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PRESENTATION

Operator

Hello, and welcome to the Fourth Quarter 2017 Fossil Group Inc. Earnings Teleconference. My name is Michele, and I will be your operator for today's call. (Operator Instructions) Please note that this conference is being recorded. I will now turn the call over to Ms. Allison Malkin. Ma'am, 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 Fourth Quarter and Full Year 2017 Earnings Conference Call.

I would like to remind you that the 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 in our earnings release filed on Form 8-K and in the Investors section of our website. Please note that you may listen to a live webcast or replay of this call by visiting www.fossilgroup.com, under the Investors section.

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

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

Thanks, Allison. Good afternoon, everyone. We appreciate you joining us today. I will begin with a few prepared remarks before returning the call over to Jeff Boyer, our CFO. Following Jeff's comments, we'll have Greg McKelvey, our Chief Strategy and Digital Officer, join us for the Q&A.

As we entered 2017, we embarked on making significant changes in the company to improve our business model by focusing on 4 key operational objectives: to advance our connected tech agenda, to leverage scale to drive cost out of our supply chain, to become more digitally enabled, and to continue the transformation of our business through New World Fossil.

Although it has been a challenging year, we have accomplished many of the goals we set out for ourselves. Our connected products nearly doubled in size, reaching over $300 million in just 2 years. Our product cost on connected products were down nearly 20% from last year. Operationally, we have reduced our overhead expenses by $95 million versus last year. And on the digital front, we made significant progress on increasing our digital marketing investments and drove strong e-commerce growth. Lastly, we completed our credit facility refinancing to provide an appropriate near-term capital structure for our business.

Within a tough environment and while executing a number of strategic initiatives, we are pleased to deliver our fourth quarter operational results with sales and earnings near the top of our expectations for the quarter. These numbers reflect the focus and outstanding execution of our team as we transition our business, bringing innovative new products to the market and drive operational efficiencies that can ultimately enhance our profitability.

The most important business in our company is our traditional watch business. Although this business remains difficult due to the dramatic growth of wearables in the overall wrist market, we are continuing to innovate with differentiated new ideas and materials in watches that we feel will resonate strongly with consumers this year. This business will be enhanced by the growing interest in smartwatches among our core fashion consumer.

As we entered this year in smartwatches, we were excited about the potential for our new product launches and their ability to positively impact the business. Given our success in 2017, we remain confident that wearables can be one of the key catalysts that offsets the declines that we've seen in our traditional watch business. In the second half of the year, we introduced a number of new hybrid and display smartwatches across 14 brands. Response from our customers continues to be very strong, and we are encouraged by these early results, particularly for some of our key brands including Fossil, Skagen, Kors and Emporio Armani and Diesel. Our connected business nearly doubled last year, but we fell short of the aggressive goals that we set for ourselves in this new business. And we learned a lot that will help us in 2018 and beyond.

The overall wearables category is very robust in creating a significant opportunity for the company. Industry research shows that it was a $17 billion business overall last year and will grow to $32 billion by 2020. It is clearly a younger customer and largely a female aspirational fashion customer that loves brands and the innovation that we launched last year with slimmer cases, brighter displays and new functionality. And this year's watches will have, again, additional features and looks that we think will be very compelling. With the ongoing enhancements of technology, the product and experience will get better and better.

Wearables was 20% of our total watch sales for the quarter and even stronger in the United States and had a positive impact on the sales trend for a number of our key brands and on our overall watch sales. Our total Fossil watch business was up 2% in the fourth quarter, improving from up 1% in the third quarter. The growth in wearables improved the growth rates for Fossil watches by more than 10 percentage points in the quarter. The same is true for Michael Kors watches, where the growth of wearables positively impacted growth trends by 8 full points for the quarter. Our launches of Emporio Armani smartwatches led the brand to a double-digit growth in the fourth quarter.

Another of our focus areas has been to leverage our considerable scale in wearables to drive supply chain efficiencies, reduce costs and improve margins. Our strategy this year was to drive significant volume in wearables, to raise awareness quickly and get these great products on as many wrists as we can while leveraging the volume we have to drive cost efficiencies.

