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Q3 2017 Fossil Group Inc Earnings Call

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PRESENTATION

Operator

Welcome to the Q3 2017 Fossil Group Earnings Conference Call. My name is Richard, 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 Eunice Han, ICR. You may begin.

Eunice Han

Thank you. Good afternoon, everyone. Thank you for joining us, and welcome to Fossil Group's Third 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 8-K and 10-Q reports filed with the SEC. In addition, the company assumes no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise, except as required by law.

Please note that you can find the 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 Investor Relations section of our website. Please note that you may listen to a live webcast and 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. I will begin with a few prepared remarks before turning the call over to Jeff Boyer. Jeff officially joined us on October 16 as our CFO and has been working with Dennis Secor during his transition into the Fossil Group. As you know, Jeff has been a member of our Board of Directors for 10 years, and we are glad to have him join us during this crucial time in the business. His knowledge of our business model and organization has been very beneficial during his first few weeks. Following Jeff's comments, we'll have Greg McKelvey, our Chief Strategy and Digital Officer, join us for the Q&A as well as Dennis Secor.

While our business remains challenging and the retail environment remains in flux, we are pleased to deliver solid third quarter sales and earnings that align with our expectations for the quarter. These numbers reflect the focus and solid execution of our team as we transition our business, bring innovative new products to the market and drive operational efficiencies that can ultimately enhance our profitability.

There continues to be significant work ahead of us, but in the quarter, we made substantial progress against 3 operational objectives: to advance our wearable tech agenda, leverage scale to drive cost out of our supply chain and continue the transformation of our business through our New World Fossil initiative. Beyond our operational efforts, we managed our working capital tightly as we continue to work with our partners to support our longer-term capital requirements.

As we enter the all-important holiday selling period, we are very excited about the potential of our new product launches and their ability to positively impact the business. We remain confident that wearables can be one of the key catalysts that offsets the declines that we've seen in our traditional watch business for some time now and ultimately, turn those headwinds into tailwinds. Response from our customers continues to be strong, and we're very encouraged by the results, particularly from some of our key brands.

While our business is still challenging and the retail environment remains in flux, we drove a sequential improvement in our overall sales trends in the quarter. In watches, sales declined 4% in the quarter, about half the decline rate that we experienced in the first half of the year. We continue to see significant green shoots in the business that give us confidence that the investments we are making are right for the long term.

Wearables already are having a significant impact on the sales trajectory for a number of our key brands. Global Fossil brand watch sales increased modestly in the third quarter, led by solid growth in both Europe and Asia. For each of the last 4 quarters, wearables have consistently improved the sales growth rates for Fossil watches by more than 10 percentage points, and they did so again in the third quarter. The same is true for Michael Kors watches, where wearables have positively impacted growth trends by more than 10 full points going back to the fourth quarter of last year. And for Emporio Armani, where we launched Emporio Armani Connected display watches just this quarter, sales are also up on a year-to-date basis.

Innovation continues to be at the center of what we do, and you will see that with this fall's product launches. Our third generation of wearables product are sleeker and thinner, giving us an even greater opportunity to appeal to our core female customers. These amazing new watches have brighter screens and improved functionality, giving customers the ability to personalize and customize the watch face to their individual preferences.

For Fossil, our Q Venture and Explorist models have already hit the stores, and we are expecting strong performance during the holiday season. These new watches are powered by Google's Android Wear 2.0, which adds a host of new features like fitness and stand-alone apps. We're supporting these new products with celebrity influencer campaigns to meet the wearable customer where they shop and where they interact with brands, in the digital and social space.

In Michael Kors, we recently launched Sofie, our next-generation display watch in the Kors boutiques, and the initial response has been very strong. We expanded the launch across all our distribution channels in late September to a strong response. And if the trends continued, the Sofie is on pace to be our #1 wearable style.

We launched 2 more brands on to our wearables platform, Emporio Armani and Diesel, both late in September, and the responses thus far exceeded our expectations. We recently launched our Misfit Vapor smartwatch, which has heart rate and swim-proof functionality, and it is selling extremely well right out of the box. This gives us a total of 5 brands on our display platform.

