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Q4 2016 Fossil Group Inc Earnings Call

EVENT DATE/TIME: FEBRUARY 14, 2017 / 9:30PM GMT

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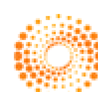

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PRESENTATION

Operator

Welcome to Fossil Group's Fourth-Quarter 2016 earnings call. At this time, all participants are in listen-only mode. Later, we will conduct a question-and-answer session, and instructions will follow.

(Operator Instructions)

As a reminder, this conference is being recorded. I'd like to turn the call over to Eric Cerny, Investor Relations.

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

Thank you, and good afternoon, everyone. Thank you for joining us, and welcome to Fossil Group's fourth-quarter 2016 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 a reconciliation and other information regarding non-GAAP financial measures discussed on this call and our Earnings Release filed on Form 8-K and the investor section of our website. Please note that you may listen to a Live Webcast or replay of this call by visiting www.FossilGroup.com under the investors section. Now, I'd like to turn the call over to the Company's Chairman and CEO, Kosta Kartsotis.

Kosta Kartsotis ***Fossil, Inc. - Chairman of the Board & CEO***

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

The Fourth Quarter of 2016 was pivotal for the Fossil Group as our wearable launches offset most of the continued softness in traditional fashion watches. Despite a difficult environment for much of the retail industry, our team remained laser-focused on our strategic priorities and advanced many of the initiatives that we believe will enable us to drive growth and improve our financial performance in the future. We grew our own brands, FOSSIL and Skagen, with notable strength in wearables through the expansion of the FOSSIL Q assortment and the launch of Skagen connected styles. We also saw significant improvement in Michael Kors watch sales with the launch of Michael Kors access, and we drove growth in Asia and Europe and saw progress toward our new world fossil initiative.

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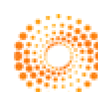

Let's begin by revisiting the strategic priorities we laid out coming into the year. I'll take a moment to give an update on each and then outline our priorities for 2017. The first one is driving future growth through wearable technology. Second, a continued commitment to the growth of Fossil and Skagen. Third, evolving and leveraging our digital and OmniChannel investments to better serve the customer, and finally, improving our profitability and growing our core watch business.

So, first on driving wearables. 2016 was a year that the Fossil Group demonstrated its ability to move very quickly to adjust to consumer demands. In one short year, we acquired Misfit, integrated their team into the organization, and leveraged their technology platform across our portfolio of brands. We were able to launch over 100 SKUs of wearables in 8 brands, 40 countries, and 20 different languages. Across display smart watches, hybrid smart watches, and activity trackers, we gave customers the new functionality that they desired in innovative, stylish, branded products that they have come to expect from us.

All the while these new products had a materially positive impact on our business. Even with overall fourth quarter sales at the low end of our expectations, we began to observe new emerging trends to support our thesis that wearable technology can be the catalyst to drive growth in the watch category. In fact, following several consecutive quarters of declines, watches stabilized in the quarter as smart watches reversed deteriorating trends in traditional watches, and in some of our key brands, had a double-digit impact on the category. We are very pleased with the improvement and the fact that much of the business driving the smart watch trend today is attributable to the display watches, a category once thought to be limited due to technology brands. We are disrupting this category with our fashion brands. Hybrid smart watches are also contributing to our success in wearables. These devices showcase our proven design and fashion capabilities, incorporate the misfit engineering capabilities, and provide unique functionality.

Next, on driving growth in Fossil and Skagen -- both did very well last year considering the difficult retail environment. We are pleased that Fossil was plus 2% for the year, and Skagen was plus 9%. For both brands, growth in watches drove their performance, and for Fossil, which had a wearables presence throughout the year, smart watches drove the growth in the category and the brand. While Skagen's growth was across categories, watches also drove the brand's growth with the launch of Skagen connected contributing to that growth. These brands are succeeding by offering compelling innovation with unique functionality, supported by clearly communicated brand stories that we can bring to the customer wherever they choose to shop.

A lot of this was driven by our third priority which is developing and investing in our digital and OmniChannel capabilities. Today, developing and growing brands means doing so digitally across eCommerce platforms, mobile platforms, and social media channels. To compete in today's retail environment and to drive growth, it is paramount to have these capabilities. As consumers continue to show a preference for online shopping, declining mall traffic is likely here to stay, and we are positioned to compete in this new reality. In addition to our third-party websites, our own eCommerce business is thriving, and while it is a small portion of our retail business, it grew by 50% in Q4 as consumers accelerated their migration to eCommerce, particularly mobile platforms, a phenomenon not only occurring in our own brands but across the wholesale channel.

While mall traffic declines contributed to a 7% drop in our comp store sales, that comp decline is only 3% when you include our eCommerce business. Our strength online is supported by our recent investments in improving the shopability of our websites and providing a world-class digital experience for the customer that effectively communicates our brand and our product stories. These investments will continue to serve us well, particularly as wearables become a bigger part of our business, given this is how customers are more likely to shop for tech products in today's world.

And, finally, improving our profitability and growing our core watch business. This will always be a key focus for us. Last year, we launched our new world Fossil initiative and made progress in the fourth quarter optimizing our store fleet. As we told you when we introduced the initiative in November, this is a comprehensive multi-year plan to reinvent all aspects of our business and evolve our business model in every way -- the way we work, the way we develop product, and the way we bring our products to market. We are on a mission to create a leaner and more nimble Company, and an operating platform that is quick and responsive to consumer demands. We believe these actions will best position the Company for future success and drive long-term growth and shareholder value.

We are always in pursuit of ways to grow our core business. Today, we believe the way to do that is through technology. Having now added to our arsenal of competitive strengths, we are in an even better position to gain share to attract the best new brands as well as

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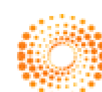

grow our existing brands beyond their current levels.

So, now, let's shift gears and talk about our priorities for 2017. Our mission is very clear. We have two major priorities. Executing against our new world Fossil initiative and building upon the early success of wearables in a meaningful way. In 2016, we saw broad-based global acceptance of wearables across all channels. We saw it in our own retail with the successful performance of Fossil Q, and across our wholesale channels with the introduction of wearables across our licensed portfolio. Adding technology features and new functionality to our watches opened the door to new distribution in the CE channel, a channel not previously available to our fashion brands.

During the fourth quarter, the one thing we learned clearly is that we can sell wearables at scale in all of our channels. We also learned that the customer for these is largely female, younger, might not have been an avid watch wearer, and is willing to pay more for an innovative wrist device. In 2017, we'll double our efforts in wearables by launching over 300 SKUs, introducing most of our brands to the platform. Keep in mind that the products launching this year are much improved even from last year. There are more innovations in function and design, more vibrant screens, better software and Apps, and they are slimmer and sleeker which will attract even more females to the category.

