a significant opportunity for us, particularly with a pipeline of innovation focused on delivering dramatically improved product with this each new generation. We continue to gain insight on the impact pricing can have on driving volumes, valuable information we are using to evolve our production and supply chain capabilities with a focus on driving scale to achieve sustainable margins.

Innovation continues to be at the center of what we do and you will see that at the product launches this fall. We remain on track to double our SKU count to nearly 300 this year and we'll add 5 more brands on to our wearables platform. DKNY, Marc Jacobs, Michele, Relic and Tory Burch will join the other 9 brands we've already rolled out and support our goal to more than double the wearables business we delivered in 2016.

Our updated touchscreen smartwatches launching later this year will have better screen resolution, smaller case sizes and branded micro apps, and in addition to Fossil and Michael Kors, will also be available in Diesel and Emporio Armani. New products for 2017 will begin to launch in September and continue into the holiday season. We are working very closely with Google. And combined with the support of key brands in our portfolio, we are in a position to go after the display category in a very meaningful way. Efforts to innovate through improved quality and additional functionality with better technology include heart rate monitoring and swim-proof functionality for future generations of products across even more brands.

Ahead of these new product launches, we launched a celebrity influencer campaign for Fossil and Emporio Armani. This is the first time we have done this on such a large scale and have been very careful to launch these campaigns in a way that reflects the heritage of the brands. We identified celebrities with a genuine connection to the brand and stories to share about their first Fossil products. Working with great brand ambassadors, such as Kristen Bell and many others, enabled us to reach new customers that are not familiar with the brand or the functionality of the Fossil Q assortment. At the same time, the campaign has provided an opportunity to reintroduce customers to the Fossil brand, showing them sophisticated functionality not previously available in fashion accessories.

We're supporting our license brands in similar ways with Shawn Mendes recently introduced as the brand ambassador for Emporio

Armani Connected, and Michael Kors sharing his enthusiasm and support for the category and new products. These are important marketing investments. We're spending over 40% more than we did last year on wearables advertising, all designed to build awareness for the new functionality available in these fashion-first technology accessories.

Our successful entry into the wearables space has enabled us to expand our addressable market and to work with new wholesale partners in the consumer electronics channels. We continue to make progress expanding in this channel but we didn't get as far as we wanted to during the second quarter. Much of our time has been spent finalizing the specifics around margin and other details, given that this is a new distribution channel for us. Commitments for the new product launches later this year are being finalized and we are excited to bring the first lifestyle fashion brands to this channel on such a large scale.

Now moving to our New World Fossil restructuring initiative. This program continues to be instrumental in paving a path to a leaner and more nimble operating platform that can support improved profitability in the future, all while better serving our customers and competing in the new retail environment. While we are mindful of the capital we're investing in the program this year, specifically related to store closures, this does not prevent us from driving efficiencies and recognizing significant benefits in our supply chain and our sourcing capabilities. In fact, we are further ahead of where we thought we would be in the plan and our team is focused on accelerating other initiatives in an effort to realize additional benefits sooner.

So far this year, we've driven savings by better leveraging our scale across all of our brands to source improved cost on everything from materials to production and freight costs. Our design-to-value efforts are yielding better product cost as we prioritize design features that consumers value most and eliminating other costly features not as highly valued, all while still developing on-trend compelling products.

Within our organizational structure, we've driven savings by operating with a leaner and more efficient infrastructure while directing our resources to the areas of the business that represent the greatest opportunity to drive growth. As it relates to our retail footprint, store closures are driving savings this year and will remain a focus for us as we look to exit underperforming locations primarily through natural lease expirations. This year, we expect to close nearly 50 stores in addition to the 50 stores we closed last year. Our efforts to date in driving expenses out of our structure and improving our margins should drive $100 million in profit improvements on an annualized basis. As we shared before, we expect that roughly $80 million of that will flow through earnings this year. Now certainly, future volumes can affect those numbers but we feel we are well on our way to delivering those results.

Our entire team is focused on ensuring that we are in a position to improve our performance. We remain focused on growing our core watch business through innovation and leveraging our core competitive strengths. While technology is the most current form of innovation, design and style remain what we do best, and we are distorting trends across our portfolio of brands to improve the performance of our traditional watch business. While the category continues to experience unprecedented disruption and decline, that portion of our business actually performed in line with our expectations in the second quarter. We believe the fashion watch business is settling in after several years of outsized growth and that innovation, technology and compelling brand stories will put it on a growth track again.

In closing, our focus remains on executing our New World Fossil restructuring efforts, advancing our wearables initiative and stabilizing and growing our core watch business to drive long-term profitable growth. Given our conviction and the positive impact these initiatives can have on our financial performance, we are also working to ensure that we have the proper capital structure needed to support our long-term financial objectives. We are taking the necessary steps to strengthen our financial position to further enable us to execute our strategies well into the future and position our business model for continued strong cash flow generation.

Now I'd like to turn the call over to Dennis for additional color on our financial performance.

