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PRESENTATION

Operator

Welcome to the Q2 2019 Fossil Group Incorporated Earnings Conference Call. My name is Adrienne, and I'll be your operator for today's call. (Operator Instructions) Please note this conference is being recorded.

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

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

Good afternoon, everyone. Thank you for joining us, and welcome to Fossil Group's Second Quarter 2019 Earnings Conference Call. I would like to remind you that information available during this conference call contains forward-looking information and actual results could differ materially from those that will be discussed during the call.

Fossil Group's policy on forward-looking statements and additional information concerning a number of factors that could cause actual results to differ materially from such statements is readily available in our Form 8-K and 10-Q reports filed with the SEC.

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

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

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

Good afternoon, everyone, and thanks for joining our call today. I will begin with a few prepared remarks and then turn the call over to Jeff Boyer to provide a financial update. Following Jeff's comments, we'll have Greg McKelvey join us for the Q&A.

Second quarter sales performance was in line with our expectations with Q2 adjusted operating income near the high end of our guidance. Though top line sales trends remain challenging, we're making solid progress on our key strategic initiatives such as our China and India growth plans, our direct to consumer expansion, our connected product performance, and our investment in more advanced e-commerce and marketing cloud platforms. As we commented previously, the watch and accessories business is evolving as consumer shopping patterns continue to shift. Those dynamics, particularly in our wholesale channels continue to pressure our core sales, which declined in high single digits in the quarter. While we're not pleased with our overall sales results, we are seeing some underlying positive signs in parts of the business.

Overall, the contraction in our core sales in the second quarter improved 4 percentage points sequentially from the first quarter. Our Asia business continues to perform well and deliver double-digit core sales growth in the quarter with both China and India, posting strong double-digit growth. Fossil full price retail comps, which include Fossil brand full price retail stores and our own e-commerce sites were roughly flat for the quarter.

Our connected business as expected declined slightly in the quarter, due to higher liquidation levels last year, which were not repeated. But within the overall connected results, our newest generation display smartwatch product continues to resonate well with consumers and grew double-digits in the quarter. In addition, our New World Fossil program continues to drive meaningful improvements to profitability both on our gross margin and in the cost structure. Gross margin for the quarter was in line with our expectation and expanded year-over-year excluding the negative impact of currency. Total SG&A expenses, including $7 million of restructuring expenses declined 15% versus last year. Overall, adjusted operating income for the quarter was $9 million, which was near the high end of our guidance.

Earlier in the year, we shared 4 overarching priorities, improving our overall profitability, driving product innovation, maximizing top line growth, and transforming our business model. Our most critical goals are to change the trajectory of our sales, while also transforming the company to unlock significant growth in the future. While we remain focused on profitability, delivering exciting new product innovations and engaging consumers in unique and creative ways is essential in this disruptive environment.

Innovation remains at the core of our business and we're excited about the new products that will be hitting the market this Fall and holiday across our portfolio of brands. Within the Connected category, we continue to expand on our lineup of great products with a focus on fashion, functionality, and wellness features. Our fashion display smartwatches continue to resonate well with consumers and the designs continue to advance as we move into the most important selling season of the year.

In addition, the underlying technology is expanding even more with our Gen 5 product. We are continuing to improve functionality and are introducing smartwatches with much improved chipsets, extended battery life, and speaker capabilities to better support Google Assistant. They also have an enhanced proprietary interface for iOS users, which gives us the capability for tailored calls for iPhones in addition to Android phones. These new technology enhancements combined with exciting new fashion designs will build on our current successful Gen 4 product and provide even more smartwatch functionality for nearly all consumers regardless of their phone choice.

In addition to the fashion segment, we're moving aggressively to maximize the opportunity within the sports segment of smartwatches. Last holiday, we had a very successful test with our Fossil Sport product. Based on the success, we are expanding the Sport offering across other brands as consumers increasingly are focused on wellness as well as connectivity. This product maintains the most important smartwatch features while using design elements and materials to support our customer's active lifestyle.

Within the traditional category, our teams are launching exciting new products based on trends we're seeing in the marketplace including brighter colors, new materials and updated design concepts. We're also continuing to expand our use of limited editions and exclusives across all our brands. Consumers are responding more to innovation and personalization and our teams will deliver on this in the back half of the year.

