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PRESENTATION

Operator

Welcome to the Q3 2018 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 Malkin, you may begin.

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

Thank you. Good afternoon, everyone. Thank you for joining us, and welcome to Fossil Group's Third Quarter 2018 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 discussed during this call. Fossil Group's policy on forward-looking statements and additional information concerning a number of factors that could cause actual results to differ materially from such statements is readily available in our Form 8-K and 10-Q reports filed with the SEC.

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

Please note that you may listen to a live webcast or a 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 comments and then turn the call over to Jeff Boyer, our CFO, to cover our Q3 financial performance and the outlook for Q4. Following Jeff's comments, we'll have Greg McKelvey, our Chief Strategy and Digital Officer, join us for the Q&A.

Note that our sales comments today will be based on constant currency unless otherwise noted.

Our approach for 2018 was to plan our top line prudently, but operate all elements of our business very aggressively with the overall goal of improving our profitability. I'm pleased to state that this approach continues to work well for us. In the third quarter, due to the outstanding efforts of our global teams, we performed better than our expectations on all key dimensions. Sales levels, though down, were near the high end of our guidance with even stronger performance versus our forecast on gross margin expansion and expense management initiatives.

We also continue to make great progress strengthening our balance sheet as we reduced inventory and improved our overall working capital position versus the year.

In the third quarter, sales declined 11% on a constant currency basis. With our focus on profitability this year, we are exiting marginal businesses, closing underperforming store location, and as previously announced, we made 2 licensing agreements. These exits and store closures had a significant negative impact in Q3, creating a top line drag of about 6 full percentage points.

Other important sales metrics which provide additional insights into our business performance, include: our connected product grew nearly 30% in the quarter, primarily due to the successful launch of our Generation 4 product across multiple brands. With this continued growth, smartwatches represented almost 18% of our total watch sales, up from 13% in the third quarter of last year. Asia grew 1% in the quarter behind strong double-digit growth in both China and India. Excluding store closures and business exits, our underlying core sales growth in Asia was plus 9%.

Overall, our Fossil direct-to-consumer business, which is our retail store plus our owned e-commerce sites, contracted 3% on a comp store basis, mainly due to lower sales levels on our outlet channel.

During the quarter, we were less promotional in Fossil outlets, trading top line sales for bottom line profits. Looking at full price Fossil stores, plus our Fossil e-commerce business, comp sales increased about 3%, driven by a double-digit increase in Fossil e-commerce sales.

On the license business side, our Michael Kors watch business was down in the mid-single digit range on a global basis with a mid-single-digit increase in Americas offset by softness in Europe.

Emporio Armani continued to demonstrate strong digit growth, powered by the watch category in Asia.

We managed margin and expense in the business well during the quarter. Gross margin was 53.6% in the quarter, better than our expectations and above the high end of our guidance range, representing an improvement of about 700 basis points versus last year.

SG&A expense, including restructuring costs of $6 million, was near the low end of our guidance and was about $17 million below last year. Our gross margin and expense management results reflect the continuing progress and benefits from our New World Fossil initiative.

In a few minutes, Jeff will cover our key financial metrics, but our adjusted operating income, which excludes restructuring actions and impairments, improved significantly versus the third quarter of last year.

As we mentioned on our last several calls, we outlined 4 key objectives that drive our strategies and initiatives this year. First and foremost, we are focused on improving our overall profitability. Our second objective is to increase innovation across our product offerings. And third, we are pursuing initiatives to further expand our e-commerce and digital marketing capabilities. Lastly, we are continuing our New World Fossil program focused on transforming our business model to improve efficiency and reduce our cost structure.

Due to industry challenges facing us in the near term, we expect to become a slightly smaller but a more profitable business. As we've previously indicated, total sales are forecast to contract as we exit unprofitable stores, businesses and product lines. Connected watches and our online businesses are expected to grow, but the absolute dollar decline in traditional watches in the wholesale channel will be greater in the short term. Though overall sales will decrease as a result, our operating income is expected to improve as we navigate through this challenging environment.

A portion of our improvement in operating income comes from exiting unprofitable stores and product lines. In addition, we are working to optimize our promotional programs and in the third quarter, we were significantly less promotional overall, affecting our top line sales but improving our gross profit contribution.