Dennis R. Secor ***Fossil Group, Inc. - CFO, Executive VP & Treasurer***

Thanks, Kosta, and good afternoon, everyone. Before I provide an operational review of the quarter, let me discuss the impairment charge we've reported on today.

In the quarter, we recognize a $407 million, or $6.50 per share noncash charge, to impair certain intangible assets primarily related to goodwill. The impairment was triggered by the sustained compression of our market cap that occurred throughout most of the back half of the second quarter. This charge significantly impacts this quarter's operating expenses. However, it does not impact our liquidity or financial covenant calculation. I will isolate it, where relevant, as I discuss our overall results.

Second quarter constant currency net sales decreased 12% and on a reported basis decreased 13% to $597 million. Our traditional watch business performed within our expectations, though still down compared to a year ago. During the quarter, wearables continued to positively impact the trend of our business. Overall, wearables represented roughly 9% of our sales for the quarter, a sequential improvement from the 7% in the first quarter. Our Connected business, which posted more than a 300% increase off a relatively low base last year did not fully deliver against our ambitious goals for the quarter. Overall, our sales for the quarter were just short of our expectations.

We were able to offset the shortfall in our sales goals with higher traditional gross margins as we delivered stronger cost reductions in our supply chain and managed the quarter with lower recurring expenses. Excluding the noncash impairment, we delivered a bottom line at the top end of our expectations.

We reported a net loss of $7.11 per share, including $6.50 per share due to the intangible asset impairment charges. We recorded $10 million or $0.13 per share related to our New World Fossil restructuring initiatives. The decline compared to last year was primarily driven by impairment charges, lower sales in gross margins and restructuring charges, which was partially offset by lower recurring operating expenses. Second quarter loss per share was negatively impacted by $0.08 due to changes in foreign currency given the stronger U.S. dollar's negative impact on sales and operating margins.

Our watch business declined 8% in constant currency for the quarter with traditional watch trends generally continuing their recent trajectory. We grew our wearables business both compared to a year ago and sequentially compared to this year's first quarter, delivering $51 million for the quarter. While we're pleased with the growth we were achieving from this business, we did not see the productivity we had anticipated and our distribution expansion plans, particularly with new CE partners, has been slower than planned. We ended the second quarter with about 8,500 points of distribution for wearables and plan to add another 3,000 by the end of 2017. We do continue to see strong sell-throughs in key display watch styles and display watches did represent the vast majority of the quarter's wearables sales.

Fossil declined 9% in constant dollars compared to last year, all driven by softness in leathers and jewelry. Our Fossil watch business grew in the quarter with smartwatches, both display and hybrids, positively impacting the category growth rate by more than 10 points. Skagen sales declined 9% compared to last year.

In the retail channel, comp sales declined 11%, in line with first quarter trends driven by traffic declines. E-commerce sales, which were included in comp sales, increased 8% for the quarter. For Michael Kors, while watch sales declined in the quarter, smartwatches positively impacted watch trends for the brand by more than 10 percentage points.

In the Americas, second quarter sales decreased 16% to $289 million with declines in all 3 product categories. Declines across all of the brands in the portfolio were driven by decreases in traditional watches, partially offset by connected watches with our best performance coming in Michael Kors and Fossil. Both wholesale and retail sales declined at similar rates in the quarter.

In Europe, reported sales decreased 10% to $195 million, a 7% constant dollar decrease. Declines in all 3 product categories contributed to the results. In watches, declines in traditional watches were partially offset by connected watches. Within the region, growth in Armani Exchange was offset by declines in the other brands in the portfolio. In Fossil, smartwatches drove an overall increase in the watch category for the brand. Modest growth in Spain was more than offset by declines in the Middle East, France and the U.K., with both the wholesale and retail channels decreasing at similar rates in the quarter.

In Asia, reported sales decreased 9% to $113 million, an 8% constant dollar decrease. Declines across all 3 categories drove the decrease. In watches, declines in traditional watches were partially offset by connected watches. Growth in India and China was offset by a decline in nearly all other countries within the region.

In the quarter, gross profit decreased to $301 million and gross margin declined 140 basis points to 50.5%. Lower margins in the retail channel due to promotional activity in our outlets and e-commerce business, combined with a higher mix of connected products, which currently deliver lower margins, were the biggest drivers of the decline. Our connected margins for the quarter were stronger than we had anticipated as we have made even further progress in reducing our manufacturing costs. A higher level of off-price sales and the negative impact of changes in foreign currencies also contributed to the decline. We partially offset those margin headwinds with international sales mix and the benefits of New World Fossil.

While most of our New World Fossil benefits today have affected operating expenses, we are beginning to see these benefits flow through our margins. We have been working with our direct sourcing partners to reduce cost while still delivering high-quality products that meet the needs and expectations of our customers. These efforts delivered greater savings than we had anticipated going into the quarter and drove roughly an 80 basis point benefit to Q2 margins. As we move through the rest of the year, we anticipate this benefit will accelerate as we deliver more products, which had benefited from our margin expansion initiatives.