Our new e-commerce and marketing technology platform is also expected to launch in the third quarter and will greatly enhance our ability to drive more consumer engagement with all of our products. This platform provides better insights and tools to reach customers in a more targeted manner across both direct and wholesale channels. We also continue to see great consumer response to our digital marketing initiatives and these new tools will only accelerate our ability to reach the customer directly.

Our ongoing company transformation also remains a critical priority. New World Fossil 1.0 will be completed in 2019, and we will have delivered $200 million of run rate profitability improvements over a 3-year period. The program has been critical to our ability to improve profitability while also funding investments such as digital marketing capabilities and product innovation. We're quite proud of our teams all over the globe for their tremendous efforts to deliver New World Fossil 1.0.

As we mentioned on our last call, our New World Fossil 2.0 - Transform to Grow program will be even more critical to our ability to invest in the business and improve profitability. As disruption continues across retail and consumer shopping behavior evolves, there are significant opportunities to capture market share in the growing watch market. Capitalizing on those market share opportunities will require investments and a reallocation of resources, which we will fund through New World Fossil 2.0. Within the New World Fossil 2.0 program, we see significant opportunities to drive value within our revenue management, procurement and supply chain processes. We're also taking a zero-based budgeting approach across the company in order to rework our business model and create organization and operational efficiencies.

All these enhancements will allow us to invest more in DTC and digital capabilities, while streamlining our model to move closer to the consumer and to react more quickly to trends. There is much work still ahead of us with this program, but the initial work streams continue to indicate a potential for significant profit improvement and are generally consistent with the level we achieved in the first phase.

In closing, while second quarter operating profits were at the higher end of our expectations and sales improved sequentially, we remain unsatisfied with our sales performance. Our most critical mission is to change our overall sales trend while continuing to improve profitability. The entire company is focused on delivering exciting product innovation across our portfolio of brands and accelerating our DTC and digital capabilities. We are also highly focused on transforming the company to unlock our significant potential for future growth.

And now I'll turn the call over to Jeff.

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

Thanks, Kosta, and good afternoon, everyone. As Kosta mentioned, stabilizing sales trends is critically important for us. At the same time, we remain highly focused on improving our profitability and strength in our balance sheet. We continue to make solid progress on each of these objectives. The top line performance remains challenging, sales trends did show improvement relative to the last 2 quarters and these trends are expected to continue. Our adjusted operating income approached the high end of our guidance and our balance sheet is much improved over the same time last year.

For the second quarter, we reported a net loss of $7 million compared to a net loss of $8 million last year. Our reported loss of $0.15 per diluted share included New World Fossil restructuring charges of $0.11 per diluted share. Last year, our second quarter EPS was a loss of $0.16 and included restructuring charges of $0.23 and non-cash intangible asset impairment charges of $0.10 per diluted share.

Currencies including both the translation impact on operating earnings and the impact of foreign currency hedging contracts had an unfavorable $0.06 impact on our EPS in the second quarter. Sales decreased 13% to $501 million and decreased 11% on a constant currency basis, an improvement of 4 percentage points over sales trends in the first quarter. Second quarter sales results were negatively impacted by store closures, less off-price and liquidation sales this year and licensed brand exits. Excluding store closures and business exits, our core sales declined high single-digits primarily driven by lower sales in our wholesale and off-price channels.

Asia wholesale increased double digits driven mainly by emerging markets in China and India. While our Asia business is quickly gaining scale, the gains are not yet big enough to overcome the continued challenges in our wholesale business in our mature markets in Americas and Europe.

Our direct business, while continuing to contract mainly due to store closures, improved to a moderate single-digit decline as compared to a double-digit decline in the first quarter. We closed 51 stores since the second quarter of last year and ended the quarter with 456 stores. Overall, retail comp sales decreased 4% as positive e-commerce comps were more than offset by comp declines in our retail stores.

Our watch business declined 8% in constant currency for the quarter, with traditional watch sales improving from a double-digit decline in the past several quarters to a high single-digit decline this quarter. Connected sales decreased moderate during the second quarter, largely due to the reduced liquidation levels as compared to last year. Fossil connected watches grew modestly despite these challenges. For all brands, excluding the negative impacts of prior liquidations, sales of newer generation connected display of products increased over 20% during the quarter. Our connected watch business delivered $85 million in sales, representing 21% of total watch sales for the second quarter.