Our New World Fossil initiatives also contributed significantly to our profit improvement efforts. Through a combination of pricing programs, direct and indirect sourcing efforts, organizational efficiency initiatives, we continue to forecast $200 million of annual run rate savings from gross margin expansion and operational efficiency benefits by the end of 2019.

We've been extremely pleased with our organization's efforts since we began the program late in 2016, and we remain on track to achieve our New World Fossil objectives.

Last year, we generated $80 million of benefits from New World Fossil programs. We forecast another $60 million of profit improvement benefits this year, driven by a combination of both gross margin expansion and SG&A efficiencies under this successful program.

Our second key objective is to continue to focus on innovation and design in the watch category. Our outstanding design capabilities start with traditional watches, where we combine consumer insights with our creative product engine to innovate in materials, colors and designs. Iconic styles with bold design elements, coupled with new product drop strategies, will lead our storytelling for the holiday season and into next year.

For the upcoming holidays, we are making strong statements in color materials and embellishments across a number of our owned and licensed watch brands. Much of our new holiday product has already reached the stores and websites in late October, and we are pleased with the initial consumer response.

In addition, we continue to innovate in the fast-growing smartwatch segment as well. In the third quarter, we launched 2 new display watch platforms for the fall and holiday season, under both our owned and our licensed brands. Ranging in size from 40 to 44 millimeters, our new Gen 4 platform includes the features that consumers want most, heart-rate tracking, GPS, NFC for payments and rapid charging, and early reaction from consumers has been very positive. Our goal is to bring fashion, branding and style to the connected watch business, with exciting new products tailored to each of our brand's unique points of view.

And we're very excited about our new smartwatch, which will be unveiled in the press tomorrow and will be available soon globally. This new smartwatch features the newly released Qualcomm Snapdragon Wear 3100 platform and the redesigned Google Wear operating system and will be the first of its kind to hit the market at a competitive price point. The strong fitness and wellness focus of this new device is a welcome addition to our existing wearables lineup that provides the perfect combination of fashion and function. Our partnerships with Qualcomm and Google, along with our internal development team, continue to drive consumer-focused innovation in this space.

These great new offerings are expected to support continued growth in our wearables business, which increased nearly 30% in the third quarter. Overall, our smartwatches continue to have a positive impact on sales trends for a number of our key brands and our overall watch sales. Wearables were 18% of our total watch sales for the quarter, up from 13% in Q3 of last year.

In the Americas region, wearables were 21% of the total watch sales for the quarter.

During the third quarter, we were pleased to announce a strategic partnership with Citizen Watch Company, to grow and expand the hybrid smartwatch category, another innovative product in our connected watch portfolio. In this new licensing partnership, Fossil Group will supply Citizen with our proprietary hybrid technology for use in both their brands and in third-party watch brands. In addition, we are collaborating with Citizen to develop, manufacture and market additional enhanced hybrid watch products. With hybrid smartwatches projected to make up a significant portion of the smartwatch industry, our partnership is positioned to accelerate the adoption, awareness and innovation of the entire hybrid market.

Our third key strategy is to invest in digital marketing and expand our efforts in e-commerce, particularly for the Fossil brand. We continue to focus our media mix on digital, investing in digital channel

(technical difficulty)

on global digital media spend was up over 24% for Fossil in the third quarter, helping drive the Fossil brand core sales up 5% in our direct channel, which includes our own stores, store-in-store concessions and our own e-commerce sites.

We are enhancing our consumer targeting and social content initiatives to further improve engagement, while driving product sales through search, affiliates and retargeting efforts.

Social influencers remain a critical part of our marketing program and includes celebrity influencers, such as Mandy Moore and KJ Apa for the Fossil brand.

In addition to our celebrity influencers, we work with hundreds of brand ambassadors and activation partners globally to expand our reach through segmented engagement-driven storytelling. As a result of our efforts and the success of these programs, unique visitors to our sites continue to increase solidly.

Sales on our owned e-commerce sites grew by 15% in the quarter with growth of 18% in the Americas region, 6% in Europe and 22% in Asia. For the remainder of this year and into 2019, we will continue to generate strong brand moments online to build momentum and awareness. For example, in late September, we reissued, in limited quantities, a watch favorite from the '90s, our classic Fossil Mood watch. Using an integrated PR influencer and social media strategy, we generated over 50 million impressions and increased traffic to our website by over 25%.