On hybrids, we're launching 5 more brands with the introductions of Tory Burch, DKNY, Marc Jacobs, Michele and Relic, which will bring us to a total of 14 brands in wearables and support our goal this year to at least double the wearables business we delivered in 2016. We're excited about these amazing new products, and we're committed to creating awareness and buzz around them to drive sales.

To communicate these new product launches, we are using celebrity influencer campaigns across multiple brands that are more significant than anything we've ever done before. We're getting behind these launches with significant increases in marketing. Among ourselves and our partners, we're adding more than $20 million of additional marketing support beyond last year's fourth quarter levels to drive awareness in these fashion-first tech accessories, educate customers on the features of these new products and to drive traffic to the stores and our e-com sites.

Another of our key focus areas has been to leverage our considerable scale in wearables to drive supply chain efficiencies, reduce cost and improve margins. Our strategy this year has been to drive significant volume in wearables to get these amazing products on as many wrists as quickly as we can and to leverage that volume to drive cost efficiencies. We're creating products that consumers have never seen before, fashion-branded connected devices, so gauging consumer responsiveness and demand with little history has been challenging. Our plan this year was to invest roughly 10 points of connected margins in an effort to gain scale. So far for the first 3 quarters of this year, we have tripled our connected business for the same period last year, an impressive growth rate, and we're extremely proud of that. But we're still short of the aggressive goals we set for ourselves. As a result, we're carrying more inventory than we planned, and we are working on selling that product through. That created some margin pressure as we set up reserves in the third quarter, and Jeff will provide some color on that.

However, more important to note is that we are actually exceeding our connected cost goals, delivering better initial margins than we had planned going into the year. We believe that bodes very well for the future. As we move into next year, our inventory planning will be informed by what we have learned this year about the customer's responsiveness to our products and the effectiveness of our marketing. As we better align our inventory buys with demand, we believe that the progress we've made this year in our supply chain will set us up to quickly improve our connected margins and deliver our longer-term margin goals.

As to New World Fossil, we're making excellent progress on this comprehensive program to reinvent the company, drive efficiencies throughout the organization, streamline the way we work, enhance our margins with a focus on the customer and ultimately drive significant profit to the bottom line. Our goal continues to be to build 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. We set a strong target when we launched the program last year to drive $200 million of profit improvements in the near term, and we're well on our way to delivering that. So far, with our efforts to date, we believe we are more than halfway to that goal and ahead of the schedule we set for ourselves. Most of that should flow through the P&L this year with even greater acceleration of the benefit as we move to 2018.

As to our capital structure, in the third quarter, we also managed our resources and capital tightly. As a management team, we are keenly focused on generating solid cash flows and driving the return for our shareholders. Our goal continues to be to diversify our capital structure beyond our existing bank partners with longer tenors to support our long term strategic objectives. This is particularly challenging right now for retailers, but we are continuing to take the necessary steps to strengthen our financial position. There's a lot of focus on this right now, and Jeff will provide more color in his comments.

In closing, while our performance is still not where we would like, we are confident that we are making progress across the entire enterprise that will ultimately deliver strong and sustainable profitable growth for our shareholders. We remain focused on stabilizing and growing our core watch business with innovation, and we are making solid progress on bringing more brands into our portfolio. We're excited about our fall leathers assortment, and we're beginning to see signs of improvement in that challenging category.

We are also encouraged by the growth we are driving in wearables so far this year. We know the fourth quarter is an important quarter for our businesses, even more so with wearables, and we feel we are in a strong position with improved product, additional brands and a significant increase in marketing to drive the category. And we're committed to delivering our New World Fossil agenda and to continue to gain momentum in expanding our margins.

And with that, I'll turn it over to Jeff.

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

Thanks, Kosta. It's great to be here with you on the call today. I'm excited to officially be on the job in my new role with Fossil. In my first few weeks, I'm very energized by what I'm seeing across the organization and the many opportunities we have in front of us as we work to improve our product offerings, our financial performance and our overall profitability.