In the Americas, second quarter sales decreased 20% on a reported basis to $223 million, improving from a 24% decrease in the first quarter. The sequential improvement was driven by improving retail performance, traction on our third-party e-commerce strategy shift, and lessening the impact of last year's liquidations, inter department store channels, partially offset by lower sales in our off-price channels. Comp store improvements and e-commerce growth drove the improved retail performance.

In Europe, reported sales decreased 16% to $147 million. On a constant dollar basis, sales declined 12%, improving from a 19% decrease in the first quarter. EMEA core sales, excluding business access and store closures, contracted high single digits versus the same quarter last year, an improvement from Q1's double-digit core sales decline. Across the Eurozone, sales were down in most major markets with the greatest decline in the U.K., in distributor markets and in Germany, while Italy sales increased modestly. While sales contracted in Germany during the second quarter, sales performance improved double digits on a sequential basis driven by improvements in the wholesale channel.

In Asia, we reported sales increased 4% on $126 million of sales and on a constant currency basis increased 9% driven by the wholesale channel. Excluding store closures and business exits, our underlying core sales in Asia grew low double digits.

The Emporio Armani traditional watches posted strong double-digit growth while Fossil watches increased moderately with sales growth in both the connected and traditional watch categories. Strong growth momentum continued in China and in India primarily driven by third-party e-com and wholesale growth. Hong Kong also posted positive results.

Gross profit decreased to $265 million and gross margin decreased 70 basis points to 52.9%. The gross margin contraction was primarily driven by an unfavorable currency impact of approximately 90 basis points. In addition, factory cost absorption and royalty costs and lower sales volumes increased product costs. These additional costs were offset by favorable region and product mix from higher margin Asia sales, benefits from our New World Fossil initiatives and decreased off-price sales mix with improved margins.

On a reported basis, second quarter operating expenses were $263 million, including $7 million in restructuring costs. Last year, operating expenses were $308 million and included $15 million in restructuring costs and $6 million in non-cash intangible asset impairment charges. Excluding restructuring and non-cash intangible asset impairment charges, operating expenses decreased $31 million in the second quarter as compared to the prior year and included a $7 million favorable currency impact. Lower expenses in the second quarter resulted from lower store expenses, given the significant number of stores we closed since last year, corporate and regional infrastructure reductions driven by our New World Fossil initiatives, and the currency effects of a stronger dollar.

Our second quarter operating income was $2 million compared to $1 million a year ago. Interest expense decreased $4 million to $7 million on lower outstanding debt. Second quarter other income of $1 million was favorable to last year, mainly due to more favorable transactional currency gains and losses this year. Income tax expenses were approximately $1 million in the second quarter and pre-tax losses of $5 million. The resulting negative effective tax rate was driven mainly by the recognition of deferred tax asset valuation allowances and an unfavorable impact from the GILTI provisions of the Tax Cuts and Jobs Act. Income tax benefits in the prior year were $3 million and pre-tax losses of $11 million. We continue to establish valuation allowances on our deferred tax assets in the U.S. and certain international subsidiaries given our operating losses in those jurisdictions, thereby increasing our effective tax rate.

Regarding GILTI, the mechanics of the GILTI provision effectively result in double taxes on some of our foreign income. We're pleased with our continued progress, strengthening the balance sheet as we improved our net debt position by more than $150 million from a year ago. We have almost 0 net debt with debt levels down to $228 million and cash of $227 million and we continue to maintain a low bank leverage ratio. Our adjusted EBITDA for the quarter was $31 million, resulting in trailing 12 month adjusted EBITDA of $218 million and our bank leverage ratio was 1.1 times.

Now turning to our 2019 outlook. We have adjusted our guidance for the third and fourth quarters to reflect the strengthening of the dollar, while also adjusting our full year guidance for actual results in the second quarter. We expect full year sales to range from a decline of 12% to a decline of 8%. The sales range includes approximately 250 basis points of headwinds from store closures and business exits and 200 basis points of headwind from changes in foreign currency exchange rates, which is a 50 basis point increase in the full year currency headwind.

Operating margins for the fiscal year are expected to range from 2.5% to 3.5%. Excluding restructuring charges, which we expect to range from $33 million to $37 million, adjusted operating margin is expected to range from 4% to 5%. Given the recent strengthening of the U.S. dollar, we have adjusted our foreign currency rate assumptions for the euro and the British pound, 2 of the currencies most impactful to our results, our guidance now uses prevailing rates of $1.11 and $1.22, respectfully.