We had a great response to the new products at CES in January and quite a lot of very positive press. For example, our new Misfit vapor, a display smart watch, won six awards at the show including PC Magazine's best of CES 2017. So, we have turned what was once a head wind for our business into a tail wind that should only continue to get stronger.

To step back for a second, as you know, the global watch market has experienced significant disruption over the last couple of years, prior to that, we were clearly positioned as a competitively advantaged leader in a growing category. However, with the introduction of technology into wrist devices, traditional watches came under pressure, and we were disadvantaged. We didn't have the technology capabilities to compete with smart watches, leading to a decline in our addressable market. Adding the technology platform and introducing new functionality to our watches has enabled us to expand our addressable market to include not only traditional fashion watches but the wearables category as well. Now, we are aggressively competing to take share in a market that is 30% larger than the single-category market we competed in just two years ago. And, the wearables market happens to be growing at a 20% CAGR, faster than the traditional watch market was during its peak.

Looking at each opportunity, display watches are already the largest segment within the wearables market and expected to approach $15 billion in 2020. With the Android platform representing the majority of the category, and research shows 80% of the global phone market, we can uniquely compete with brands, fashions, and style and our Android wear watches can connect to almost any Smartphone in the world. Not every supplier can say that, and that can be a significant advantage to us.

We also believe we are uniquely positioned to drive business in hybrid watches, a market expected to grow to $7 billion in 2020. These watches look like traditional watches and incorporate the same design, style, fashion, and branding that had become the hallmark of what we do. These watches offer a robust branded App experience and an enhanced feature set that is broad, incorporates fitness tracking, fleet monitoring, and notifications, all without the hassle of routine charging. In doing this, we created a new connected watch movement, a watch movement that we believe will be the standard bearer going forward for our watches.

With our advantages of design and branding and scale to drive attractive economics, we believe this to be a very significant opportunity to gain share in the watch business and to draw renewed interest and new customers to the business. In our experience, energetic innovation in watches always drives consumer interest. With connected jewelry, we can do the trackers, a market expected to grow to $4 billion in 2020 what our hybrid watches can do to traditional watches. Turn a beautifully designed and styled accessory into a technology device with compelling functionality.

Overall, we feel with our new technology capabilities we are even more competitively advantaged today and positioned to gain share as the two wrist businesses of watches and wearables collide. Our objective is to disrupt the watch business with connectivity and to compete in the wearables business with style, branding, and storytelling. We maintain the same advantages we have always enjoyed around design and branding, and our significant scale and distribution have enabled us to reach more consumers than our competitors.

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That particular mode around our business model is still intact and a strong advantage.

We can bring our success in the traditional watch base to wearables given our scale and compelling economics. We learned in the fourth quarter that in the wearable space, price is important, and we intend to increase our market share by fine-tuning our price points to be ultra-competitive in the category particularly for our own brands. By driving volume, we will be able to improve our product cost to provide the right long-term product margins for the category.

Regarding our new world Fossil initiative, we will be relentless in pursuing the full potential of the initiative in 2017 and beyond. We are working to drive efficiencies in everything we do from production to distribution. We will continue to make adjustments to our store fleet as we push to meet the customer wherever they choose to shop today or in the future. With the new operating structure in place, we will have a tremendous opportunity to leverage as we drive growth.

Operating with a leaner infrastructure and an enhanced business model, we expect to drive $200 million in improved operating profit over time. Beyond those two key priorities, we will continue to maximize the power of Fossil and Skagen, with an emphasis on innovation and work to stabilize and grow our licensed brands. We remain focused on driving growth by increasing our market share and with an enhanced set of competitive advantages, we intend to be aggressive in the marketplace with the potential for adding new licenses, driving growth with existing brands, and continuing to grow our own brands.

In closing, we continue to be confident in the strategies we're pursuing and their ability to enable us to improve our financial performance and drive long-term shareholder value. Our success with wearables over the last year clearly shows that the pursuit of the category and the expansion of our addressable market are significant long-term opportunities for the Company. And, as we build a more nimble and responsive operating platform through our new world Fossil initiative, we will be even better positioned to improve profitability in a very leveragable business model. And, now, I would like to turn the call over to Dennis for more detail.

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

Thanks, Kosta, and good afternoon, everyone. Before I get into our review of the fourth quarter, I want to elaborate on Kosta's thoughts about our major priorities for 2017 and how delivering on those will position the Company for longer term success. In doing so, I want to draw your attention to the guide posts that should become evident to you as we execute against our goals to drive growth in wearables and improve our financial performance through new world Fossil over the coming year.

To begin, I want to first review the recent changes in our model. Between 2014 and 2016, currency has eroded our sales by $250 million and our operating income by $150 million. In that same period, operating margins have declined by roughly 11 points from 16% in 2014 to 2016's 5% which excludes restructuring charges. Roughly 4 of those points reflect the negative impact of currency. Unfortunately, with the recent further strengthening of the US dollar, these top line earnings and margin pressures will intensify in 2017. Beyond currency, nearly all of the remainder of the margin compression comes from a higher expense rate, roughly 6 points given sales declines over that time frame. Since 2014, our sales have declined at roughly a 3% rate and down 7% including the currency impact.

During that same time, our expenses remained flat. However, within that expense base, there has been a significant shift to investing in our strategic priorities to drive growth, building brand awareness, enhancing marketing, building our OmniChannel platform, and of course, wearables. Since 2014, these have added about $90 million to our expense base, the majority of which relates to wearables, and we have funded those investments by reducing infrastructure and under-productive store costs. These new investments especially wearables have not yet driven their ultimate returns, and our reductions in the expense base have not been sufficient to both fund these new investments and prevent the deleverage given the top line headwinds.

Now, as we pivot to the future, our investments in these strategic priorities to drive growth are largely in place. Where we still have work to do is further optimizing our base cost structure, eliminating additional under-productive stores, and enhancing our margins. That is the objective of new world Fossil. We believe that we can return to low teen operating margins in the future, and our ability to do that turns principally on three key factors.

First, is new world Fossil. As you know, the financial goal of the program is to improve profitability by at least $200 million over time, and

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we will invest up to $150 million in one-time costs to drive that annuity. We're still in the very early stages of the program, but we've already made great progress. To the changes we've already executed, adjusting our organization and store fleet, improving contractual terms and consolidating facilities, among others, we believe we've achieved nearly 40% of that goal already which should benefit 2017 and help offset other headwinds.