Before I cover our financial performance for the quarter, I'd like to share a few key points. First, during a challenging retail environment, we continued to make strong progress on transforming Fossil. This year, we expect our New World Fossil initiative to drive underlying improvement in our product cost as well as significant reductions in our expense structure to the tune of over $100 million this year on a run rate basis. Second, in this environment, we are highly focused on improving our working capital efficiency and overall capital structure. During the past year, we have reduced our net debt by $170 million, reduced our net working capital by $230 million and generated positive cash flow from operations. And third, as we shared with you in the past, we recognize this transformation will take time, but we are making significant progress to evolve our key categories and streamline our business to position us for profitable growth over the long term.

Now turning to our financial results. Third quarter constant currency net sales decreased 8% and on a reported basis decreased 7% to $689 million. Sales exceeded our expectations for the quarter due in part to customers accelerating certain deliveries from the fourth quarter into the third, primarily to take advantage of pending price increases. We estimate that those additional sales favorably impacted the quarter's sales rates by roughly 3 points, and we expect that benefit will largely reverse in the fourth quarter.

Our wearables business, which represented over 10% of total sales, continues to contribute significantly to the overall top line trend and roughly doubled in sales for the third quarter compared to last year.

For the quarter, we reported a net loss of $0.11 per share, including $0.08 resulting from $6 million of New World Fossil restructuring charges. Last year, our third quarter EPS was $0.36 and included $0.22 impact from restructuring charges. The decline compared to last year's EPS, after excluding restructuring charges, was driven by lower sales and gross margin, mainly due to our connected product mix and higher interest expenses, partially offset by lower operating expenses and taxes. Third quarter loss per share was positively impacted by about $0.02 due to changes in foreign currencies.

Our watch business declined 4% in constant currency for the quarter, which represents a significant change in sales trajectory for the quarter as our watch business had been down roughly 8% for each of the preceding 2 quarters. Sales in our traditional watch business, though still down compared to last year, was actually higher than we had anticipated going into the quarter. Most of that relative strength against expectations resulted from customers taking deliveries earlier than initially planned in advance of a price increase on certain styles that took effect at the beginning of Q4. Even without those early deliveries, the traditional business, while still challenging, performed within our overall expectations. Sell-throughs of our traditional watches remained fairly stable in the Americas, though we did experience some declines in trends among certain of our European wholesale partners.

We continue to grow our wearables business, both sequentially and compared to a year ago, delivering $71 million in sales for the quarter, roughly double what we sold in the third quarter of last year. We're continuing to see strong sell-throughs in key display watches, which still represent a significant majority of this quarter's wearables sales.

While we don't expect to achieve the ambitious wearables plans we initially set for this year, the business is favorably impacting our watch business in a material way, an 8-point improvement in the growth rate for the watch category this quarter. And we're achieving that 8-point improvement with more brands still to launch on the platform and largely driven by display watches, where we are taking advantage of increased awareness in this category segment.

Hybrids, where we're having more modest success, will take longer to build the awareness considering there's no significant competition at scale in the market right now.

Total Fossil brand sales declined 7% in constant dollars compared to last year. Effectively all of the decline in the Fossil brand was driven by weakness in our leather and jewelry categories. Fossil brand watch sales increased modestly in the quarter with smartwatches, both display and hybrids, positively impacting the category growth rate by about 11 points. The display watches continue to represent the largest percentage of wearable sales for the Fossil brand, though we are achieving greater success in hybrids with Fossil, where our marketing efforts, store experience and celebrity influencer campaigns are yielding results. With our Fossil Firsts campaign with Kristen Bell, the Fossil Q Accomplice hybrid is now one of our top 10 SKUs in our Fossil watch collection.

Skagen sales declined 12% compared to last year, with growth in Asia that was more than offset by declines primarily in the Americas and in Europe as well. In our retail channel, comp sales declined 6%, representing an improvement in the trends from the first half of the year with traffic declines continuing to be the driver of the trend.

Our leathers business was the most significant drag on comps for the quarter. Our watch performance, both online and in our stores, was very encouraging with comps down only 1%, further demonstrating the impact that wearables is having on the category. E-commerce sales, which are included in comp sales, increased 26% for the quarter.