In 2019, we will build on this success to further expand awareness and increase purchase consideration for both traditional and connected watches.

Our fourth key initiative for 2018 is the business model transformation work under our New World Fossil initiative. This is our ongoing comprehensive program to reinvent our company to address changing consumer trends, drive efficiencies and speed throughout the organization, streamline the way we work, enhance our margins and ultimately drive significantly improved economics to the bottom line. We have made significant progress on the initial transformation of the company, which is projected to drive $200 million in gross margin and efficiency benefits by the end of 2019.

Currently, we expect to deliver $170 million of these annual run rate savings by the end of this year through the combination of both gross margin expansion and operating expense efficiencies. These benefits are clearly evident in our improved profitability so far this year.

As we bring New World Fossil 1.0 to a conclusion, we continue to work on the next phase, New World Fossil 2.0, which will build on the foundation of our successful initial phase. We will focus the organization on prioritized consumer market and channel opportunities, create long-term process and system enhancements to maintain productivity and pursue key opportunities in the areas of speed-to-market, strategic sourcing, indirect procurement and revenue optimization. We're excited as we continue our transformation efforts and enter this next phase of our multiyear New World Fossil project.

So we have significant work ahead of us on our transformation initiatives to address the structural changes in our categories and channels. Our current focus on near-term profitability has provided stability in a challenging environment. This affords us the opportunity to develop and execute longer-term initiatives that are expected to deliver strong and sustainable growth for our business.

We continue to forecast our top line conservatively to put pressure on the elements we have the most control over, our gross margin structure and our expenses. We are planning prudently, but being very active in the marketplace as we position the company for sustainable growth. We are focused on stabilizing and growing our core watch business, innovating in wearables and expanding our digital capabilities, while driving efficiency throughout the company.

In closing, we have a lot of work to do, but we are making progress. And we'd like to thank our Fossil Group teams all over the world for their unique spirit and great energy. This is what drives the company forward.

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. We're pleased with our progress this quarter as we drove double-digit growth in connected watches with favorable customer response for our next-generation smartwatches. We expanded gross margin to 53.6%, reduced expenses by $17 million, and we delivered a much stronger balance sheet.

While our business continues to face top line headwinds stemming from the declines in the traditional watch category, especially in the wholesale channel, we remain focused on narrowing the gap with gains in connected and e-commerce sales. And we continue to deliver benefits from our New World Fossil initiatives and from exiting marginal businesses and closing unprofitable stores as we become a smaller, but a more profitable company in 2018.

We reported net income of $5 million for the third quarter compared to a net loss of $5 million last year. Our reported earnings of $0.10 per diluted share included New World Fossil restructuring charges of $0.09 per diluted share. Last year, our third quarter EPS was a loss of $0.11 and included a restructuring charge of $0.08 per diluted share.

Excluding these items, our adjusted EPS was $0.19 this year as compared to a $0.03 loss last year. Currencies, including both the translation impact on operating earnings and the impact of foreign currency hedging contracts, unfavorably impacted our EPS comparison in the third quarter by $0.01.

Sales, which were slightly better than expectations, decreased 12% to $609 million and decreased 11% on a constant currency basis. We launched new connected product during the quarter, with additional features and functions including heart rate and GPS that were well received by consumers, helping to drive a 29% sales increase in the category. Note that the third quarter connected product sales growth rate also reflects incremental clearance sales of previous generation connected product.

While store closures unfavorably impacted sales comparisons during the quarter, profitability in our direct business improved significantly as we exited unprofitable stores and were less promotional overall in our retail concepts. Store closures negatively impacted total direct channel year-over-year sales comparisons by 530 basis points. We have closed 75 stores since the third quarter of last year and ended the quarter with 485 stores.

Excluding store closures, direct sales decreased 3%

(technical difficulty)

sales due mainly to lower promotional activity. Comp sales in our full price stores, combined with our double-digit increase in e-commerce sales, increased 3%.