There is more work to be done, and some of that work will take longer to achieve. Through our design-to-value work, we can develop products with an understanding of which features consumers value most and eliminate features that only serve to add cost. We look to optimize the way we source products to better leverage our significant volumes across all brands. We're adjusting our SKU counts to lower cost by reducing the long tail of under-productive SKUs and tell better and more focused stories. Traditional watch SKUs are already down 16% compared to a year ago, and our teams are working to further reduce those skews. Margin initiatives take longer to deliver P&L benefits given design calendars, production cycles, and time to market. However, given the great progress we've made to date, we are optimistic about achieving the full financial goal of the program.

Next is growth. We believe we can achieve our low teen margin goals with only modest single-digit revenue growth, though we feel our opportunities can be much larger. Looking back to 2014, we estimate our addressable watch market at our price points which at the time was limited to non-text devices, was roughly $35 billion. Since then, industry estimates suggest the traditional watch market has been declining in the low to mid-single digits driven mainly by the disruption of technology. We slightly over-indexed that decline in part because of the enormous historical growth of the Michael Kors brand, but until recently, we have not been able to meaningfully address the consumer's demand for technology on their wrist. That we believe has now changed.

For 2016, we sold more than 1.5 million wearables devices and generated sales of almost $170 million. The majority of those sales were fourth-quarter smart watch sales for Fossil and Michael Kors. We did roll out more brands in a more limited way late last year for a total of eight brands, and we're excited to build on the momentum for 2017. With the strong success of Fossil and Michael Kors wearables, there is clearly a place for fashion and branding in tech-enabled wrist devises. In the short time since we launched, both of these brands have experienced more than a 10-point improvement in watch growth trajectory since the first quarter of 2016, and that has been driven primarily with display watches. With an overall Company sales decline of just under 6% last year, if our experience with Fossil and Michael Kors reflects the growth power that wearables can bring to our model, that could be the catalyst to ultimately turn our net headwinds into tailwinds and drive us back to at least a single-digit growth rate.

The structure to support that growth is in place. Our OmniChannel platform is working and driving growth -- 40% last year, and we've expanded our global distribution reach with new CE channel partners. With our investments now largely in place and the benefits of new world Fossil, we can drive significant margin expansion on relatively modest growth. We are now competing in a wearables market for wrist devices that analysis shows was $13 billion in 2016 and is forecasted to double in four years. All that growth is expected from watches. We've always viewed the wearables and traditional watch markets as converging, and these estimates would suggest that our addressable wrist device market is now roughly 30% larger than it was in 2014 and growing. As Kosta shared with you, at every point within this market, we believe we have significant advantages.

Across the full spectrum of the wrist device market whether traditional, hybrid, or a full-display watch, we can address all of those segments in a way that no one else can given our design and branding capabilities, significant scale and distribution, and scalable technology platforms. The third driver of future margin expansion will be connected margins. As we've entered the market, we've been adjusting pricing to find the sweet spot in the market. The changes we made in Q4 drove significant acceleration in volume, obviously at the expense of margins. Scale in Android wear fashion watches can be a significant advantage to us. In 2016, we achieved wearables margins in the mid-40% range. Our strategy for 2017 is to invest roughly 10 points of near-term connected margins to drive the volume momentum that we can then use as currency with our suppliers to drive costs down through better volume pricing and to enable them to confidently invest in automation.

We are deeply engaged with our connected supply chain partners and are working with them on costing models as we achieve greater scale. We believe that even with just a modest single-digit share of the market, we can drive sufficient cost improvements to at least restore the connected margins we achieved in 2016 and even greater volume could support improvement beyond that. We still have a lot to learn in pricing which could also be a factor that can and will affect those margins.

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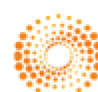

So, with that context of our long term vision, let me examine our Q4 performance and share our expectations for 2017. Fourth-quarter constant currency net sales decreased 2%, and on a reported basis, decreased 3% to $959 million. During the quarter, we achieved sequential improvement across all three regions driven mainly by wearables. For the quarter, reported diluted earnings per share were $1.03 compared to $1.46 last year. Excluding restructuring charges, diluted EPS was $1.24, with a decline compared to last year largely driven by lower sales and gross margin. This year's EPS was negatively impacted by $0.22 due to the strong US dollar and the benefit of last year's hedging activity, $0.21 of restructuring charges, and $0.08 due to Misfit purchase accounting charges. Last year's fourth-quarter EPS included $0.13 for Misfit transaction costs, $0.14 of impairment charges, and $0.04 of restructuring charges.

Recapping the quarter, let's start with watch sales. While it is still early, the strong performance of wearables is proving to be the catalyst to offset the recent headwinds in the watch category. Overall watch sales were virtually flat on a constant currency basis versus last years fourth quarter, a significant improvement from the first half of 2016 when watch sales were declining in the high single digits. For the quarter, wearables grew to represent more than 11% of our total sales with sales across eight brands dominated by the strong performance of Fossil and Michael Kors display watches. Watch performance was very strong for both these brands with Fossil increasing double digits in constant currency for the quarter. And, for Michael Kors, watch sales were flat, a substantial change in trend. And, consumer acceptance has been very strong. Based on data reported by our American channel partners, combined with our own, retail watch sell-through trajectories have improved double digits for both these brands since the beginning of 2016.

Jewelry and leathers declined during the quarter with leathers continuing to be weak as customer response to the assortment continues to put pressure on results. Fossil grew 2% in constant dollars compared to last year driven by watch growth in all three regions. The double-digit watch growth more than offset declines in jewelry and leathers. Overall sales growth in Asia and Europe was partially offset by a decline in the Americas. Skagen sales grew 8% in constant dollars with watches driving the growth and jewelry and leathers also contributing. Growth in Asia and Europe was partially offset by a decline in the Americas. In the retail channel, store comps declined 7% though only 3% considering our strong eCommerce performance where sales increased 50% in the quarter.

The investments we've made in our OmniChannel platform are certainly leveraging the continuing consumer preference to experienced brands and shop online. Overall retail comps increased in Asia but declined in Europe and the Americas. Globally within our retail channel, performance was consistent across our Fossil full-price and outlet stores. Now, from a regional perspective, in the Americas, fourth-quarter reported sales decreased 7% to $483 million, a 6% constant-dollar decrease. Traditional watches and leathers drove the overall decline. In watches and across brands, Fossil and Tory Birch delivered solid increases, offset by declines in traditional watches and nearly all of the other brands in the portfolio. Michael Kors Axes continued to have a positive impact on the brand nearly offsetting the entire decline in traditional watches.

Both wholesale and retail sales declined in the quarter with wholesale representing the majority of the decline in the region. In Europe, reported sales decreased 4% to $333 million, a 1% constant-dollar increase with growth in watches driven by wearables partially offset by declines in jewelry and leather. Within the region, continued growth in Fossil and Skagen drove the increase, partially offset by a decline in the licensed portfolio. Growth in our travel retail business and in Spain was partially offset by declines in the UK and Germany.