We're also seeing a change in the trajectory for Michael Kors, where watch sales declined in the single digits for the quarter, with smartwatches positively impacting that rate by more than 10 percentage points.

In the Americas, third quarter sales decreased 15% to $308 million with declines in all 3 product categories. Watches were the biggest driver of decline as continued softness in traditional watches was partially offset by connected watch sales, with our best sales performance continuing to come from Fossil and Michael Kors.

Most brands posted sales declines in the quarter, though we did grow our Emporio Armani watch business with the introduction of Emporio Armani Connected. While both our wholesale and retail businesses declined in the quarter, our retail business was relatively stronger.

In Europe, reported sales increased 2% to $247 million. On a constant dollar basis, sales declined 2%. Sales in Europe did benefit from early deliveries to certain wholesale customers who opted to take shipments earlier than planned given price adjustments, which were required to be announced to customers in advance. Watch sales, both in constant and reported dollars, increased modestly in the quarter, while sales of both leathers and jewelry declined.

We posted watch sales increases in several brands, including Fossil, Emporio Armani, Diesel and Michael Kors. Other brands, including Skagen, posted sales declines. Certain wholesale customers did report that they experienced some deterioration in traditional watch sales within the quarter. We are also gaining traction with our wearables business in the region. We delivered modest sales increases in the U.K. and Poland, while our Middle East business delivered the sharpest sales declines.

In Asia, reported sales were flat with the same period last year at $133 million with no material impact from currencies. Sales of watches increased with connected watches more than offsetting declines in traditional watches. Both leathers and jewelry declined in the quarter, offsetting the growth of watches. Growth in India and China was offset by decline in nearly all other countries within the region.

In the quarter, gross profit decreased to $320 million and gross margin declined 580 basis points to 46.4%, driven primarily by the impact of connected products due to both lower connected margins as well as additional product valuation reserves.

Our 2017 connected strategy was to invest roughly 10 points of connected gross margin this year from the mid-40s connected margin we delivered last year in order to drive greater volumes. And those higher volumes were expected to drive down production costs. So far this year, we tripled our connected sales volumes and are well ahead of the initial cost goals that we set for ourselves this year. However, we haven't hit the aggressive sales goals that we set for ourselves in this new category. Consequently, we are carrying greater levels of connected products that we need to clear and have deferred some receipts into the first quarter of 2018. In the quarter, we recorded a $23 million valuation charge to support our efforts to clear this inventory, which negatively impacted our gross margins by 330 basis points. Excluding this charge, our year-to-date connected margin would have approached 40%. Other significant drivers of our margin compression include ongoing promotional activity in our outlets and online as well as lingering, though diminishing, negative currency impact.

Higher volumes through off-price channels also modestly reduced gross margins in the quarter. Partially offsetting these headwinds was the favorable impact of our New World Fossil initiatives, which favorably impacted our margins by nearly a full point.

Third quarter operating expenses were $320 million, 9% or roughly $33 million lower than the third quarter of last year. This year's expenses included $6 million in restructuring charges, while last year's expenses included $15 million in restructuring costs as well as a $10 million benefit resulting from real estate gains we recorded last year.

Lower expenses this quarter resulted from corporate overhead reductions as well as cost reductions in our regional organizations across the globe. Retail store expenses were also lower given the significant number of stores we have closed since last year. And advertising royalties were also lower given our decline in sales of licensed products.

Our third quarter operating loss was $0.5 million compared to operating income of $31 million a year ago. Third quarter other income increased to $4 million due to greater favorable foreign currency activity. Interest expense increased roughly $5 million to $12 million due to higher interest rates tied to our amended credit agreement. We recorded a $3 million income tax benefit in the quarter compared to a $6 million income tax charge a year ago.

Now turning to our cash flows and balance sheet. We improved our net debt position by roughly $170 million compared to a year ago. We ended the quarter with roughly $167 million in cash compared to $236 million last year, and debt of $485 million compared to $724 million a year ago. We generated operating cash flow of $25 million in the third quarter, which benefited from our effective working capital management and timing of payments, some of which will have an offsetting effect in the fourth quarter.