Importantly, we have made significant progress on improving our product cost and learned a lot about how to better operate this business. We now feel we have a platform from which to operate in this rapidly growing market. Our significant advantage in fashion traditional watches combined with our wearable capabilities put us in a unique position to compete in the evolving wrist wear business.

As to our digital efforts, in 2017, we put significant resources and efforts into our digital marketing capabilities and into expanding our e-commerce capabilities, both for our own sites and for our wholesale.com partners. We continue to focus on developing and growing our brands digitally across e-commerce platforms as well as mobile and social media channels. We also increased our overall investment in digital marketing. We've optimized our marketing mix to achieve the most efficient path to purchase and identified our most receptive customers. As a result, over 1/3 of our Fossil brand business started with the digital interaction via social, search, digital media, e-mail or other digital marketing effort.

Our CRM efforts drove an increase in repeat customers, while our celebrity campaigns and upper funnel marketing efforts drove healthy new customer acquisition growth. Our celebrity campaign delivered over 2 billion impressions with over 50 million social engagements, and our social followings expanded by 20%. These successful programs propelled our celebrity-featured styles to achieve top performer status across all watches.

This past year, we also took a number of actions to respond to changing consumer needs. We launched buy online, pick up in store in the United States, continued our personalization efforts, expanded our online review capabilities and enabled online chat functionality. As a result of these programs, our own e-commerce platforms across the globe continue to drive significant growth, expanding 31% in the quarter with sales growth of 23% in the U.S., 59% in Europe and 44% in Asia.

This past year, we significantly expanded our growth with many pure-play online retailers in the United States and all over the world. Our business with this critical group of online retailers grew by 77% this year. When combined with our own e-commerce platform, this online channel represented about 17% of total sales in the fourth quarter, up from 9% in last year's fourth quarter. Including e-commerce sales from our traditional wholesale partners, this would push our total e-commerce sales even higher.

We made excellent progress on our New World Fossil initiative this past year. This is our ongoing comprehensive program to reinvent our company to drive efficiencies and speed throughout the organization to streamline the way we work and enhance our margins and ultimately drive significant economics to the bottom line.

Our goal continues to be to build a leaner and more nimble operating platform that can support improved profitability in the future, all while better serving our customers and competing in the new retail environment.

We set a high target when we launched the program last year to drive $200 million of profit improvements in the near term, and we're well on our way to delivering that. So far, with our efforts to date, you are seeing many of the benefits of this program in the fourth quarter, and we are ahead of the schedule we set for ourselves. Though many of these efficiencies are reflected in our P&L this year, we expect acceleration of these benefits, particularly in the gross margin area, as we move into 2018.

As to our 2018 outlook, as mentioned, we have made a lot of progress on our key objectives this past year, but we still have a lot of work to do and have a number of challenges ahead. The traditional watch business at our price points has clearly been negatively affected by the significant growth in the overall smartwatch category.

There's a difference cadence to the wearables business. It is a significant opportunity, but we have to continue to improve on this model. Our hybrid watches are selling very well in our own channel but not as well in the wholesale channel. We have to increase awareness on this topic. And the disruption in retail is continuing with more sales and customer engagement moving to digital.

As we look ahead to 2018 and beyond, there is significant work necessary to successfully transform our business model to meet the evolving challenges in this high-margin category, but we are confident we have the strategies and the team to meet those challenges. We have 4 overarching objectives that drive our strategies and initiatives: to improve our profitability, to innovate our product offerings, to expand our e-commerce and digital marketing, and to transform our business model.

First, to talk about profitability. In this upcoming year, we will become a slightly smaller but a more profitable business. Sales will contract in 2018 as we exit unprofitable stores and businesses and product lines. Connected watches are expected to experience strong growth this year, but the absolute dollar decline in traditional watches in our wholesale channel will be greater than that growth. Though overall sales will decrease as a result, our operating income is planned to improve. A portion of our improvement in operating income will come from exiting unprofitable stores and product lines, but most of the improvement in profitability is a result of our New World Fossil initiative, which we kicked off in early 2017.

Through a combination of category management programs, direct and indirect sourcing efforts and organizational efficiency initiatives, $80 million in benefits were reflected in our operating income last year. We've been extremely pleased with our organization's efforts under this program so far, and New World Fossil benefits are expected to expand to $200 million when completed in 2019.