Second quarter operating expenses were $731 million and included $407 million in noncash intangible asset impairment charges and $10 million of restructuring costs associated with our New World Fossil initiative. Excluding those items, all other expenses declined roughly $26 million from last year's $340 million as we continue to realize the benefits of New World Fossil, including lower infrastructure and store costs. Advertising expenses were higher compared to last year, given the launch of our celebrity influencer campaigns to better create awareness and support our significant wearables rollout later this year.

Our second quarter operating loss was $430 million, largely driven by $407 million of noncash intangible asset impairment charges. Without that charge, our operating loss would have been $23 million, given our lower sales in gross margin and a $10 million restructuring charge being partially offset by lower operating expenses.

Second quarter other income decreased slightly to $2 million due to more favorable foreign currency activity. Interest expense increased roughly $5 million due to higher interest rates tied to our amended credit agreement. Our effective income tax rate for the quarter was 22% compared to last year's 30% due to the effect of the noncash impairment charge and changes in jurisdictional earnings. The lower tax rate is generally a function of the lower tax bases on the goodwill impairment as well as higher forecasted foreign losses in certain jurisdictions, where we are unable to record tax benefits.

Now turning to our cash flows and balance sheet. We improved our net debt position by roughly $175 million compared to a year ago. We ended the quarter with roughly $320 million in cash compared to $232 million last year and debt of $646 million compared to $735 million a year ago. During the quarter, we invested $8 million in CapEx and increased borrowings by $30 million, primarily driven by inventory investments to support connected product launches in the third quarter. We expect our capital expenditures will be about $30 million for the full year.

Inventory levels at the end of the second quarter were down 6%, with traditional watch inventories down substantially. This has enabled us to invest in wearables inventories, which are higher than we had initially planned, given our sales performance to date, and we are adjusting our forward purchases to reflect this performance.

Accounts receivable decreased by 7% to roughly $240 million and wholesale DSOs increased by 4 days compared to the prior year due to shifts in customer mix. Depreciation and amortization expense totaled $21 million for the quarter.

Let's now move to our outlook. As we've shared for many quarters, we continue to operate in a challenging market where visibility is very limited. Both the consumer and our markets are changing rapidly and it continues to be difficult to predict sales volumes, especially as we introduce branded fashion wearables to the market. As we move into the back half of the year, we are applying what we've learned from the first half of the year and adjusting our expectations to reflect our updated view on the size of this year's wearables business as well as more favorable expectations for our traditional margins. For the first half of the year, our traditional watch business, while still under pressure, has performed roughly in line with our overall expectations. We've been planning into these declines and has positioned our traditional inventories down to adjust to these trends. We have identified certain fashion trends and have quickly designed into these and expect to see some modest benefits from those in the second half of the year. But overall, we're maintaining our outlook for the rest of the year in our traditional watch business.

We continue to make excellent progress on delivering our New World Fossil goals. And to our efforts to date, we expect to deliver roughly 40% of the program's overall $200 million profit improvement in our 2017 results. Those expectations were already reflected in our prior guidance. In addition to those initiatives, we have been continuing to work with our suppliers to deliver even greater cost reductions through our supply chain. Those improvements favorably impacted the second quarter, and we expect benefits to continue into the second half of the year. In addition, the U.S. dollar has weakened against several currencies that affect our business, in particular the euro. Assuming currencies roughly maintain their current levels, that, too, will favorably impact our margins from our previous expectations but mostly in the fourth quarter.

Offsetting those margin improvements is our near-term expectation on wearables sales. So far, for the first half of the year, our wearables' sell-in and sell-throughs have not met our goals, though as Kosta shared, we are seeing some strong results with some of our key styles that have been supported by our new marketing and social media efforts. We remain very encouraged about wearables and variability to positively impact the watch category, which we have been consistently seeing with both Fossil and Michael Kors for the past 3 quarters. We expect that we can ultimately improve those trends as we build awareness in hybrids, though this is proving to take longer than we had anticipated. We have updated our expectations for the second half of the year, given clearer distribution plans and updated productivity assumptions based on what we've experienced to date.

By the end of the year, we plan that our products will be distributed in 50 countries, up from 40 in 2016, and our goal is to nearly double last year's distribution points. By the end of the year, we plan to have increased our brands on the platform from 9 to 14 and should have nearly 300 wearables SKUs in the markets. We now expect wearables revenues to be in the mid-$300 million and the lower $400 million range. Therefore, we're updating our annual sales expectations in the range between a 4.5% and 8.5% decline, reflecting our updated expectations of our wearables rollout in 2017.

We are continuing to invest heavily in the success of this new category. This year, we're increasing our wearables marketing investments by over 40% to support our new product launches and build awareness in the category. Coupled with the investments we expect our partners and licensors to make -- to support wearables. That marketing increase would be over 60%. We continue to expect gross margins will be lower than last year, though we see an improvement relative to our prior expectations, given our change in anticipated wearables mix, the improved impact of currencies, given prevailing rates, and our New World Fossil traditional margin initiative.