The overall environment in our traditional wholesale channel remains challenging. Our wholesale business declined double digits in the Americas and Europe as sell-out trends remained soft. Despite the difficult wholesale environment

(technical difficulty)

continued to decrease as a result of better inventory management.

Sales comparisons in Europe were also challenging as our third quarter sales last year were favorably impacted by customers accelerating certain deliveries from the fourth quarter into the third, primarily to take advantage of pending price increases in Europe.

Our watch business declined 11% in constant currency for the quarter as strong growth in connected was more than offset by continued traditional watch declines in our Americas and Europe wholesale channels. The sales in our traditional watch business, while still challenging, performed within our overall expectations with fairly consistent wholesale sell-through trends in the Americas compared to last quarter, with weakening trends in Europe.

Third quarter sales were also unfavorably impacted by the Burberry and adidas license brands exits. We continue to grow our connected watch business, delivering $90 million in sales representing 18% of total watch sales for the quarter, up from 13% last year.

Total Fossil brand sales decreased 10% in constant dollars compared to last year with declines across all product categories. Fossil watch sales also decreased 10% in constant dollars, driven mainly by the closure of underperforming stores and significant declines in traditional wholesale business in Europe.

Our connected business continues to gain traction, positively impacting the category growth rate by about 8 percentage points. Our marketing efforts, store experience and celebrity influencer campaigns continue to yield strong results for our Fossil brand, driving comp sales up 3% on a combined basis in our full price stores and our own e-commerce sites. Sales decreases in our outlet stores, driven by a reduction in promotional activity to increase profitability, drove the overall 4% decrease in our total direct channel.

Our global direct e-commerce sales continued double-digit growth in the third quarter in all regions.

Michael Kors brand sales declined 7% with declines in both watches and jewelry. Kors watch sales declined 5% for the quarter with smartwatches positively impacting the rate by 9 percentage points.

Regionally, Kors watches grew mid-single digits in Americas, were essentially flat in Asia, and experienced significant softness in the Europe wholesale channel.

The jewelry category continued to be negatively impacted by the repositioning of the line as we transitioned into the higher priced assortment that will begin expanding distribution in the fourth quarter and into next year.

In the Americas, third quarter sales decreased 12% on a constant currency basis to $269 million, with declines in our 3 main product categories, driven primarily by softness in the wholesale channel, retail store closures, and Burberry and adidas license brand terminations.

Watch trends were slightly better than the overall Americas' region sales trends as continued softness in traditional watches was partially offset by strong growth in connected watch sales led by Michael Kors and Fossil.

Our overall retail performance in the Americas declined as double-digit e-com growth was more than offset by negative store comps, driven by lower promotions in our outlets and a negative impact on sales from closing unproductive stores. Excluding the impact of store closures and business exits, core sales in our Americas' direct channel is up modestly.

In Europe, reported sales decreased 16% to $208 million. On a constant dollar basis, sales declined 15%, representing decreases across all product categories. Wholesale sales in the prior year benefited from early deliveries to certain customers who opted to take shipments earlier than planned, given price adjustments, which were required to be announced to our customers in advance.

Underlying wholesale sellout continued to weaken during the third quarter, while retail sales trends improved particularly in our outlets. Strong performances in our outlets and e-com resulted in positive comps, while our total retail sales were down largely as a result of store closures.

Fossil watch sales in Europe were negative due to declines in traditional watch sales, partially offset by growth in connected sales. Connected sales positively impacted the category growth rate by about 5 percentage points.

Within our watch portfolio, sales declined across most brands.

Across the Eurozone, sales were down in most major markets with the greatest declines in Germany, the U.K. and France. In Asia, we reported a sales decline of 1% on $132 million of sales. And on a constant currency basis, sales increased 1%, driven by the wholesale channel. Retail sales decreased slightly as strong e-commerce growth was offset by the negative impact of productive store closures combined with Burberry and adidas terminations. Excluding store closures and business exits, our underlying core sales growth in Asia was positive 9%.

Fossil brand was flat in Asia as modest growth in leathers offset a slight decrease in watches. Emporio Armani, our second largest brand in Asia, posted strong double-digit growth, driven by traditional watches, which is not enough to [overcome] the Burberry and adidas brand exit within our license portfolio.