During the quarter, we invested $5 million in CapEx and continue to expect our capital expenditures will be about $30 million for the full year. Inventory levels at the end of the third quarter were down 2% compared to a year ago. We have successfully reduced our inventories of traditional watches significantly, and we are working to clear the previous generation connected products over the next few quarters.

Accounts receivable decreased by 3% to roughly $311 million and wholesale DSOs increased by 3 days compared to the prior year due to shifts in customer mix. Depreciation and amortization expense totaled $19 million for the quarter.

Now let's move to our outlook. As we look ahead to the fourth quarter, we are adjusting our outlook based on the trends and factors that we observed in the third quarter as well as October. In our traditional watch business, we did meet, in fact, exceed, our sell-in expectations for the third quarter. Those sales did benefit from early shipments against price increases in Europe and some modest levels of additional sell-in to off-price partners. Adjusting for those 2 factors, our third quarter sales were within our range of expectations.

In Europe during the quarter, wholesale sell-throughs remained relatively strong in July, but that trend did diminish in the later half of the quarter. That, coupled with the early sell-in of product, has likely left wholesale channel inventories higher than planned at the end of the quarter in Europe. Therefore, we are adjusting our sell-in expectations in Europe to reflect tighter channel inventories by the end of the fourth quarter.

In addition, sell-throughs in the Americas have been relatively stable and consistent with our expectations. These wholesale sell-throughs, while still negative, were relatively stronger in the third quarter than our sell-in, as our wholesale partners work to reduce their inventories. We now expect that this will continue in the fourth quarter, with retailers accelerating their efforts to reduce their own inventories by year-end. We have also adjusted our expectations to reflect the impact on our Q4 sell-in.

In wearables, we remain pleased with the impact that wearables are having on our overall watch trends already. Since last year, wearables have consistently improved the watch trends for both Fossil brand and Michael Kors, largely based on the initial success of display watches. And we saw a similar impact with the third quarter's introduction of Emporio Armani Connected. We remain confident that hybrids can further expand this impact as we bring more of our brands on to the platform and as we educate more customers about the feature set of our stylish and branded hybrid watches. We are excited about the new wearables product rolling out this holiday season. We and our partners are getting behind these launches with significant marketing investments. Among our partners and us, we are planning more than a 50% increase over last year's marketing levels in the wearables category.

Though we have tripled our wearables business so far this year, we have not seen the sell-throughs that we had expected when we initially planned this year. That productivity has also impacted the door openings we had expected for the year. We are still in learning mode with this business, and we will continue to read and react to what we learn in the marketplace over the holiday season. Accordingly, we've adjusted our connected sales goals for the remainder of the year to reflect our experience to date with an overall goal to roughly double last year's connected business for the full year. We have positioned our inventories well and are prepared for even stronger demand if customers respond in a significant way. Therefore, we are now planning constant dollar fourth quarter sales to be in the range of a 6% and 13.5% decline, which includes a negative 2.5-point impact from the early deliveries in the third quarter.

Given the prevailing currency environment where the U.S. dollar has weakened against many of the currencies that affect our business, we are planning GAAP revenues in the range of a 3.5% and 11% decline. This will result in a full year constant dollar sales decline in the range of 9% and 11%, and a reported GAAP sales decline in the range of 8.5% and 10.5%. We expect that our fourth quarter gross margins will continue to be negatively impacted by promotional levels and connected mix, and we expect that we'll need to rely more heavily on off-price channels to clear our connected inventories.

Offsetting these factors at prevailing rates, currency should finally turn from headwinds to modest margin tailwinds. And we are continuing to see traction in our New World Fossil initiatives, where we expect to see slightly accelerating benefits from the third quarter assuming we can deliver on our volumes. Overall, we do expect to operate with lower gross margins in the fourth quarter compared to last year, though the comparison will likely be more similar to the beginning of this year rather than the third quarter given the significant valuation reserve that we recorded in the third quarter, which we do not expect to repeat in the fourth.

For operating expenses, our fourth quarter should continue to benefit from the efforts around New World Fossil, and we expect to operate with lower operating expenses and a lower expense rate in the quarter.