Our second overarching strategy is innovation. Innovation has always been the cornerstone of our business model, and 2018 will be no different. Our design capabilities are unique and are focused on new ideas in watches with differentiated looks and unusual materials. We have a number of initiatives launching this year that are quite different that we believe will resonate with our customers.

Our consumer research shows that our brands are well known for great design and fashion relevance, and we are continuing to push on this topic. We also continue to maintain our size and scale advantage over our competitors, which provides us with the resources and ability to be an industry leader in traditional watches.

To fully utilize our scale and size advantage, we continue to pursue a number of additional brands to incorporate them into our portfolio of licensed businesses. Our strength and innovation has expanded into smartwatches and continues in both display and hybrid formats. Late in 2017, we added heart rate and enhanced fitness applications to our display models. These latest smartwatch models quickly became bestsellers in only 2 months. We also saw a strong response to our marketing efforts where we emphasized Google Assistant, which is Google's virtual personal assistant that is now integrated into smartphones, home devices and smartwatches.

This year, across both owned and licensed brands, we will launch 4 new formats of display and hybrid smartwatches during 2018. In addition to current product features, our 2018 innovation plan is focused on curating the best fitness and assistant experiences that Google's powerful platform allows. Our objective remains to fashion branding and style to the connected watch business by tailoring the technology that our customers want with each of our brands' unique point of view. These great new offerings are expected to continue to support significant growth in our connected products category.

Our third strategy is to build upon our digital infrastructure improvements and expand our e-commerce programs. Based on our successful social media programs in 2017, we will continue to expand our social media programs such as celebrity campaigns to increase our social media platform engagement. We will expand buy online, pick up in store capabilities for more of our global markets, enable ship from store capabilities and increase our collaboration with wholesale partners to optimize online performance. We are excited about our e-commerce expansion opportunities, including expanding the number of markets in which we have direct e-commerce.

Our final overarching strategy for 2018 will be to continue the transformation work we began in 2017 as part of New World Fossil. As I've mentioned, we have made a lot of progress on the initial transformation of the company, which is projected to drive $200 million in gross margin and efficiency benefits through 2019. We will be working this year on the next phase of New World Fossil, which will begin with a deep dive into insight on what the traditional and connected watch businesses will look like over the next 5 years. The consumer world is changing quickly, and we must continue to reinvent the company by increasing speed and simplicity and reducing complexity and cost. This will include further expansion of our digital capabilities for not only digital marketing and e-commerce but also for consumer insight, analytics and the use of data across many parts of our company. This next phase in New World Fossil is also a multi-year project and could benefit us with a similar profit improvement as the first phase.

In closing, our performance this past year is not where we want it to be, but we are confident that we are making progress on the initiatives that will ultimately deliver strong and sustainable growth for our business. We remain focused on stabilizing and growing our core watch business on bringing more innovation to connected products with new features and function, driving efficiency through the company while investing in our e-commerce and digital marketing opportunities.

Importantly, in 2018, we are extremely focused on delivering improved profitability. We have planned our top line conservatively to put pressure on the things we have more control over, our gross margin structure and our expenses. Though we feel we planned the year prudently, we will operate aggressively in the marketplace, positioning the company for growth.

Our recent financing has provided additional operational flexibility in the near term. However, we are continuing to take steps to further strengthen our financial position to enable us to execute our strategies well into the future and to position our business model for continued strong cash flow generation.

Our longer-term view is that, after top line contraction in 2018, our initiatives should begin to stabilize sales levels in 2019 with sales growth returning in 2020 and continuing to grow annually thereafter. And with our New World Fossil transformation initiatives, we are targeting growth in operating income to expand from low single digits this year to a high single-digit level by 2020. Our long-term goal is to return to double-digit operating margins.

And now I'd like to turn the call over to Jeff for more comments.

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

Thanks, Kosta. Before I cover our financial performance for the quarter, I'd like to build on a number of Kosta's comments. Overall, 2017 was a challenging year, more challenging than we originally expected. The mid-priced fashion watch business and our strongest Channel, wholesale, was under significant pressure from the smartwatch segment.