Most other brands in our portfolio were relatively flat to modestly down in sales dollars for the third quarter.

Strong growth momentum continued in China and India, primarily driven by third-party e-com and wholesale growth. Hong Kong and Korea posted positive results, while Japan, Australia and Taiwan were down double digits during the quarter.

Gross profit increased to $327 million and gross margin increased 720 basis points to 53.6%. This gross margin extension was driven in part by a favorable comparison over last year when we recorded an inventory valuation reserve for excess levels of connected products. Lower promotions and markdowns improved off-price margins. And favorable product mix, along with the benefits of our New World Fossil initiatives, also added significantly to the gross margin expansion.

Favorable impacts from currency also added about 100 basis points to the gross margin improvement.

On a reported basis, third quarter operating expenses were $304 million, including $6 million in restructuring costs. Last year, operating expenses were $320 million and also included $6 million in restructuring cost.

Excluding restructuring charges, operating expenses decreased $17 million in the third quarter as compared to the prior year and included a $2 million favorable currency impact. The lower expenses in the third quarter resulted from lower store expenses, given the significant number of stores we've closed since last year; lower variable marketing expenses; corporate and regional infrastructure reductions, driven by our New World Fossil initiatives; and the currency effects of a stronger dollar, partially offset by increased incentive compensation.

Our third quarter operating income increased by $23 million and improved to 3.7% of sales as compared to an operating loss of $500,000 a year ago. Excluding restructuring charges, operating margin was 4.7%, a 390-basis-point improvement from the less than 1% recorded last year.

Interest expense decreased $2 million to $10 million on lower outstanding debt. And third quarter other expense at $3 million was unfavorable to last year, mainly due to net foreign currency losses compared to net gains recognized in the third quarter of last year.

Income tax expenses were approximately $4 million in the third quarter on pretax income of $10 million, resulting in a 40% effective tax rate compared to a 30% rate in the third quarter last year. The higher effective tax rate in the third quarter was mainly driven by the recognition of deferred tax asset valuation allowances and an unfavorable impact from the GILTI revision of the Tax Cuts and Jobs Act that was signed into law last December. These unfavorable impacts were partially offset by an income tax benefit related to the reduction of the 2017 income tax liability from previous estimates.

We continue to establish valuation allowances on our deferred tax assets in the U.S. and certain international subsidiaries, given our recent operating losses in those jurisdictions, thereby, increasing our effective tax rate.

Regarding GILTI, though we don't expect to incur payments under this provision, the GILTI calculation is having an adverse consequence unique to our particular earnings profile. The mechanics of the GILTI revision effectively result in double taxes on some of our foreign income. Until alternative strategies are implemented, we are reflecting the double taxation impact on our financial statements. We estimate this full year impact could range between $5 million and $10 million.

We improved our net debt position by $157 million compared to a year ago. We ended the quarter with $236 million of cash compared to $167 million last year and debt of $397 million compared to $485 million a year ago.

During the quarter, we invested $4 million in CapEx.

Our adjusted EBITDA for the quarter was $50 million, resulting in trailing 12-month adjusted EBITDA of $225 million. Our third quarter bank leverage ratio was 1.8x. Comparable inventory levels at the end of the quarter were down 23% versus a year ago. We remain focused on our inventory reduction initiative and have made significant progress in clearing our previous generation connected products and other slow-moving inventory.

Accounts receivable decreased by 16% to roughly $262 million and wholesale DSOs decreased 2 days as compared to the prior year as a result of increased collections primarily in Europe.

Depreciation and amortization expense totaled $16 million for the quarter.

Now let's move to our 2018 outlook. As Kosta mentioned, we remain focused on 4 key objectives to drive our strategies. Improving profitability remains our #1 financial objective, which we delivered on in the first 3 quarters of the year as we exceeded our initial sales plan and as our New World initiatives improved profitability. We remain excited about delivering compelling consumer experiences through new innovations across traditional and connected products and utilizing our enhanced e-commerce and digital marketing capabilities.

While we remain excited about the opportunities, we recognize the overall environment within our traditional channels and categories continues to be challenging. And in light of the challenges, we're continuing to plan our business prudently, while our entire global organization is focused on aggressive actions to change those trends.