As the U.S. dollar weakens at current rates, currency will begin to have an increasingly negative impact on our year-over-year expense comparisons. We're also planning roughly $3 million in restructuring expenses in the fourth quarter. Therefore, we expect our fourth quarter operating margin in the range between 2% and 6%, and for the full year in the range between negative 15% and negative 17%. This includes the large unusual items, namely restructuring charges and impairments, among others, that have negatively impacted our results.

Similarly, those unusual items and the tax accounting required in loss situations yields an unusual income tax rate for the year. While we expect that the more normalized tax rate for our business is in the high 20s to 30% range. This year, we are expecting a significant tax benefit and a tax rate in the range of between 17% to 20%. However, for the fourth quarter, we expect the tax rate to be approximately 35%.

We continue to expect the interest expense will be higher than the year ago given higher interest rates. Therefore, for the fourth quarter, we expect GAAP earnings per share in the range between a loss of $0.08 and earnings of $0.47. That would result in a full year GAAP loss per share in the range of $7.75 and $8.30, which includes the negative impact of $7.56 for impairment and restructuring reserves taken during the year.

For the fourth quarter, we expect that our existing cash balances will be adequate to fund our operations, working capital and CapEx needs and any required revolver payment that may be required dependent on our actual EBITDA generation in the quarter. As a management team, we remain focused on cash flows and effective working capital management, and we are continuing our efforts to diversify our capital structure, both in terms of tenor and sources of capital.

Now with that, we'll open up the call to your questions. (Operator Instructions)

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our first question comes from Ed Yruma from KeyBanc Capital Markets.

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

I guess really want to click down a little bit on wearables. The performance commentary about being certainly short of goals, is that in regards to the product that was kind of the legacy product? Or kind of how has the new product, the product that kind of dropped in the September time frame, performed relative to expectations? And then, I guess, as a follow-up there, as you think about kind of the balance between the display, smartwatch and the hybrid, is there an opportunity over time to kind of tilt more toward display if that's where the market is pointing toward?

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

Sure. First part, primarily, with the sell-through for older products, the generation launched last fall, the first 3 quarters of the year is well below our expectations. We came into the year with a revenue target that turns out was significantly higher than we're able to achieve. So that's the majority of the revenue delta versus our initial expectations. And then as we go to the fourth quarter of the year, we've launched successfully all of our new products, we're seeing some encouraging sell-through trends. Although as we go into Q4, it's -- we're taking a relatively conservative approach in how we're thinking about the target for Q4. And we're just prepared to deliver on both great product, great marketing, broad distribution and see where we land for the year. Second part, we're going to be coming out of Q4 and reading the market for hybrids versus display. I would tell you though, I think we're in the early innings of both of those categories being very material for us. We're seeing some encouraging signs in hybrids in our Fossil business where we're seeing a high degree of penetration in hybrids and some early success there. And we're pretty excited about the innovation we have coming. So we will pivot and respond to the market trends. But right now, we're seeing encouraging trends in both categories.

Operator

Our next question comes from Omar Saad from Evercore ISI.

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

I'd love to hear some follow-up, Greg, on what are some of the encouraging signs you're seeing in hybrids and it's giving you confidence over the long term? And then what are some of the key obstacles to kind of get -- reaching that tipping point in the wearables category where it becomes material or significant enough to really start to move the P&L? And do you guys need to use social media or influencers? And do you have the capital budget to pursue those strategies well to get the word out on these products?

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

Sure. Yes, a little bit more on hybrids. If you remember, we launched last year and we launched products that were typically $80 to $100 premium over its traditional watch counterpart. This year, we've done a bunch of cost engineering and got the cost down so that it's only a $30 to $60 incremental upcharge versus traditional watch. Our design teams have brought great products, key selling styles now into hybrids. And so in Fossil stores, you're now seeing a roughly 60% to 40% -- 60% hybrids, 40% unit sales mix versus display. So that's a good leading indicator on where that category, the balance of that category is going. And we're also seeing now that the styles are -- we launched thinner and smaller styles. We're seeing female penetration increase significantly there. In terms of obstacles, we've got to create the category. It's not normal for the large player out there developing a category, so allowing Fossil to lead the way. A significant part of their marketing in Q4 will be against hybrids. They have influencer campaigns in social media as a heavy emphasis there. And so I think category awareness is now the biggest obstacle. We've got great product, beautiful designs, significant amount of cost out. And we're now hitting the sharp price points needed to really grow the category. So it's really about awareness.