Excluding the impact of the second quarter noncash intangible impairment, we continue to plan with operating expenses that are significantly lower than last year and with an expense rate that is flat to down. We continue to plan this year's restructuring charges of $45 million, $36 million of which was incurred in the first half with another $5 million expected in Q3. Therefore, we're updating our GAAP EPS guidance to be in the range of a loss of $7.42 and $6.62 per share. This includes a $0.60 charge for restructuring and a $6.50 charge related to the noncash intangible impairment. This range reflects our updated expectations for our wearables rollouts, given the relatively newness of the category.

For the third quarter, we expect a sales decline in a range between 8% and 14%. We expect that increasing our penetration of wearables represents our biggest opportunity to change the trajectory of our top line coming out of the first half, and we've positioned ourselves well for a stronger quarter. We're increasing our marketing investments to support our launches, which are weighted more to the back half of the quarter. Based on our current plans, we've increased our distribution with nearly 25% more points of distribution than in the second quarter. We're planning that Q3 gross margins will be lower than last year, given the larger mix of wearables, a stronger relative U.S. dollar compared to last year and lower margins in our traditional business, given continued promotional activities to drive our business in retail. We expect that we'll partially mitigate these headwinds with the positive effects of New World Fossil. We're planning Q3 operating expenses to be lower than last year, which were favorably impacted by last year's real estate gains. Therefore, for the third quarter, we expect loss per share in the range of a loss between $0.44 and $0.11, which includes $0.06 related to restructuring charges.

I want to spend a few minutes and share some insights on our cash flows and our debt position. Even in a challenging commercial environment, our business model continues to generate solid cash flows. Since the beginning of this year, we have modestly improved our net debt position with a slight increase both to our cash and debt balances for the first 2 quarters of the year. We ended the second quarter with an adjusted EBITDA ratio well within the 3.25 cap established by our amended credit facility. As we amended our credit facility earlier this year, we worked with our banks to increase the adjusted EBITDA covenant in the third quarter to 3.5x adjusted EBITDA to reflect our historical inventory buildout in the third quarter as we prepare for the holiday season. That adjusted EBITDA calculation allows for adjustments for, among other things, depreciation and amortization, which we expect this year to be in the low to mid-$80 million range; stock compensation expense estimated in the mid-$30 million range this year; noncash charges, which would include this quarter's impairment charge; and restructuring expenses.

We began the third quarter with $320 million of cash, virtually all of which is overseas, and $646 million of debt. Based on our range of expectations for earnings for the third quarter, along with the 3.5x adjusted EBITDA covenant, we expect that our maximum allowable debt at the end of the third quarter would range from roughly $575 million to the mid-$600 million level, which is roughly where we ended in the second quarter. Thus, based on our guidance and our estimate of third quarter adjusted EBITDA, we expect that any required repayment at the end of the third quarter would likely be fairly modest.

We believe that our opening Q3 cash balance of $320 million should be more than adequate to fund our Q3 operations, including any net investments in working capital and to adjust our Q3 ending debt balances to maintain compliance with our covenants with minimal unfavorable near-term tax consequences. As a management team, we are very focused on efforts to optimize our use of cash and to improve our working capital efficiency, including how we manage our inventories and work with our suppliers on terms. For the full year, we continue to expect to generate solid free cash flow. At the upper end of our expectation, our goal is to generate free cash flow at near similar levels to last year and lower if our earnings are lower in our range. Those assumptions reflect the changes in operations, along with this year's higher interest expenses, improved by lower taxes, lower capital expenditures and improvements in net working capital.

In today's press release, in addition to providing our earnings on a GAAP basis, we have provided a table at the end of the release that helps quantify and isolate the impact from nonoperational items impacting both 2016 and 2017. And with that, we'll open up the call to your questions. (Operator Instructions)

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And from KeyBanc, we have Ed Yruma.

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

Dennis, best of luck going forward.

Dennis R. Secor ***Fossil Group, Inc. - CFO, Executive VP & Treasurer***

Thank you.

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

I just want to drill down a little bit on the wearable business. You mentioned kind of productivity or not seeing the productivity levels with some new doors as being part of the shortfall. I guess how do you score kind of consumer acceptance of the current gen product? Do you think that you were impacted potentially by the forthcoming release of the next-gen product? And I guess in response to that, have retailers shifted their order plans for the back half of the year?

Dennis R. Secor ***Fossil Group, Inc. - CFO, Executive VP & Treasurer***

Yes, I'm -- let me just give you some color on sort of how it's affecting the numbers and then -- and then Greg can add some more color. So we had, going into the year, a fairly ambitious program to drive our wearables business, recognizing that the first half of the year was largely going to be dependent upon last year's product, but not a lot of new products coming later in the year with full brands on the portfolio. What we've seen so far in the first half of the year, we have not seen the sell-throughs that we had anticipated. And consequently, the door expansion has not been as robust as we had anticipated going in. So we're mindful of that and we've tempered our expectations for the back half of the year. Now just to support, we feel -- continue to feel very good about the program going forward. We've got a lot of opportunity. We're going to end the year with 14 brands on the platform. We're going to have roughly double the door count we have. And as we said in our prepared remarks, with the support of our partners, we should be increasing by 60% the amount of marketing investment that we're making to support that. So of a lot of -- and Greg can talk about the improvements that we've seen in the product and the slickness and the smaller size with a lot of improvements. But so far, for the first half, we didn't see the productivity gains that we were hoping to see.