Before I cover specifics, I'd like to address several factors impacting our overall guidance.

Since we last provided guidance back in August, the U.S. dollar has strengthened, which will negatively impact results for the fourth quarter. We're updating our guidance based on roughly prevailing rates with the euro and British pound, 2 of the currencies most impactful to our results, at approximately $1.14 and $1.28, respectfully. Using our updated exchange rates, currency will have roughly 100 basis points negative impact in the fourth quarter compared to our previous guidance and about 100 basis points negative impact compared to last year's performance.

Also as we commented during our call in August, it's important to remember sales results in the first half of 2017 were more challenging, while sales trends in Q3 and Q4 of 2017, though still negative, did improve versus 2017 first half sales trends. Therefore, the relative sales comparison in Q3 and Q4 this year is more challenging. Our Q4 guidance assumes roughly year-to-date 2018 trends on a 2-year stack constant currency basis, along with approximately 500 basis points negative impact from store closures, business exits and licensing terminations.

Given these factors and with the completion of the third quarter, we're narrowing our full year sales guidance range to minus 9% to minus 7%. We expect Q4 to range from minus 16% to minus 10%. Compared to our previous guidance, the Q4 sales range includes 100 basis points negative impact from changes in currency rates.

Our updated full year gross margin guidance ranges from 52% to 53%, and we expect Q4 gross margins to range from 51.5% to 53.5%. Our guidance implies approximately 350 to 400 basis points of gross margin expansion from 2017, primarily driven by our New World Fossil initiatives, fewer discounts and markdowns and improved connected margins as we do not expect to repeat the connected liquidation reserves recorded in 2017.

We expect operating expenses for the year to range from $1.27 billion to $1.29 billion, including an expected $50 million of restructuring charges related to our New World Fossil initiatives.

For the fourth quarter, we expect operating expenses to range from $340 million to $360 million, including approximately $9 million of restructuring charges.

Therefore, for the full year, we expect operating income margin in the range of 2% to 3%. Operating income margin for the fourth quarter is expected to range from 8% to 10%. We expect net interest expense of $43 million for the full year and expect Q4 interest expense to be approximately $11 million.

Other incremental expense, which is primarily related to hedge contract gains and losses, was a benefit in 2017 and has been a negative expense in the first 3 quarters of 2018. Based on the foreign exchange rates used on our guidance, other income in Q4 will be a loss of approximately $1 million, though this may change as exchange rates move.

Based on the foreign currency exchange rates assumed in our model, net other expense will be a loss of approximately $6 million for the year. As I discussed earlier, given Q3's tax expense and the increased clarity of the impact of tax reform, based on the profile of our geographical earnings, including a tax loss in our U.S. companies, we now expect tax expense to range from $11 million to $14 million for the full year and $4 million to $7 million in Q4.

For 2018, we expect adjusted EBITDA in the range of $205 million to $230 million, and we expect Q4 adjusted EBITDA in the range of $90 million and $115 million. We're planning to invest approximately $20 million in capital expenditures and expect full year diluted share count to be approximately 50 million shares.

Before we open up the lines for our Q&A session, I'd like to update you on 2 items of note. The first is regarding tariffs. Based on the tariffs in place as of today, our traditional connected watches have been excluded from all currently imposed tariff penalties. A portion of our leather goods and some of our product packaging are currently sourced out of China, and will be impacted by tariffs. We are actively working to move sourcing and adjust pricing to mitigate these impacts. Overall, given the limited tariff exposure we have on these products and the actions we're taking, we do not expect the tariffs currently in place to have a material impact on our profitability.

The second item regards the exit of a licensed business contract next year. We have come to an agreement to terminate our licensing rights to manufacture, market and distribute watches for the Mark Jacobs brand. Given the scale and profitability of this business, this agreement is not expected to have a material impact on our overall financial performance next year.

In closing, while the industry continues to see significant changes in consumer preferences across our product categories and the channels consumers shop, we continue to develop plans and strategies to address these challenges and maximize our opportunities. Our progress so far this year has been an important step in the transformation journey, and we're pleased with how far we've come, particularly with our #1 priority of improving profitability. While challenges remain to reach our long-term goal of returning to double-digit operating profits, our global team is excited and energized as we continue to focus on actions to improve our profitability and begin stabilizing our core sales.