Sell-throughs for traditional watches in some key markets in the wholesale channel continued to decline offset by sell-in of wearables. In Asia, reported sales increased 13% to $144 million with constant-dollar sales increasing 12%. We delivered growth in all three categories with particular strength in watches driven by wearables. Constant-dollar growth in India, China, and Australia was partially offset by a decline in Taiwan. Comp store sales increased in the region in both our full-price and outlet Fossil brand stores.

In the quarter, gross profit decreased to $489 million, and gross margin declined 200 basis points to 51%. Promotions, mainly to drive outlet business, continued to be the biggest headwind for gross margin while wearables mix represented roughly 50% of the net margin decline. The currency headwinds of earlier in the year abated [so much] in the fourth quarter so we do expect these headwinds to intensify in 2017. Our margin improvement initiatives, along with the benefit of operating with much lower and cleaner inventories, helped to partially offset these headwinds.

Fourth-quarter reported operating expenses decreased $14 million, or 3%, to $423 million and included $13 million of restructuring costs

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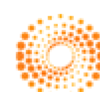

primarily related to store closures. Our normalized expenses, which exclude for both 2016 and 2015 restructuring charges, impairments, Misfit acquisition costs, and purchase accounting charges, were down compared to last year. This was slightly better than our original guidance and driven by lower core infrastructure and store costs, but we did invest slightly more in marketing and building out our wearables team.

Nearly all of our Q4 restructuring charges supported our efforts to optimize our retail store fleet as we closed 27 stores -- 12 full-price and 15 outlets -- primarily in the Americas. Operating income decreased to $66 million including unfavorable impacts of $7 million from currency and $13 million from restructuring charges. Operating margin decreased to 6.9%, including a 60-basis-point headwind from currencies and approximately 140 basis-point headwind from restructuring costs. Fourth quarter other income decreased roughly $4 million to $8 million due to lower gains on foreign currency contracts compared to the prior year. Interest expense increased $2 million. Our effective income tax rate for the quarter was 23% compared to last year's 24%. Fourth-quarter net income decreased to $50 million primarily due to lower sales and gross margin and a reduction in other income due to the prior-year benefits from hedging activities partially offset by lower expenses and taxes.

Now, turning to our cash flows and balance sheet. For the full year, we generated operating cash flow of $210 million compared to $361 million in the prior year. We invested $66 million in CapEx, $7 million in share repurchases, reduced borrowings by $171 million, and realized $42 million in real estate sales proceeds. We ended the year with roughly $297 million in cash compared to $289 million last year, and debt of $636 million compared to $808 million a year ago.

We're very pleased with our efforts to manage capital tightly and maintain tight inventories. Year-end inventory was $542 million, down 13% from the prior year. Our traditional watch inventories declined significantly as we are building wearables inventories to support our growth. Accounts receivable increased by 1% to roughly $376 million, and wholesale DSOs increased by one day compared to the prior year. Depreciation and amortization expense totaled $21 million for the quarter and $95 million for the full year.

So, now, let me share our outlook for 2017. Before I go into the details, let me first discuss GAAP versus non-GAAP measures. There are several factors that will cause volatility in 2017 GAAP EPS. Currency changes, restructuring charges, higher interest expenses, and income tax benefits that will result primarily from restructuring charges as well as certain changes in tax accounting standards. In order to assist investors in understanding our underlying operational trends, I will isolate and quantify the impact of those factors in my analysis. We will also provide both GAAP guidance and also a non-GAAP analysis that neutralizes the effect of these factors for both 2017 and 2016 and also neutralizes the impact of a real estate gain in 2016.

In today's earnings release, we have provided a table that quantifies these items for both 2017 and 2016 and reconciles our GAAP to our non-GAAP disclosures. As we move then to 2017, we expect that the rollout of wearables can continue to be the catalyst to offset the headwinds from traditional watches. Our goal is to drive modest overall constant-dollar sales growth for the year so that growth will be skewed toward the second half of the year. At current rates, the weaker US dollar will absorb that growth. We expect our wearables business will grow progressively throughout the year as we continue to introduce more products and bring additional brands on to the platform.

We're planning our largest wearables sales increase for the third quarter as we launch NextGen display watches for Fossil and Michael Kors, and add other brands. Still more will roll out in the fourth quarter. We'll introduce a larger assortment of NextGen hybrids also mainly in the third quarter including the Misfit Vapor which received incredible attention at CES. Our goal for 2017 is to leverage the momentum we are building in wearables, our brand platform, improved technology and distribution to gain roughly 3 points of share of the overall connected wrist device market. We expect the first quarter will be the most challenging from a sequential sales trend perspective for a few reasons. We're operating with roughly 40 fewer stores than a year ago, and we also expect to sell less through off-price channels given our relatively clean inventory position. We are also anniversarying last year's first quarter when channel sell-in significantly exceeded sell-through given the downturn we saw in traditional watch demand a year ago. Coming out of the first quarter, our goal is to drive sequentially improving top line growth throughout the year as we introduce more wearables into the market.

Now to gross margin. We are planning the year with a lower overall gross margin. We expect retail traffic trends to persist, and that we will still need to rely on promotions especially in our outlets to drive conversion. As we said earlier, we are investing roughly 10 points of

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connected margins to generate the volumes that we can use to drive better costing through our supply chain over time. And, given prevailing exchange rates, currency will be a further drag on gross margin. Partially offsetting those, we expect to drive benefits from our new world Fossil initiatives. The net headwinds should gradually build throughout the year and likely spike in the third quarter when the year-over-year change in connected mix will likely be the greatest.

Excluding our restructuring charges, we expect to operate with a lower annual expense rate and lower expenses throughout the year. The areas of our business model we have been developing for the future including our wearables team and our OmniChannel platform are now largely in place. We expect our advertising investments to be relatively similar to 2016 levels overall though more heavily weighted to the third quarter of this year to support our large rollout of NextGen wearables. Our new world Fossil initiatives along with store closures will drive the year-over-year reduction in operating expenses.

Based on our current estimates, excluding restructuring activities, we expect our earnings to sequentially improve as we progress throughout the year. As we move into the third quarter, gross margin pressures should likely be the strongest given the greatest year-over-year change in connected mix relative to 2016. The shifting of greater advertising investments in the third quarter will likely dampen the earnings benefit of our anticipated wearables growth so we would expect that expense timing to turn in the fourth quarter when we expect to generate the substantial majority of this year's earnings.