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

Yes, and I'd make 2 additional observations. The first is, this is a matter of versus expectations. So we're a company that for the first year really had -- or for the first time, really, are coming off of a big quarter in a wearables. We've now got a meaningful business. Our ability to then project and forecast what the first half of the year is going to look like with end-of-life product is proving to be where we've got a lot of work to be done there. And then sell-through is going to be a function of product, price and marketing primarily. And in all 3 of those dimensions, we've got a lot of learnings about end-of-life products. So at this point, we've got a product that's still too large for a female customer. We still kept the price even though a lot of the -- particularly on Kors, it's an end-of-life product. We kept it largely as a full-price business this year and we really pushed all of our marketing to the back half. So we, as a result, had some implications on sell-through. But on all 3 of those dimensions, it really sets up well for the back half. So dramatically improved products, sharp price points, some pretty incredible marketing and a lot of marketing support to go with increased distribution. So it's setting up well.

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

And I would just add that this is the biggest product initiative we've ever had as a company. We have exciting new products across most of our brands all across the world. The products are slimmer, the battery life is better, better software, brighter screens. One thing we've clearly noticed, both through our own analytics and also anecdotally is this is a female customer buying wearables. That's our customer. We're in the right place with the right brands. We do have globally our entire organization from sales and visually more excitingly designs, software development or factory brand teams, every single part of the company has gone to every nook and cranny to distort this across our entire platform. To me, it's the most exciting product initiatives we've ever done. The most different, we do have a great retail partners all over the world that are ready for this and excited about it. We do have a lot of support from our brand partners and they're all getting behind it. We are in a position now where wearables in our -- basically our second year will be 14%, 15% of our company and, in some brands, 25% or more. And we're in a great position, we think, to change the direction of our overall wrist business by adding technology. We think the best way to mitigate the declines we've had is to have a toolkit that includes both traditional watches and technology toolkit. We're in that position so we'll be able to follow a customer wherever they go.

Operator

And from Evercore ISI, we have Omar Saad.

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

Best of luck, Dennis. I wanted to ask about the dramatically improved product, Kosta, that you were just alluding to. Maybe can you dive into deeper details? Is it just the waterproofing and heart rate monitor and smaller battery size? And how do you communicate -- how are you going to communicate? How are those marketing dollars going to be spent in the back half? How do you get that message across to consumers and really kind of turn the tide a little bit here and get some momentum in your business? Yes, more details around that and kind of the cadence of how it'll flow would be really helpful.

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

Sure. On dramatically improved product, I think sometimes the basics are what matter most here. Right now our products are too big for female customers, and female customers are our core. 70% of our traditional watch businesses is the females. Whether it's hybrids or it's display watch, they're just simply too big, both in diameter and in thickness. And that is where the single-most dramatic improvement is going to be is we're just going to have a product that looks better, it feels better and allows for much better branding and design, and that's in both categories. We're seeing the early effect of that on hybrids with Fossil and Skagen with the Fossil SLIMLINE, the slim watch that we launched in April this year, same with Skagen, really good response, pretty dramatic improvement in both the female penetration of the product and the overall mix in our business. And we then are launching another hybrid that allows us to get to much smaller diameter in October, and that's -- both of those platforms will be driving over the next year across the majority of our brands. So you'll see pretty dramatic shift to female penetration and female-friendly product back half of this year and then all through next year. With -- for display, same thing. We have a much smaller-sized 1.2-inch female display that's also dramatically thinner versus product that on the market right now, and that will go across Fossil and Michael Kors. These products are already approved by Google through techno approval and are starting to ship now. So they'll be in stores pretty quickly here, so we are on track with all of those. And then as we go into next year, we'll have 5 brands on display this year. We will continue to push that agenda and get in many more brands as we go through next year on those same platforms.

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

And sorry. On the communications side, how you get the word out? How are you going to kind of change the marketing strategies to make sure you're getting to the right consumers and they understand the product and features and benefits?

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

Yes. Well, most of the programs in advertising are social media, influencer base, celebrity, video, we had -- I think as we mentioned before with Fossil, we had our Kristen Bell video talking about hybrids that resonated and went somewhat viral, and we have people coming to our stores asking for the Kristen Bell watch. So a lot of our efforts more than ever before are really focused on social media influencers, celebrity, mobile, and we're going to see that not just in the U.S. but global. And it's not just ours but one of the benefits we have is our partners, our brand partners from Kors, Armani and others they have, obviously, big marketing and PR machines with a huge amount of capability are putting behind their products that are launching in wearables. They're putting a huge amount of effort behind it. It's going to be big in their stores and in their social media campaign. It's one of the most significant launches we've ever had as a company, if not the most, from all of our brand partners and ourselves. So it's a full court press to really communicate how these products are different and what they do and how they look different, what the functionality is. There's also a big focus now and ongoing on the software capabilities. The Kors watch has social capabilities, et cetera, that are very unique. So it's not just selling a product but there's technology inside that enables us to engage consumers with software in new ways that they can engage with brands and new ways that's never been done before. So we're not just selling things that tell time. These are ongoing engagement tools. I think one of the examples is just you can, obviously, change your dials on the display smartwatch, and we're seeing literally millions of dial changes going on every month across consumers that have already bought the products. We do have the capability and we're doing this -- downloading new dial designs or new ideas to -- the branded products that people bought either recently or some time ago. So it's not just products but it's -- you have a full line engagement with social media viral and other techniques, including downloading right to the watch.