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

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, there seems to be a pretty strong divergence or has been between the performance you guys are seeing in your DPC channels versus what you're seeing at wholesale. I know that there's a higher SKU to wearables in DPC, but kind of help us think through should that divergence start to compress? What can you do to help your wholesale partners, I guess, sell more of your product? And then as a follow-up, you guys did a great job kind of delevering the balance sheet. I guess, how do we think about thresholds by which you could maybe take a more structural reduction to interest expense?

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

On the first question, we have, as you know, made a huge amount of progress on our digital capabilities, social media, e-commerce, et cetera and that's mostly been around our own brands. So we've, as you know, the Fossil brand has been pretty strong over the last couple of years. We're still seeing huge growth in e-commerce, and we're working now with our e-commerce partners, both pure play and partners, to use some of the same messaging and methodology to get that same kind of growth there and this is globally. Part of the issue with it is that we have to be the best in the world at digital capability, and we have to be able to do it globally and it's

(technical difficulty)

degree so it's very complex. And we've been, over the last couple of years, putting resources in place globally to be able to do that, and we're still midway on that journey and we have a lot more work to do to bring everyone else along.

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

Ed, on the structural changes to the balance sheet, particularly our debt levels on it, we have a term loan that starts to amortize next year, with a full payment in December of 2020. As you can appreciate, one of our goals is always to refinance our balance sheet, our debt, way in advance of that becoming current. So probably sometime next year, you'll look at us doing some level of refinancing, hopefully by the mid part of the year, which given our ability to generate cash, through both operating performance as well as the balance sheet initiative we had, we should be in a good position to structurally reduce our debt level. And also given the performance we've had, we expect that our interest rate that we'd have on that lower level of debt will also be much more favorable than we did this the last time. So I think midpoint of next year, you should see some refinancing that should reduce our debt level and also reduce our interest rate overall.

Operator

And the next question comes from Simeon Siegel from Nomura.

Julie J. Kim ***Nomura Securities Co. Ltd., Research Division - Retail Analyst***

Hi, this is Julie Kim on for Simeon. Could you provide color on the traffic metrics between full price and outlet stores as well as the online channel? And as a follow-up, could you give color on units versus pricing within both traditional and connected watches?

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

We don't release traffic information by channel on that, so I'm going to pass on that question. And we also don't go into that much detail in terms of units and ASP on it. I will tell you that with the amount of liquidation we've done this past quarter, past couple of quarters, there's been a little bit of pressure on ASP overall as we liquidate a particular connected product. That should return to normal as we get through this year into next year. So the only thing that's really driving that a little bit is our liquidation of some connected product. In terms of units, the units have been solid -- they've still been down overall, but we have some pressure on both the unit side as well as on the pricing side.

Julie J. Kim ***Nomura Securities Co. Ltd., Research Division - Retail Analyst***

And then just regarding the full price in outlet stores versus the online channel, could you give any color on, I guess, just general performance between full pricing outlet. And then within online, if you've seen any specific promotional pressure?

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

So we've actually, as I mentioned in the comments, we've had less promotional activity in the last quarter than we've had in the past, especially in our outlet stores. If you look at our comps, our regular price stores actually did pretty well. When you look at our regular priced e-commerce plus stores, we actually had positive comps on the Fossil brand. In the outlets where we chose not to be as promotional, we actually -- comps were negative, but our gross margin dollars were very solidly plus comps. So we're looking, over the next several quarters, to really understand what the correct cadence would be, how do we optimize both our margins and our sales in this channel. The other thing I would say is that just in an ongoing basis with all digital activities, we're raising increasing traffic on our own e-commerce sites and our partners globally. And we're doing everything we can to facilitate that growth to be ongoing because that's becoming a larger part of the business. Also driving traffic to our stores as well, so the entire omnichannel thing is kicking in, I think, to a certain degree.

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

I will just add on that to build on Ed's comment. We are seeing better performance on our direct channel, full price outlet as well as e-com overall and across the regions, on our core, taking out the Burberry, adidas portfolios, actually positive in each region on that particular direct measure. Our challenge is in wholesale. It's the wholesale channel that's the most challenged for us. So we do have work to do on that. But from a direct standpoint, we've had mid-single digit growth in that direct channel.