We expect capital expenditures of approximately $30 million. You can refer to today's press release for our guidance and additional financial metrics, including specific expectations for the third and fourth quarters. Excluded from our current guidance is the potential impact of a 10% tariff charge for list for items under Section 301. List for items would primarily impact smartwatches, but may also include certain components of traditional watches based on a recent letter ruling. The estimated gross exposure from an additional 10% tariff, which could be recognized in the second half of this year is approximately $5 million to $10 million, assuming no offsets for price increases, sourcing changes or other additional changes to regulatory rulings which are all currently under review.

Now let me take a moment to provide some additional context relative to our outlook for the remainder of the year, specifically on the top line. As we move into the back half of the year, we are maintaining our generally conservative planning posture given the limited visibility we have as the fashion watch category continues to evolve. That said, as you'll note in our quarterly guidance in our press release, we do expect our third and fourth quarter sales trends to materially improve on a sequential basis relative to our first half results. Currency, business exits, and store closures remain a headwind, but the negative impact of these items lessen as we move into the second half of the year. In addition, the higher liquidation levels in the first half of 2018, which caused tougher comparisons for the first and second quarter of 2019, diminish as we move into the third and fourth quarter.

In the back half, we expect positive sales trends to continue in Asia, strong growth in display watches in Q4 due in part to much improved product availability and solid performance in our direct to consumer business. Our New World Fossil program continues to drive benefits in gross margin and we're also seeing benefits from product, region, and channel mix. These benefits, however, are being offset by negative impact of currency causing gross margins to be relatively flat to last year.

Our New World Fossil program is also continuing to lower operating expenses, which combined with the expense benefit from store closures is expected to deliver meaningful expense reductions for the year and operating expense leverage in the fourth quarter. We remain highly focused on improving our near-term results while also executing against the strategic objectives that Kosta outlined, which provide a platform for sustained growth and profitability.

Now I'd like to turn the call over to the operator for Q&A. Thank you.

QUESTIONS AND ANSWERS

Operator

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

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

I guess first, it sounds like you have some really interesting functionality embedded in the new gen smartwatch. How should we think about the transition from old products to new product kind of what's in the channel? And I know there have been times where the transition in wearables has been a little bit rocky. So I guess, how should we expect this on a map out versus some of the previous transitions?

Gregory A. McKelvey ***Fossil Group, Inc. - Executive VP & Chief Commercial Officer***

Sure. This is Greg. First, I'd like to highlight Gen 5 a bit more and kind of where we see the business going. At the heart of our innovation focus is a dedication to listening to our customers, improving user experience of these products. So it's why we first off focused on fitness and health and wellness device. It's why we've invested in the proprietary iPhone compatibility apps and the battery life apps as well. So we're really proud of the team and the significant leap forward on the products that we just announced and we'll continue to scale across brands as we go through the rest of the year here. We've got now several years under our belts as it relates to bringing products to market and thinking through new generations of product. We think we've done a nice job this year of managing that transition, without getting into the too many specifics. So we are excited about the new products that are coming. And think also that the Gen 4 products that are currently in market still have some staying power as well as a value offering in our line. So we're pretty pleased with the balanced view of the product here that we've got right now in market.

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

Yes, I'll just add also we had our PR launch for Gen 5, Monday, and we've seen a strong response already. We had a significant amount of impressions online, but also we're starting to see on our e-commerce site and in our stores, we're starting to see out of the gates really strong sales there. The product is -- got a lot of advanced features from the last generation and this will continue as we continue to move along over the next couple of years, our products getting better and better, battery life will get better, the functionality will be better, will have more better software and easier to use and everything will get better, they'll get slimmer. As this business, it was $17 billion globally the smartwatch business was last year. In 3 years, it's going to be $33 billion. We're in the game and we're participating and we think we have a very strong future in that business.

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

Great. And shifting quickly to the traditional watch market. I know that you seem like you've added a lot of fashion, you've innovated with some new product. And I think ex close out the results, it seem to be improving normally. I guess how do we think about when you kind of hit the tipping point where either the losses in that business are kind of minimized or you're potentially able to stabilize the traditional watch business?