We have put a strong foundation in place to start improving our profitability in 2018. We have a sizable presence in fashion-focused wearable products, both display and hybrid. We are quickly improving the margin profile of this business. We are aggressively building out our digital capabilities to reach consumers in new ways and sell our product in the growing number of online channels. We recognize that we must make our business model more profitable. We are executing well against our New World Fossil initiative, improving our product economics and reducing expenses. Though we're executing on many positive fronts across the enterprise, we are on a segment of retailers going through significant structural change in both products and channel. However, our long-term goal remains the same: to return to our profitable high-return business.

Now turning to our financial results. Reported net sales for the fourth quarter decreased 4% to $921 million, while fourth quarter constant currency net sales decreased 7%. Overall, sales were in line with expectations, driven by modest improvements in our direct channel, while our wholesale business continues to contract in the low double digits.

Store closures negatively impacted total direct channel sales by roughly 450 basis points. Excluding store closures, our direct channel posted mid-single-digit gains with positive store comps and solid increases in our online business driven by growth in connected sales. Our connected watch business, which represented almost 20% of total watch sales continue to contribute significantly to the overall top line trend and grew over 40% in sales for the fourth quarter compared to last year.

For the quarter, we reported a loss of $1.65 per share, including $2.20 per share in tax-related charges, mainly from the impact of the recent changes in tax legislation combined with valuation allowances established on deferred tax assets and $0.09 resulting from $6 million in New World Fossil restructuring charges. Excluding these items, adjusted EPS was $0.64.

Last year, our fourth quarter EPS was $1.03 and included an $0.18 impact from restructuring charges. After, excluding the tax charges and restructuring costs, the fourth quarter EPS decline this year was driven by lower sales and gross margin, mainly due to our connected product mix and higher interest rate expenses, partially offset by lower operating expenses.

Currencies, including both the translation impact on operating earnings and the impact of foreign currency hedging contracts, favorably affected the EPS comparison in the fourth quarter by $0.09. Our watch business declined 6% in constant currency for the quarter, finishing the back half of the year with an improvement in sales trajectory for the category.

Sales in our traditional watch business, while still challenging, performed within our overall expectations. Sell-through trends of our traditional watches remained fairly stable in the Americas, though we did experience some declines in trends among certain of our wholesale partners.

We continue to grow our connected watch business, delivering $142 million in sales for the quarter, 44% higher when compared to the fourth quarter of last year. We're continuing to see strong sell-throughs in key display watches, especially in our own stores, where we control the customer experience.

While we did not achieve the ambitious wearables plan we initially set for this year, the business is favorably impacting our watch category in a material way, a 7-point improvement in the growth rate this quarter. And we're achieving that 7-point improvement largely driven by display watches. We're taking advantage of the awareness of this segment of the wearables category. Hybrids, we are having more modest success, will take longer to build considering there is no significant competition at scale in the marketplace right now.

Total Fossil brand sales declined 2% in constant dollars compared to last year, finishing the year with consecutive sequential improvements for all 4 quarters this year. The decline in the Fossil brand was driven by weakness in our leathers and jewelry categories.

Fossil brand watch sales increased modestly in the quarter, up 2% in constant dollars with smartwatches, both display and hybrids, positively impacting the category growth rate by 11 points. Display watches continue to represent the largest percentage of wearable sales for the Fossil brand, though we are achieving success in hybrids with Fossil in our direct channel where our marketing efforts, store experience and celebrity influenced campaigns are yielding results. With our Fossil Firsts campaign with Kristen Bell, the Fossil Q Accomplice hybrid is now one of our top 10 SKUs in our Fossil watch collection.

In our retail channel, comp sales for our Fossil and Watch Station businesses increased [2%], representing our first positive comp since 2015 despite ongoing retail traffic declines. Our watch performance for these businesses, both online and in stores, was encouraging with comps up 5%, further demonstrating the impact that wearables is having on the category. E-commerce sales, which are included in comp sales, increased 31% for the quarter. We're also seeing some stabilization in the trajectory for Michael Kors, where watch sales declines slowed to 10% for the quarter with smartwatches positively impacting that rate by 8 percentage points.