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

And in addition, as we mentioned before, we've got a significant amount of advertising more than last year. Between ourselves and our partners, there's something like 40% to 60% more marketing going out there. Most of it is based around influencers, social media, video. It's pretty incredible stuff. A lot of that just started. I think we actually started a little later this year than last year. So that's in place. One other thing I would mention because it's very important is, we talk a lot about wearables, but keep in mind that our #1 objective is to gain share of the traditional watch business. We just think technology can be a catalyst for doing exactly that. And we are seeing, globally, a -- somewhat of a stabilization we saw in both Europe and Asia, traditional watch business stabilizing there. U.S. is still a challenge because we think that, that's where most of the strong competition in wearables is, in the United States. And we have identified in traditional watches a number of categories, brands in different geographies, new materials and ideas. There's a lot of innovation going on across the entire company. That's pretty exciting product coming. We do think that long term, what we're doing with hybrids specifically, which is basically the traditional watch with connectivity, is bringing a younger customer into the business. And we know there's some cross-shopping going on there. The hybrid activity is really a -- it's a way for us to bring more excitement to the younger customer into the category. And we think we can accelerate that with new ideas and materials and products, et cetera. And that's our strategy.

Operator

Our next question comes from Ike Boruchow from Wells Fargo.

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

I have a question on the balance sheet, I think for Jeff. So at the end of Q2, I think almost all your cash was overseas. Did you have to repatriate cash to make the debt paydown that you did during Q3? And then if I can ask, what level of EBITDA do you need to generate in Q4 such that you won't need to pay down more debt to manage the covenants in the quarter?

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

On your question regarding what we did at the end of Q3. We didn't have to repatriate any cash at the end of Q3 to have the balance sheet that we had. And regarding Q4, we're not anticipating having to repatriate at this point any cash for the covenants. Given our current projections right now, we seem to be fine. We do go through, as you know, a temporary paydown at the end of third quarter, and we disclose that in our -- reported results on that. So there's no repatriation, but there's a temporary paydown for covenant purposes.

Operator

And our next question comes from Simeon Siegel from Nomura Instinet.

Gene Vladimirov

This is Gene Vladimirov on for Simeon. Can you speak to the differences you've seen between Kors Access and the Fossil brand wearables? And why do you think the full price sell-through is different? And as you ramp up other portfolio brands, would you expect them to exhibit similar trends?

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

Well, I think we mentioned this before that we've seen, right out of the box, starting last year, the Kors selling extremely well. And part of that is just the average retail on Kors is higher, obviously. It's around $250. So to go $350, $400 for a smartwatch is not as much of a lift. In Fossil, the average retail is $120 and we were going to $300, which is why we put in place some promotional activity in Fossil just to generate sales and demand and engage the customer. So that was the main reason for it.

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

And I would you say, both brands are selling really well. So they've got unique designs. They're both hitting, I think, better designs year-over-year. We've got smaller female sizes in both brands. And it's resonating. They're just different brands at different price points, both performing well.

Operator

And our next question comes from Erinn Murphy from Piper Jaffray.

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

I guess my question is on just the Kors business overall. You talked about it improving to the down low single digit rate in the quarter. Can you just compare and contrast what trends look like in that brand in Europe versus the Americas? And then just pivoting from focusing on the watch business, any comments on longer-term plans in your business for the leathers and jewelry divisions? They've both been a fairly significant drag year-to-date on the top line.