Operator

And the next question comes from Ike Boruchow from Wells Fargo.

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

I guess, Jeff, could you maybe talk about the watch business in a little bit more detail? The growth rate of total watches was running, I think down mid-single digits in the first half, and now down low-double digits. And so I'm just trying to understand, the wearables are clearly getting to a size where they can't double every quarter. I think we get that. But what's the right growth rate for the wearables from here? And then again, within the traditional watches, it looks like they decelerated from low-double-digit to looks like -- more like down 16%, 17%. Just how should we think about that? I mean, you guys have talked about a more profitable, but a smaller business. I mean, how much smaller does the traditional watch category need to shrink to? And then again, just trying to think about how -- what the growth rate of wearables looks like as we move into '19?

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

Yes, I'll tell you that we haven't given specific guidance on '19 at this point. But probably the way to think about it is, there's still direct growth in the connected products, we have a lot of great product coming out. You heard Kosta mention in his comments about the fact that we're unveiling some fitness-oriented product tomorrow that we think will help the -- our particular business really well on the connected space. So there's still a lot of growth there. Will it grow at doubling? No, will it grow at 10%, 20% level? Yes, that's a good growth rate that's out there. On the traditional side, you have kind of 2 questions in there, is how to think about the traditional growth that we've had. We did have a bit of a slowdown in the third quarter and there's 2 pieces of that. One piece of it was being less promotional in our retail or outlet stores that did cause a drag, a point or 2 of drag overall in the watch business as we weren't nearly as promotional, both from a retail and outlet standpoint. The other thing that we witnessed more than we had thought and caused a little of the drag results were Europe. The Europe wholesale business is going through a channel shift as well. The projections we have show that, that business will stabilize out in the future, can't say exactly when. The biggest issue still remains this channel shift that we mentioned, that the consumer is shopping more online, and the wholesale channel, in traditional watches though, is down the most. From a traditional watch standpoint, our latest estimate in the first half in the U.S. at least, was it was down mid-single -- between 5% and 10% was what the traditional watch was down in our category. So the issue we've had is more of a channel issue than necessarily the traditional watch side of it. And it will stabilize at some point, but we are continuing to manage it prudently and be aggressive about margin and cost until we get to that point.

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

And one thing we've been doing, as we mentioned before, is that there's a significant amount of innovation and new product ideas in traditional watches that we're shipping right now. And we're seeing some early results to that across all our brands. But we're focused on new differentiated innovation across the spectrum, trying to do everything we can to jolt that business and we'll see how it plays out over the next couple of months.

Operator

(Operator Instructions) And our next question comes from Laurent Vasilescu from Macquarie.

Sinchian Hwang ***Macquarie Research - Analyst***

This is Werlson Hwang on behalf of Laurent. I want to ask on your gross margins, which are up 720 bps. Can you walk us through the puts and takes in more detail? You had a valuation charge,100 bps on FX. For the remaining 200 bps or so, how much was New World Fossil? How much was mix? Was there any impact from ASU 2014-09, which I believe had a 150 bps benefit in the second quarter?

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

On the decomposition of it overall, you're right about the absence of a -- inventory valuation reserves this quarter versus last quarter. That was roughly about 350 basis points. Because connected is growing faster, there is a bit of a drag on that of about 80 basis points, it's of connected mix. But in terms of the rest of the mix equation, from a product regional standpoint, we are selling some higher-margin products in some regions that actually have higher margin. So think about 100 basis points favorability in that piece of it. Our retail margins overall were up roughly 100 basis points as well, and that's per the conversations we had on the promotional activity that we've had. Currency is about 100 basis points and roughly the optimization is about 100 basis points. The lower markdowns are just about 50 basis points. So you can see we have really a broad range of benefits. Accounting changes did not impact our markdowns or anything to material effect in the third quarter.

Operator

And we have no further questions. I'll turn the call back over for final remarks.

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

Adrienne, I appreciate you helping us on this call. I want to thank everybody for joining us on the call today and look forward to updating them in February when we do our fourth quarter comp call and fiscal '19 guidance. Thanks so much.

Operator

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