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

I would also -- just to reemphasize again, just total -- just the amount of spend is up significantly and then the use of celebrity is more than ever. So you've heard Kristen Bell for Fossil, but they've got 3 other major celebrity influencers. Shawn Mendes was just announced as the celebrity endorser for the Emporio Armani watch, and there's more to come.

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

And we also have in Fossil -- this is unique for us to use celebrities and influencers but we also have both Korean and some European celebrities and influencers, too, for the first time, and we're very interested in what impact that could have on our trajectory of wearables but also on the business. So a lot of new activities going on for us.

Operator

And from Wells Fargo, we have Ike Boruchow.

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

Just it sounds like you guys have done -- made some improvements on the wearables in the cost side, on the margin side. Can you just tell us what the spread looks like right now between your traditional watch gross margin and your wearable gross margin and then where you think that can get to maybe as you move into next year if you continue to gain traction?

Dennis R. Secor ***Fossil Group, Inc. - CFO, Executive VP & Treasurer***

Yes, sure. So we said at the beginning of the year that relative to last year on our connected products, we were in the mid-40%, and we said, this year, we were taking roughly a 10 point investment in those connected margins to drive the volumes. So then that becomes a currency to work with our suppliers and really, get those -- leverage our -- that volume and get those costs down. We did say coming out of the first quarter that we had made farther -- further progress on that than we had anticipated. The same holds true for the second quarter. We didn't share the numbers for the second quarter, but they're significantly ahead of what we had expected to be at, at this point. I think we need to -- as Greg alluded, we're learning about end-of-life products and how to manage the full cycle. So we don't want to get ahead of our skis right now but certainly, relative to where we had expected to be at this point, we are ahead of the game.

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

And I'd just add, we are just relentlessly pursuing getting to the point where our wearable dollar gross margin per unit are equal to traditional watch. The minute we get to that point and we're driving growth through wearables, we're in a really good spot. That's where we're moving to and believe we have line of sight to get to.

Operator

And next from Nomura, we have Simeon Siegel.

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

I believe -- I could be wrong. I believe Kors today mentioned some commentary suggesting that the wearable gains essentially plugged the gap from the traditional declines. Do you have any opinion when you think you find the bottom for the overall Kors business driven by the wearables strength? And then just thanks for the comments on the cap structure. Can you talk about any cash flow stress test you may have done regarding the liquidity and covenants looking further out into next year? Just if you can to talk to the comfort you have in your capital levels as sales do continue to decline.

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

Yes. Both Kors and Fossil, where we have the most penetration in wearables, we've seen at least a 10% comp difference when we have wearables versus when we don't. So it's mitigated the declines in both Kors and Fossil. And with the significant launch that we have for the back half of the year and significant sales, the percentage of the Kors and Fossil business, for example, that is wearables is going to be larger. And we think that, over time, we can mitigate declines with wearables. I mean, we're clearly on that path, and it could potentially happen by the end of this year.

Dennis R. Secor ***Fossil Group, Inc. - CFO, Executive VP & Treasurer***

With respect to the cap structure, we said on the last call -- I mean, we shared some of the stress testing that we did for the third quarter on the call, and the third quarter traditionally is our -- the pressure point for us for a year. I mean, generally, our cash flow is sort of moderate in the first 3 quarters, tend to grow in the third quarter And then the fourth quarter, of course, is a very strong cash generation quarter. So we see this year continuing to play out that way. So we've done a number of stress tests on the third quarter. We still think, for the full year, as we said on the call, that we can -- at the upper end of our range, we can generate roughly similar levels of free cash flow this year as we did last year. Obviously earnings will be down. We've got a little bit more restructuring, and there's some pressure with the higher interest rate now that we've amended our facilities. But significant -- significantly offsetting those are taxes. Our CapEx is lower, and the whole management team here is really focused on working cap, optimizing our use of working cap. So that continues. As we also said the last time, one of our goals is to diversify our capital structure. All of our debt right now is provided by banks, and that puts us in a situation where our access to debt right now is really a function of our most recent 12 months EBITDA. So our goal is to diversify and get some additional tenor, and we're working hard on that.

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

And then if I can, just a quick clarification. Could you help quantify what the revenue impact to '18 should be from the expiration of the adidas and Burberry licenses?

Dennis R. Secor ***Fossil Group, Inc. - CFO, Executive VP & Treasurer***

We haven't specifically -- it's a fairly small, I mean, single-digit -- low single-digit kind of number.