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

Yes, we in Kors have seen stronger sales in Europe than we have in the U.S. So the U.S. is the one that's been mostly challenged. And that even continues, and we expect it will for the fourth quarter as well. In terms of leathers, we had -- and obviously, we had some challenges over the last probably 3 quarters in there. And we've mentioned before what we've done is totally reinvent the business. A lot of that came in for third quarter. We're actually seeing improvement in our own regular-priced stores where most of that new product is fully manifested. So we've seen quite a lot of improvement there in the fourth quarter. That will be more fully distributed around the world. So we're expecting sequential improvement, but we are seeing that happen right now. And we think long term, we have an opportunity in the category, both of the leathers and jewelry. The overall handbag business has been somewhat difficult, but the upper end, as you know, is showing some signs of life and there's more interest in handbags just globally. And we think we can participate in some growth there.

Operator

And our next question comes from Anna Andreeva from Oppenheimer.

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

I guess 2 quick ones. As you think about growth opportunity for wearables, say, for '18, do you guys expect to expand this category across additional brands or more to drive units in the brands currently launched? And then secondly, initial thoughts on CapEx for '18, what kind of maintenance CapEx number should we think about in the business?

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

Yes, I'd make 2 points as we start to think about growth in wearables for next year. First, we'll continue to expand the number of brands that we have on the platform. We'll continue to look for this to be a growth driver for the company. That said, as we go into next year, now that we've got a lot of learnings for this year on how to think about product cycles and liquidation and inventory management, demand planning, we're going to implement those as we go into next year and make sure that we've got a much more conservative approach to how we think about demand planning and inventory management, especially in the first couple of quarters of the year. But we are adding more brands. This will remain a long-term profitable growth engine for the company in summary. We just now have the benefit of a couple of years of sales to use to project better.

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

One way to look at this is that if you look at our addressable market in traditional watches, so it's $35 billion globally. The wearables business this year is about $20 billion globally, and it's expected to grow to $36 billion by 2020. So now with the toolkit we have in place, traditional watches and a lot of competitive advantages there globally, and now with our technology capabilities to go after the wearables market, we have a much larger addressable market and we're going to follow where the customer takes us. And we're going to -- we have a good position now that we can bring technology to the fashion business, and we can bring fashion to the technology business. We're very interested in how this plays out long term, but we think we're in a good position.

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

On the CapEx question, your question was about the maintenance level of CapEx on it. That maintenance-level CapEx is about $25 million a year. And we anticipate we'll be at that level as we go forward. We're not in an investment mode right now, but more in a maintenance mode at this point.

Operator

(Operator Instructions) And our next question comes from Heather Balsky from Bank of America.

Heather Nicole Balsky ***BofA Merrill Lynch, Research Division - VP***

Two questions. So first, can you talk about how your wholesale partners are managing their wearables inventory? Are they buying in line with sell-through? Are they stocking up for holiday? And that's globally. And then also, can you talk about for the connected business in terms of educating the customer and getting them more informed about the product, how do you overcome that in the wholesale channel where you're not controlling selling? Are you working to educate those -- that sales force, is it marketing, just how do you handle that?

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

So on our wholesale business, first of all, I'd say, we have a very significant amount of distribution around the world through most of our regular channels that are all prepared and they're in place. They've got fixturing. There's quite of lot of training that's going on as well, which I think we've done a pretty good job at so. And in addition to that, it's not just our normal distribution, but CE channels globally that there's a number of locations there also. So everything is in place. There's fixturing. There's visual presentation. There's videos in some stores. There's training in place. And we have -- we know how many doors are in and we are projecting sell-through percent, so our guidance is based on what we're expecting the sell-through to be in those stores. So we basically have got an indication and presentation from all our partners globally. Those are in place now. And the sell-through we get in December will determine what the shipments are from our warehouses. But I think one of the things that we've been able to do with wearables is just integrate it into our entire organization is that from soup to nuts, from product development, through all the way to point-of-sale, our training organization, we have a global repair facility and call centers that are all prepared. We have visual presentation, our go-to-market kits, our marketing. Everything is in place and it's not all around wearables either. We're just in place really to capture customers whichever category they're most interested in.

Operator

As we have no further questions, I would like to now turn it back over to Jeff Boyer for closing remarks.

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

Thank you very much. I want to thank everybody for joining us on the call today. I appreciate you dialing very much. Look forward to having you all join us in February when we cover our Q4 and year-end results. Thanks again.

Operator

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