For the full year, we expect to record restructuring charges of about $75 million, or $1.01 per share, primarily related to adjustments we've made to our organizational structure and store closures. In the first quarter, we expect restructuring charges of $30 million, or $0.41 per share. While our bank facility extends until May 2018, our goal is to replace it this year. Given the overall environment in retail, we do expect that this will result in higher interest expense for the year which we estimate will negatively impact the annual EPS comparison by roughly $0.28 per share mostly after the first quarter. Given our current earnings expectations, this year's restructuring charges, and certain changes in tax accounting rules, we expect to recognize a relatively small income tax benefit in 2017. Despite this year's anticipated first-quarter loss, we still expect to record a modest income tax expense in the first quarter related mainly to changes in tax accounting rules and mix in jurisdictional earnings. We expect the tax provision should then turn in subsequent quarters.

Therefore, for the full year, on a GAAP basis, we expect sales in the range between a 6.5% decline and flat. Both of these rates include roughly 150-basis-point negative impact from the closure of our retail stores. That store closure headwind should gradually increase throughout the year as we execute more store closures. At the upper end, our guidance assumes annual traditional watch sales trends deteriorate slightly compared to our overall 2016 annual trend. And, at the lower end, we assume further step-down in those trends. The lower end of our estimate also assumes we do not fully execute our wearables rollout.

For the full year, we expect GAAP operating margin in the range between 0 and 1.5%, and we expect GAAP EPS in the range of between a loss of $0.50 and income of $0.20. We expect GAAP first-quarter sales to decline in the range between 13% and 9.5% which reflects the headwinds I described earlier. We expect GAAP first-quarter operating margin in the range between negative 8% and negative 6%, and GAAP EPS loss in the range between $1.06 and $0.92.

Now, let me talk about our adjusted guidance, and you'll find a description and quantification of all these items in today's earnings release. If we were to eliminate the effects of non-operating currency gains and losses in both 2016 and 2017, eliminate the currency headwind between 2016 and 2017 operations, restructuring charges for both periods, higher interest expenses anticipated in 2017, net of related taxes, our adjusted guidance would be as follows. For the full year, constant currency sales would be in the range between a 4.5% decrease and a 2% increase.

These data also include the roughly 150-basis-point store closure headwind, and the range contemplates the same execution in sales risk as in our GAAP guidance. Full-year adjusted operating margin would be in the range between 3.5% and 5% with our investment in lower connected margins this year offsetting the improvements from new world Fossil. Full-year adjusted EPS would be in the range between $1 and $1.70. If we were to similarly adjust our 2016 results and eliminate last year's real estate gains, net of related taxes, we estimate our 2016 adjusted EPS would have been $1.80.

For the first quarter, constant currency sales would decline in the range between 11.5% and 8% including a roughly 130-basis-point

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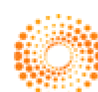

headwind due to store closures. Adjusted operating margin would be in the range between a negative 2% and zero, and adjusted EPS would be between a negative $0.25 and a negative $0.10. Adjusting 2016's first quarter to be on a comparable basis, that adjusted EPS would be $0.11. The year-over-year change results primarily from the change in sales from 2016 to 2017. Finally, we're planning the year assuming we invest approximately $70 million in CapEx.

And, with that, we'll open up the call to your questions. Please limit yourself to one single-part question so that we can give everyone a chance to ask a question. If you have further questions, please re-queue and we'll get to as many questions as time permits.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Our first question is from Oliver Chen of Cowen and Co.

Oliver Chen ***Cowen and Company - Analyst***

Hi, thank you. Regarding the discussion around price points, can you just help us understand which part of the portfolio are you calibrating? And, what was the logic as you balanced the market share opportunity? And, I'm also concerned about inventory management because you have been engaged in the test, read, and react strategy for many years, and you're entering a new era with different products. You launch on a different schedule with the types of innovation and what's happening in wearables. So, I'm a little bit concerned about your ability to manage in terms of the product release schedule and making sure you have the right products at the right place at the right time and have the markdown cadence in a brand-appropriate way? And, just as a follow-up, Dennis, what about the cash flow for next year? Should we be worried about deteriorating cash flow trends in terms of how we model the business? Thank you.

Kosta Kartsotis ***Fossil, Inc. - Chairman of the Board & CEO***

Thanks, Oliver. So, first of all, on the price of wearables, as we mentioned most of what we sold last year was display watches. Obviously, average unit retail is much higher. What we learned is, first of all, Kors by far exceeded expectations at full price. We weren't even testing prices on Kors because we were chasing inventory and still chasing inventory to a certain extent right now. So, complete blowout at that price and what we perceived is a huge amount of demand out there. Very significant for overall smart watches as well as hybrids. So, what we're doing basically is going into this, and we have line of sight that when quantities go, up our costs go down.

So, we also did a lot of testing on Fossil, and Fossil -- one thing I would say is that if you look at the average retail of Kors at $250, the smart watch was $350 so $100 more. In the Fossil brand, it was almost double the average unit retail price so we tested different price points, and we found significant demand at certain prices that we feel like long term we'll be able to drive significant sales. We also are planning on being very aggressive in the marketplace and putting very sharp prices on hybrids to get the quantities we need to drive the cost savings. So, we also, obviously, want to get this on a lot of wrists, and we wanted to go word of mouth, go viral. We're also putting all of our marketing and advertising resources for the entire year on telling this story as big as we can. We want to have a big bang to create as much excitement as we possibly can.

On the inventory side, interesting enough, if you look at -- we did, as we said $170 million. That was basically on 100 SKUs. An average of $17 million in sales per SKU. That's by far the highest we've ever had on anything. As we've talked about with new world Fossil, a big part of the initiative is reduce our SKU count. We're using wearables as a catalyst to enable us to do just that so we are going to have fewer SKUs at higher average retails doing significant amounts of more volume, but actually, it is going to make our model more predictable. And then, we also have built into our model as new generations roll in and the old generations roll off, we have a huge amount of demand in our outlet channel and our liquidation channel for this product as well. Our business has always been around read and react, and that's important when you're testing new, smaller trends, and we'll still continue to do that in our fashion traditional business. But, we have the opportunity, I think, especially that we will get more history as time goes on, we'll be able to predict pretty well what the potential size of this is. And, that's why we are going to be using price as a lever to make sure we get the quantities.

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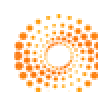

Greg McKelvey ***Fossil, Inc. - Chief Strategy and Digital Officer***

I would just add -- now that we understand sweet spot price points that drive real volume, we then translate that on to the supply side of our business. So, we've got technology costs in components and manufacturing that were negotiated and really reflect the low volume we had prior to Q4 last year. We've also completed an extensive benchmarking study so we understand where those costs will go as we get scale and are able to drive to increasing levels of automation with all our major component suppliers. And, also, just generate the benefits of scale. So, when we hit those sweet spot price points, drive volume, we are now going and working with all of our suppliers across on the technology side of our business -- deeply engage with them to figure out exactly how those pricing and cost contracts will work, and how costs will flow that will come significantly down as we flow volume in the next 12 to 24 months.