Operator

And from Jefferies, we have Randy Konik.

Randal J. Konik ***Jefferies LLC, Research Division - Equity Analyst***

I guess, just a couple questions. Just can you parse out the -- maybe the differences, if at all, between the sell-in and more importantly, the sell-through of the smart products between Fossil brand and Kors brand? I guess, the reason I'm asking that is as we embark on a massive increase in SKU count and adding more and more brands, I want to try and get a thought process on how you're thinking about pricing architecture of the different brands within the smart products but also, like, how do you think about inventory allocations across those brands because I want to try and get a sense of is the thirst for the technology all there. Or is there more of a thirst between the technology plus a certain brand or versus one versus the other? I'm trying to get some perspective on that kind of thought process right there.

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

Well, first, talking about Fossil. So where it's performing the best is in our own stores, where we have the full presentation and the full training, et cetera. So we're seeing that do very well in our own stores. And I think that Kors is seeing the same thing in their stores, where the absolute best presentation of the brands are. As far as how it's doing in other channels, it's doing -- obviously, Kors at a higher average retail, most of that's been regular prices, sold through very well and continues to. We're expecting with the new products coming out for fall that, that will accelerate quite a bit. That's doing very well. We have, as you noticed, have been trying to test and find the right kind of tipping point price point in Fossil. So we've done a lot of testing. Largely, as we mentioned before, we're trying to get significant volume to get our cost down, so we can have a much larger business. We wanted to do this quickly. We don't want to wait a number of years. We're trying to find out and identify how we can get to scale as quick as possible so that we can both have a larger communication voice. We get these on wrists, get people talking about them. We clearly know already there's a viral aspect to this. And once people see other people wearing it and asking about it, then it'll go viral. And I think that, that's part of it. We have seen, as we mentioned before, most of this display -- most of the watch business, the wearables we're doing right now are display smartwatches. But we are seeing we're getting more and more hybrids out there, and people are talking about them, wearing it. Especially in our own stores, we're seeing that start to get sparks and sell-through also. And then we're just now getting out there a number of new brands in the fall. The one thing that you just can't underestimate is the fact that the products are much slimmer, more elegant, better features and functions. So it's a really big step change for the products that are launching right now. So we're going to obviously learn a lot. We're going to -- we've learned a lot so far in the last year or so about what works and what doesn't, price points, et cetera. In the next 4 months, 5 months, we're going to learn a lot more, and by the end of the year, we'll have a -- we'll be able to answer your question much better as to exactly what works and what doesn't and how it goes. But a lot of stuff flowing the next couple of months. It's actually -- most of it's already en route to us. We've got the early production actually being shipped to us right now across the platform, and we'll be testing in a number of locations over the next month. And the big launches are in September.

Randal J. Konik ***Jefferies LLC, Research Division - Equity Analyst***

Got it. And can I ask one more follow-up? How do you think about -- obviously, we're in this consumer world where consumers are expecting the next iPhone. And look, for ex iPhones and ex phones, I guess, we've been -- technology-based products typically tend to be deflationary in their life cycles, so the price points go down as people expect new technology. The prices start up and then fall like a waterfall. So I guess, your traditional watch business, I feel like, has been more of a stable price point business, different prices for different brands, Tory Burch versus Fossil versus Kors, et cetera. So how do you guys think about managing pricing architecture and technology obsolescence in the different platforms as we go on in different life cycle duration for these products going forward in the smart category versus the traditional watch category, how you've managed it in the past?

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

Yes, great question. Very different for each category. So for hybrids, think of this as we're just adding function to watches with beautiful designs like we have in our history, and those costs are coming down dramatically. And we're actually driving them down so that the costs themselves are not much greater than the watch movement. We anticipate being there relatively soon. Think of those modules as evergreen, meaning they're not going to come in and out of the line with dramatic technology improvement year-over-year. So those are -- you don't have that same obsolescence cycle. In smartwatches, you do, and that is part of the business model that we need to manage and that we're learning from. We're at a point right now where we're early enough in the technology cycle where the costs per unit are still really high. And that's what we're working our way through, is getting the right sweet spot price point to drive big volume to then set up the supply side model the way we need to. We've done that work. And we're starting to benefit from that now and we're working through that next year. So we're feeling like the costs will come down to the point where branding and design, ultimately -- as commodity increasingly commoditize, branding design will ultimately win and drive accretive margins. And so we just got to let those costs come down. That said, we will always have this end-of-life upgrades and upgrade cycle, right? The -- but it's a blessing and a curse. We got to manage end of life, but you now have a built-in upgrade cycle for the smartwatch category that we didn't have in our traditional business.

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

I would just add, we are seeing, where we've done tests, significant demand in the off-price channel, both our own outlet stores as well as the off-price channel where we've done some tests. So there's clearly demand on that side as well.

Operator

And next from Piper Jaffray, we have Erinn Murphy.

Erinn Elisabeth Murphy ***Piper Jaffray Companies, Research Division - MD and Senior Research Analyst***

And Dennis, all the best.