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

Yes, when we look at the traditional watch business, we actually are doing very well in Asia, obviously, with double-digit growth and it's more of a traditional market. Smartwatches are not as significant over there, but the consumer itself is very active in buying and owning watches and we have a huge runway ahead of us as more and more people join the middle class. They love watches, they love our brands. So we think that's a long-term significant play for traditional watches. We're seeing some improvement in Europe even though it's still not back to where we'd like it to be. The U.S. is where it's very difficult. We think that's being impacted by not only channel shift and disruption in the overall market, but the wearables business in the United States is very, very strong. A lot of that's female, which is mostly our core customers. So it's -- we're going through a difficult challenge on that right now, but having said that, we've got a ton of new product in the market. We're focusing more on men's. We got lot of ideas around exclusives and limited editions and segment and assortments. We're going after the channels aggressively and -- the numbers are obviously less now than they were a year ago. So at some point, this is going to turnaround. We think we're going to be in a position for growth again. And we think we're in a really strong position in terms of the brands we have, our geographic diversity, our strength in Asia, and our design and brand capabilities.

Operator

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

Michael Lawrence Mayo ***Wells Fargo Securities, LLC, Research Division - Senior Analyst***

This is Michael Mayo on for Ike. So in the last call, I think you guys mentioned expectations for positive low single-digit growth in the wearables business for the year, given the positive commentary on Gen 5, I was just wondering if there's any update you can provide on that outlook for the year. And any help with the cadence in the back half, along with any commentary you can provide on how the Michael Kors watch business performed in 2Q?

Gregory A. McKelvey ***Fossil Group, Inc. - Executive VP & Chief Commercial Officer***

On the connected question, given the cadence on it, full year is still going to be a modest growth that we're forecasting overall, low single-digits for the full year and that picking up. We're very encouraged by what we saw with the Gen 5 introduction and we have some new product launches coming on a little bit later on this month as well. So we're really looking for that, but we have that factored into our sales right now, so not looking to take that number up at this point. The Michael Kors watch performance continues to be one of our more challenging brands and it was a very successful fashion brand for a long time for us, it's been cooling off as the women's fashion business has slowed down. It has been down double-digits now for a number of quarters. We've not seen big, big change at this point in time, but we are working hard with the Kors brand to bring newness and innovation, new trends there. We're seeing some elements of the trends hitting, but not enough yet to turn it overall -- turn it around overall.

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

Yes, I was just going to say too. Remember, we had significant supply issues in Q4 and Q1 last year. Liquidation that were sort of having to lap in Q2 as well and we're just working really closely with the Michael Kors boutiques and our wholesale partners around the world to just make sure that all of the newness that's coming in, gets out there in the full distribution so that we can see -- get these products in consumers' hands and see the trend improvement that we expect. We just have to make it happen.

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

The other thing I'd add about Kors is we're seeing improved sell-throughs in our new transitional jewelry assortment and we're expanding that and we think that over the next couple of quarters, we're going to see an improvement there and we think that can mitigate some of the declines we are seeing in watches.

Michael Lawrence Mayo ***Wells Fargo Securities, LLC, Research Division - Senior Analyst***

Okay, that's helpful. And I could just ask one more. As far as the margin guidance goes, it's pretty weighted towards 4Q. So I was just wondering where you guys are seeing the most areas for leverage in the quarter and what's kind of driving the confidence in the holiday quarter?

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

There's really not a major change in the guidance overall. Actually, from a quarterly guidance standpoint, it's actually a little bit less than Q3, which typically happens, it tends to be a little bit more promotional quarter on it. Really, there is no different trends or changes in the underlying drivers on it. Quarter-to-quarter, we are pretty consistent on how to perform, benefits coming from New World Fossil, benefits coming from the regional mix going on. Asia is our strongest region overall, that's been helpful. We've also cut back on our off-price sales and done a better job managing the margin in that business as well, and our retail margins have pretty much stabilized. So I'd -- actually there is no real trend change in that overall from a gross margin quarter-to-quarter this year.

Operator

And that concludes our question-and-answer session. I would now turn the call back over to Jeff Boyer for final remarks.

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

Want to thank everybody for joining us on this. We're really pleased with the progress we're making. As you heard in our comments, our Asia business is growing strongly. We expect that to continue for a number of years. Our most recent generation of connected products are being well received and continue to drive growth. We are moving through some difficult comparisons for most of this year as we move through inventory reduction, liquidation. We're making great progress on our digital and direct to consumer projects and our New World Fossil transformation is really taking shape. So we're really pleased to be able to reaffirm our overall operating guidance this year and we look forward to updating you on our continued progress next – our next call. Thanks.

Operator

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