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

Oliver, you asked about cash flows. Here is how we're thinking about liquidity and cash flow. I'll start with where we ended 2016. We've got roughly $300 million of cash, mostly international. $640 million of debt. With our 3.25 EBITDA covenant, we have roughly $300 million of available debt capacity. Now, we think about our operations against that covenant. The upper end of our range -- our operations should be fairly similar to 2016. The significant changes that are driving EPS down are interest which are not a part of that covenant and restructuring where we do have an add-back to our covenant. Currencies, which we give you in the release, which that headwind is about $30 million. That would affect that calculation. So, if you look at that impact through the filter of our EBITDA covenant, it suggests roughly about $100 million change based on those assumptions on debt capacity.

Now, look at cash flow. In 2016, we generated $210 million of operating cash flow. Again, the top of our guidance assumes roughly neutral adjusted operating results. Our table in the release should help illustrate that. So, in 2016, the taxes will be favorable. We talked about that a moment ago, but currencies and restructurings will be headwinds. Think about interest. And, we do anticipate being able to manage with tighter inventories, largely driven by running with fewer SKUs. So, all-in, we could see some compression of operating cash flow but still nicely positive. We're expecting CapEx of around [$70 million] so all-in. Still driving overall positive cash flow for the year so again that's probably mostly likely overseas. What that profile might look like a year from now based on these assumptions would be growth in overseas cash likely similar debt levels and some compression of debt capacity but still significant capacity in liquidity.

Operator

Thank you. Our next question is from Omar Saad of Evercore ISI.

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

Hi. Thanks. I wanted to dig into some of the helpful information you've given on wearables. Primarily, this kind of idea that there's a new customer coming in -- a younger, more female who hasn't worn watches in the past. Maybe help us understand in addition to that -- dive in there. But, also, the traditional fashion watch customer? Are they converting over to the more wearable products? And, also, help us understand what's going to be new -- to the extent you can -- what's going to be new in the wearables offering for the fall that you keep talking about? Thanks.

Kosta Kartsotis ***Fossil, Inc. - Chairman of the Board & CEO***

Basically from our perspective, it's two businesses colliding so you take the traditional watch business. Our intent is to disrupt that business with technology. Put connectivity across-the-board. One advantage we are going to have this year is that the hybrid watches are going to get slimmer. We are going to have more brands that will have really sharp price points. So, we think it's an opportunity for us to gain share in the traditional watch business. It also will bring a younger customer in there. It is innovation in watches, which is always what drives the watch business, so we think that by accelerating that as much as possible, that we are going to be able to change the direction of the traditional watch business. We are also going to be -- with the wearables business, we're selling new channels there, too. So, these two markets colliding, you're seeing that traditional technology Companies are selling smart watches to department stores and jewelry stores, and we're selling to CE channel. We are actually with our larger addressable market and the benefit of fashion and our distribution and all our other competitive advantages, we think we're in a really good position to continue to gain share in that business as it continues to grow.

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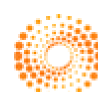

Greg McKelvey ***Fossil, Inc. - Chief Strategy and Digital Officer***

A couple other points on product. I think it's fair to say that we are going to have a step-function improvement in product through innovation, and the pipeline we've been developing over the last year-plus. Kosta mentioned smaller and thinner watches, which is a much better fit for our female core customer, which is generally over 70% of our traditional watch sales. And, also, more APAC -- Asia-Pacific-friendly sizes with smart watches, in particular. So, display smart watches not only thinner and sleeker, but we've invested in a beautiful custom display that's a full round, high resolution, bright screen with thin bezel that you saw first at CES in Misfit Vapor. And, that is going to go through the majority of our smart watch line this year. We'll also have some other features like rotating crown, and then you probably have seen some of the press around Android Wear 2.0 which we think is a massive upgrade for our customers, particularly those that are on iPhones.

Kosta Kartsotis ***Fossil, Inc. - Chairman of the Board & CEO***

So, we are going to be injecting technology into the traditional watch business and injecting fashion into the wearables business, and we're perceiving very significant demand. There's huge consumer interest -- all of our stores, partners, our license partners, et cetera. Everyone is fully on board. As we've been saying for some time is the number one trend right now in fashion is technology, and we are going to bring it to the market.

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

I'd add one other point on Misfit Vapor, which we announced at CES, really represents a sport line for us as well. So, we're going to have a fashion line which is focused on the right functionality for our customer that wants a thinner profile watch. We are going to also have a module now and a product line that's focused on sport. So, we'll start with Misfit Vapor, and then, we'll add other brands. We believe the sport use cases, which are a significant part of the overall wearables business today, is something we'll be able to tap into as well.

Operator

Thank you. Our next question is from Edward Yruma of KeyBanc Capital Markets.

Edward Yruma ***KeyBanc Capital Markets - Analyst***

Hi, thanks very much for taking my questions. I guess, first, you indicated that there was still some inventory imbalance that you aren't able to fulfill the sales trend on the screen watches. Could you talk about when you're anticipating that to normalize? I guess second, the 10 points of margin compression for wearables for 2017, is that you investing in price, functionality? I guess how do we think about how that investment takes place? And then, finally, I think you indicated that Kors was largely flattish given the wearable strength. Is it your anticipation that Kors turns positive in 2017? Thank you.

Kosta Kartsotis ***Fossil, Inc. - Chairman of the Board & CEO***

Well, first of all, on the supply when we first started shipping the new generation smart watches third quarter last year, we started seeing strong sell-through. So, we -- at that point, we started forecasting larger numbers for this year. We do have increasing flow for the first quarter, and then, we saw another step-up in sell-through in the fourth quarter, especially in December, so we placed orders for that. So, those would be coming in second and third quarter. Our new generation smart watches are landing third quarter, and as Greg mentioned, they are just beautiful watches. Beautiful screens -- much improved, slimmer. We're expecting even stronger sell-throughs on there. So, clearly, we see especially with Kors, the demand and the sell-through we got on Axes. There's a positive story here, and we're moving as fast as we can to fulfill it.

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

So, I think we're in good shape in terms of inventory management. There were styles in our launches this last fall and in Q4 that were 2.5 to 3x what our initial forecasts were so you can't help but be in a situation of chasing demand, which is a good problem, but you have a lag to deal with. This year, we have got a year of experience in managing that, and I think we'll be in pretty good shape.