Dennis R. Secor ***Fossil Group, Inc. - CFO, Executive VP & Treasurer***

Thank you.

Erinn Elisabeth Murphy ***Piper Jaffray Companies, Research Division - MD and Senior Research Analyst***

I guess, I had a clarification to a response you had to a prior question. I think, Dennis, you said that the plan is to double the door count for wearables by year-end. Can you just quantify what the door count increase was for wearables in the first half just to give us some context there? And then, I guess, secondly, if I run the math on the traditional watch business in the first half, it was tracking down about 18%, 19%. What is implied in your second half guide?

Dennis R. Secor ***Fossil Group, Inc. - CFO, Executive VP & Treasurer***

Yes. So no, when -- just to clarify, the -- when I -- we talk about doubling the door count. That's really a year-end to year-end concept. So we're going to -- as we said, at the end of the first half, we're at about 8,500, and we should expect to add about 3,000 doors for the -- by -- between now and the end of the year. With respect to the traditional watch trends, you -- those trends are about where you have them pegged, and our expectations are within the range of our guidance that those trends generally continue. Obviously, there's a range we have. You spotted some trends that we've gotten behind that we are expecting to see some improvement in those trends on the upper end. In the lower end, you don't see that. But generally, our view is that -- our expectations are that we don't see a significant fall-off between now and the end of the year in the traditional trends.

Erinn Elisabeth Murphy ***Piper Jaffray Companies, Research Division - MD and Senior Research Analyst***

Got it. So truly the acceleration, if I just look at the back half, it's coming from that incremental lift in wearables in the third and fourth quarter.

Dennis R. Secor ***Fossil Group, Inc. - CFO, Executive VP & Treasurer***

That's right. That's the growth. If you look at the third quarter, the lower end of our guidance is somewhat in line with what we've been doing in the first half. So the ability to improve modestly on that comes from wearables, although most of that product lands in the -- towards the end of the third quarter. And then the opportunity for growth is -- really sits with our ability to execute the wearables strategy for the fourth quarter.

Erinn Elisabeth Murphy ***Piper Jaffray Companies, Research Division - MD and Senior Research Analyst***

Okay. Why has the uptick in the consumer electronics channel been a lot slower than you anticipated?

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

Well, part of that was as we got into, we learned that, that channel works a little bit differently. They don't do floor sets as frequently as department stores or other stores. They tend to do it less frequently. So part of it is was just that, and part of it was just not understanding how everything worked globally. But we are, -- over the next several months, we're adding literally thousands more doors and including the websites, which seem to do a lot of the business on the wearable channel also. But I think, as usual, it's just our, I think, our lack of our understanding exactly how that channel works, but we're catching up quick.

Operator

And next from Telsey Advisory Group, we have Dana Telsey.

Dennis R. Secor ***Fossil Group, Inc. - CFO, Executive VP & Treasurer***

Dana, you may be on mute if you're talking.

Eric Cerny

We'll take the next question, operator.

Operator

It looks like Dana Telsey has a second line in.

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

Can you hear me?

Dennis R. Secor ***Fossil Group, Inc. - CFO, Executive VP & Treasurer***

Now we can.

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

Oh, good. Best of luck, Dennis. As you're thinking about the store footprint and wholesale exposure, what is your longer-term thoughts on what the portfolio should look like both in terms of number of stores, by outlet full price, what the wholesale exposure should look like? What should the business be comprised of?

Dennis R. Secor ***Fossil Group, Inc. - CFO, Executive VP & Treasurer***

I mean, I would start with what you've already been seeing and what we've been investing behind and frankly, uninvesting behind. Over the last couple of years, we have been slow in our store growth, and now we are actually reducing the store count both by getting out of some stores early and investing in that and then others, letting them run a natural -- until natural lease expiration. So as we look forward, I think that continues and we see a consumer continues to shop online. We've, over the last several years, invested heavily in building our omni-channel platform. So the way we see that, we see that evolution is continuing over time, and that's where we're investing.

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

Got it. And as you think about the store portfolio, both outlets and full lines, how do you think the -- what's the ultimate number of stores space?

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

Well, we don't know yet, but we're working on doing some testing, for example, potentially in some smaller stores, using our CRM as a tool to capture a broader customer base. We are looking at right now just what the outlet channel looks like and how it's progressing. We have seen difficult traffic in that environment, if you can imagine, over the last several months, and we're looking to see what the optimum number of stores is both on the outlet channel and the regular price and how the footprint looks based on the new reality, which is e-commerce growing very quickly and including in our channels, our own e-com site but also our partner's. And of course, there's pure play. Globally, that's impacting also that we're getting very strong traction in. So basically, I think, over the next several years, everything is going to change in terms of what our footprint looks like. We obviously are penetrating the CE channel as well. So a lot of things in flux right now and we'll see how it plays out.

Operator

And there are no further questions at this time. I would now like to turn the call back over to our CEO and Chairman, Kosta Kartsotis.

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

In closing, we would like to tip our hats to Dennis and to say thanks. And thanks to all of you for joining us today. Our next call will be in early November. Have a good evening.