On the pricing strategy side, we gave a little bit of color on that in our response to Oliver. But, what's really happening here is that our pricing and our margin strategy on wearables is this convergence of a few data points that tell us that we are on the cusp of a high volume, profitable wearables business. But, we need to act quickly to get to volume and take advantage of it. We mentioned the sweet spot pricing so we did testing particularly with Fossil around what is the sweet spot price that drives massive volume? We're still going to

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tinker with price and figure out how to evolve that strategy, but we think we found a sweet spot. And, now, as we're turning to the supply side of the business -- now that we know how much volume we can generate through demand, our work has now gone to what is the level of volume that we need to get to to drive substantial reductions in cost. What I'd call minimum efficient scale. And, we've developed that point of view in both the hybrid category and in smart watches, and our job now is to go get it. So, we are going to invest in price to go get volume, and then leverage that volume to work with our supply partners on the technology side of our business to get to scale -- economies of scale and costing quickly.

Operator

Thank you. Our next question is from Erinn Murphy of Piper Jaffray.

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

Great, thanks. Good afternoon. A couple for me. First, just going back to the fourth quarter watch stabilization that you called out, can you just speak to what you saw as the quarter progressed from a sell-through perspective of traditional watches? I know wearables made up-- I think you said 11%. And then, secondly, could you just -- I'm sorry, walk through the disconnect of Q1 sales run rate versus where you ended Q4. Are you making an assumption that Michael Kors rolls over in Q1? I know you said store closures are about 130 basis points impact to the top line, but there's a pretty broad range in there so just trying to understand that. And, finally, on the stores that you're closing, I think you said 40 was the number for the full year that you just closed. What are the characteristics of those stores you're closing? What regions are they in? Are they four-wall negative? Just anything to help us understand how we should be modeling that from an EBIT perspective. Thanks.

Kosta Kartsotis ***Fossil, Inc. - Chairman of the Board & CEO***

On traditional watches in the fourth quarter, the traditional watches continue to be soft. But, what we said earlier on the brands that have wearables, so mostly Fossil and Kors, we were able to offset most of the decline with wearable sales. So, that's where we are on that.

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

On the first quarter, there's really three things that we are -- I'd ask you to focus on. The first is the store closures. That is obviously creating a headwind in the top line. The second is that given where our inventory position is, we were down now 13%. A year ago, our inventories were up 5% coming out of the fourth quarter a year ago, so we were expecting that in this first quarter sales, we will have less off-price sales because of the much stronger and cleaner inventory position. And then, the third issue is for last year in the first quarter so we actually delivered our sales in the first quarter, but that's a quarter in which we saw a fairly significant and worldwide downturn in traditional watches. So, we think that what we effectively did there was build channel inventories through the first quarter. We're now up against that fairly relatively strong sell-in perhaps versus what the sell-throughs would have suggested. So, we're up against that. In terms of store closures, we'll be continuing to close stores throughout the year. We'll probably close a similar number in 2017 to what we did in 2016, but the profile is they cut across all regions. The biggest is in the Americas, but they are also -- all concepts are [affected]. Effectively, we were targeting is those stores that are underperforming in terms of their financial metrics, and/or those stores that are no longer of strategic value to us.

Operator

Thank you. Our next question is from Simeon Siegel of Nomura.

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

Great, thanks. Good afternoon. Dennis, just to follow-up on the store closures. How large would you like your ultimate store fleet to be? And, how much of that low teens margin opportunity is driven by these closures?

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

We've been on this journey for the last several years where brick and mortar stores are becoming less important to the model, and we've been investing in OmniChannel which is driving significant growth. We expect that to continue so we're taking a fairly large number of stores out of the system this year and last year, and then, we will wait and see. Some stores we won't close. Perhaps some stores we will just let run through expiration and not renew those. But, we certainly see stores that will remain an important part of our business model

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but just that shifting as the consumers shopping pattern is shifting. In terms of the impact to the long-term operating model, if I look at the key drivers that I called out -- growth, new world Fossil, connected margins. The stores are stores that are dragging down current earnings. But, if I prioritize those, I would say the impact on earnings would be the least -- stores would be the least impactful on those earnings.

Kosta Kartsotis ***Fossil, Inc. - Chairman of the Board & CEO***

If you look at our stores over the last couple years, we've changed them quite a lot. The entire visual merchandise in the store is different. It's much more experiential, and I' would encourage you to see our store on Fifth Avenue. It was remodeled last year [reported history]. What we're doing in there now is a lot of embossing on leather goods, engraving on watches. A lot of our sales in the stores are now actually done over the Internet. So, a customer comes in, we work with them over an iPad, and they can convert on our website. We also have on our website all of that embossing and engraving and the ability to build your own watch the way you want. So, it has changed quite a lot, and we're interested how the stores evolved and how it dovetails into our marketing, social media, CRM program. So, as we close some of these stores, we are using some tools to try to identify those customers and communicate and engage with them in different ways. We're also interested in going forward to how maybe we have a smaller store that's totally more customization and more experiential and really it maybe drives people to our website and just communicates the brand and where we are going.

Operator

Thank you. Our next question is from Anna Andreeva of Oppenheimer.

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

Great, thanks so much. Good afternoon. I guess two questions for us to Dennis. I think you mentioned you already realized 40% of that $200 million of SG&A rationalization. What drove that reduction? And, what kind of SG&A dollar decline should we expect for 1Q and for the full year? And then, secondly, to Kosta. As you think about your wholesale exposure, any opportunity to exit any of the department store doors out there? And, just any view on brand composition in the portfolio? Do you see any benefit to maybe downsizing given likely some cannibalization across the brands? Thanks.

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

I'll start with what we've been working through new world Fossil now for roughly six months and a lot of the activities that we've already essentially executed on will flow through the P&L in 2017. We did have an action in the Company that affected the global organization that reduced our overall headcount. It's tough -- those are tough decisions, but the right thing to do for the long term. So, that will benefit the P&L throughout the year. We've closed some stores. We've also gotten some quick wins through contract negotiations, better leveraging our volumes, reducing indirect spending. The way we're viewing that is that accumulates to approaching 40% of that overall $200 million goal, which as the P&L rolls through 2017, we should see those benefits rolling through. That's fundamentally going to offset the investment that we're making in connected margins. So, again, if you step back and you look at our adjusted guidance, the implication is that our normalized operations are roughly flat, which is us investing in those margins and using new world Fossil benefits that we've been able to execute that will hit 2017 to offset those.

Kosta Kartsotis ***Fossil, Inc. - Chairman of the Board & CEO***

On the store side, over the last several years, we have actually closed a number of smaller stores whether they are small department stores or smaller specialty stores. Some of those stores self-elected to close, et cetera. But, generally, the impact of that was negligible on us because those stores were not very productive, and typically, if you move the inventory to larger doors you get better sales anyway. So, we don't see that -- some of that will be ongoing [if it's not an impact]. We are, as we mentioned, adding a lot of additional distribution for especially wearables. So, CE channels CE websites globally so I think that's going to penetrate even more this year. We're very interested to see how that plays out.

And, on the brand side, I would say especially now with our new capabilities of technology, I think we've put ourselves in a position where we will be adding additional brands over the next couple of years. We're being very aggressive in the marketplace with our brands. We're pushing wearables as a differentiator as fast as we possibly can. We think we're going to gain share and get additional space, and we think we're in a position to add additional brands to take a larger share of the watch business and the wearables business.

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Operator

Our next question is from Scott Krasik of Buckingham Research.

Scott Krasik ***Buckingham Research Group - Analyst***

Hi. Thanks very much. I just wanted to be clear on how you're looking at the guidance, Dennis. If we take out for the interest expense and the FX, it seems like you're adjusted guidance is $0.51 to $1.21? Is that right? And is that what we should be using for 2017? Secondly, I'm just wondering if you expect a much larger percentage of your revenues than normal to come in fourth quarter as well? And, early discussions with your retailers -- how are they planning to invest in the wearables category? I know some of them did in a pretty big way in holiday 2016. Thanks.

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

I didn't quite follow your math on the front, and I think the best way to understand how we're thinking about the adjusted guide is to just refer to the chart that we have in the press release that eliminates the impact of restructuring from both periods, eliminates the incremental interest expense -- not total interest, but incremental interest expense that we expect we're going to occur, last year's gain, and then, the impact of currency. So, that you get both years on a relatively like-for-like basis.

In terms of the sales trends, I think -- and we said this on the prepared remarks. We should see an increasing sales trend rate over as we move through the quarters. Obviously, the first quarter is going to be tough for some of the reasons we talked about. But, largely, it's going to be driven by bringing more and more wearables on to the platform. The majority of our wearables rollout this year will be second half so you are going to some more of the weighting in the back half of the year. But, we think wearables will be -- can be the offset. Now, I would just again remind everybody that sequencing is important here. So, you've got headwinds. You've got tailwinds. We certainly believe that connected can be the tailwind to ultimately offset those headwinds. Predicting them -- exactly when they happen is always a challenge that we face still operating in a business with limited visibility.

Scott Krasik ***Buckingham Research Group - Analyst***

And, just to clarify because it's hard for investors to exclude higher interest expense if that's going to continue -- and then, also currency. So, just the GAAP EPS plus the restructuring charges sound to me like $0.51 to $1.21?

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

I'm not sure. I'm not doing your math here. Maybe we can talk offline, but I don't know if your math is right. I can tell you the way we're thinking about it. It's not to imply that that's the right number. It's really to help one compare year-over-year. That's what we are trying to accomplish with that.

Operator

Thank you. Our next question is from Ike Boruchow of Wells Fargo.

Ike Boruchow ***Wells Fargo Securities - Analyst***

Hi, everyone. Just really simply, can you tell us maybe the high end to the low end of the guide, Dennis? What's included in your guidance in regards to wearables revenue and wearable EBIT? I'm not sure, are you planning to make money on the wearable business this year? And, if the answer is no, is there a certain revenue point where you start to scale that business?

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

We didn't specifically quantify that. We are expecting given that we're investing in the margins this year to drive significant improvement in acceleration of the business. We told you that our goal was to get perhaps another 3 points of share of the overall connected wrist device market. We did handicap that in the range so that the lower end of the range assumes that we don't fully execute on the plan. There's a lot of moving parts, and we're flying 1,000 miles an hour here. We didn't comment yet on whether the full connected business is profitable.

Ike Boruchow ***Wells Fargo Securities - Analyst***

Okay, but -- .

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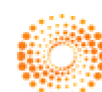

Operator

Thank you. Our next question is from Betty Chen of Mizuho Securities.

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

Thank you. Thanks for taking our question. I guess following up on what Ike was saying, it sounds like the team has done some comprehensive analysis already of the balance between volume and costing. Where I guess -- where do we need to be for that costing to come down so that the margins will retrace the 10 points being invested this year? Is it roughly a double of what we saw in 2016? Or, something higher than that? Any sort of help around that would be really helpful. And then, the other is -- just want to understand the idea around the new world Fossil? Dennis, you're saying that you've already achieved 40% of that $200 million in EBIT in operating profit improvement and that's already embedded into the 2017 guide? Or, is that something that's going to be recognized in 2018? I just want to make sure we understood that. Thanks.

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

The first part of that question around volume. I point to a couple things on the supply side of the business part of the answer is just volume-based pricing and getting that our volume reflected in our contract with our supply base. But, more than 50% of the opportunities actually getting to volume that allows us to get our supply base to deliver dedicated manufacturing lines with a high degree of automation because several of the components are specific to smart watches and hybrid smart watches and sometimes even unique to just us. So, we've got to get to that volume. What I'd say is our goal is to get to -- to aggregate the amount of volume that would meet our -- what I'd call our minimum efficient scale by the end of the year or early next year. And then, the next question is how does the economics and costs flow? But, this is not a multi-year thing. This is aggregate the volume now, work with our suppliers to make it a win-win cost model -- or find different suppliers. And, that's a lot of work to get there, but I'm spending nearly 100% of my time making that happen.

Kosta Kartsotis ***Fossil, Inc. - Chairman of the Board & CEO***

With respect to the new world Fossil, so what we're trying to communicate is that through the actions we've already taken, the contract renegotiations that we've had, facilities that we may have closed, the better pricing that we're getting because we're doing a better job consolidating our volumes -- all of that effort should roll -- and stores we've also closed. All of that effort should roll throughout into the benefits of 2017 P&L based on the work that we've already done. And, that's roughly 40% of our overall goal.

Operator

Thank you. Our next question is from Dana Telsey of Telsey Advisor Group.

Dana Telsey ***Telsey Advisor Group - Analyst***

Good afternoon, everyone. As you think about the wholesale business and whether it's department stores, whether it's selling to the off-price channel, what's happening on the order patterns? What's happening on the promotions in the margins on what you're seeing in that channel? And, what percentage of the business do you expect that channel to account for going forward? Thank you.

Kosta Kartsotis ***Fossil, Inc. - Chairman of the Board & CEO***

Well, I think that the one thing we're seeing on wholesale is that we have some very desirable product sell-in pretty quickly. It's bringing in a new customer, averaging retails higher, so I think we're in good shape in terms of that. As we mentioned, we're going to have because our inventories are leaner, and we expect them to be on an ongoing basis leaner that we would have less off-price sales. And, over time, I think we can get our margins up for that.

Operator

Thanks. At this time, I'd like to turn the call back to Mr. Secor.

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

So, thank you all for joining us today, and we look forward to speaking to you again on our next call which should be in May. Thank you very much.

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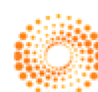

Operator

Ladies and gentlemen, thank you for your participation in today's conference. This concludes the program. You may now disconnect. Everyone have a great day.

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