In the Americas, fourth quarter sales decreased 9% on a constant currency basis to $442 million with declines in all 3 product categories. Watches declined at a similar rate as the total Americas region as continued softness in traditional watches were partially offset by connected watch sales with our best sales performance continuing to come from Fossil, which did grow in the region for the quarter, up 4%, driven by connected performance across all channels. Most other brands posted sales declines in the quarter. While both our wholesale and retail businesses declined in the quarter, our retail business was significantly stronger than wholesale.

In Europe, reported sales increased to 1% to $337 million, while on a constant-dollar basis, sales declined 6%. As we said in our August earnings call, Q3 sales benefited from early deliveries to wholesale customers who opted to take shipments earlier than planned given price adjustments, which we were required to announce to our customers in advance. In turn, Q4 sales were negatively impacted by the sales benefit seen in Q3.

Sales declined across all product categories. We continued to see traction in our direct business with positive comps across most categories, in particular, strength in watches. Wholesale, which is impacted by the sales shift into Q3, declined. Additionally, we're seeing wholesale customers in certain European countries experience some deterioration in traditional watch sell-throughs as the European customer accelerates their adoption of online channels. Fossil watch sales in Europe were relatively flat with growth in connected sales offset by declines in our traditional watch sales. Within our watch portfolio though, Emporio Armani, Armani Exchange and Diesel grew. However, this growth was more than offset by declines in other brands, including Michael Kors and Skagen. Across the Eurozone, sales were down modestly, while distributor markets in Eastern Europe and the Middle East declined significantly.

In Asia, reported sales declined 1% to $142 million and on a constant currency basis, declined 3%. Our Fossil brand was essentially flat in Asia, driven by strength in watches offset by men's leathers. And Emporio Armani, our second largest brand in Asia, posted strong growth driven by both traditional and connected watches. Most other brands were down in the quarter. Growth in India and China was offset by decline in nearly all of the countries within the region with the sharpest decline coming from Japan.

In the quarter, gross profit decreased to $448 million and gross margin declined 230 basis points to 48.7%, driven primarily by the impact of connected products due to both the increase in sales mix of connected products, which carry lower overall margins as well as additional product valuation reserves.

We increased our connected sales volume by more than 30%, and we are well ahead of the initial cost goals that we are targeting for this year. However, we did not hit the aggressive sales goals that we have set for ourselves this year in this new category. Consequently, we are carrying greater levels of connected products that we need to clear and have deferred some receipts into the first quarter of 2018.

We recorded $18 million in valuation charges this quarter, which totaled roughly $40 million for the year, to support our efforts to clear this inventory. This negatively impacted our overall gross margins by 190 basis points for the fourth quarter. Excluding the valuation charges, our connected margin would have approached 40% for the fourth quarter and full year.

Significant drivers partially offsetting the margin compression from connected sales include the benefits from our New World Fossil initiatives, which improved margins by 130 basis points. Gross margins were also favorably impacted by currency movements, mainly from a stronger euro and a shift in sales mix towards higher-margin international sales and better margin channels such as e-commerce. Also significant in the quarter were lower markdown rates within wholesale customers and an improved trend for direct channel margins, which declined much less than in prior quarters due to more targeted promotions.

Fourth quarter operating expenses were $397 million, 6% or roughly $26 million lower than the fourth quarter of last year. Expenses included $6 million in restructuring charges, while 2016 fourth quarter expenses included $13 million in restructuring charges.

The lower expenses in the fourth quarter resulted from lower store expenses given the significant number of stores we've closed since last year as well as corporate overhead reductions and cost reductions in our regional organizations across the globe.

Marketing was also lower in the quarter as we reduced fixture spend and invested more in digital campaigns this year compared to more expensive television advertising executed during the fourth quarter of last year. For the full year, our marketing investment as a percentage of sales was roughly in line with last year, though we significantly the reduce spend in less productive areas such as [fixtures] and displays and redeployed our marketing dollars towards higher-return digital-related activities.

Our fourth quarter operating income was $51 million compared to $66 million a year ago. Fourth quarter other income of $2 million was lower than last year, mainly due to net foreign currency contract losses compared to net gains recognized in the fourth quarter of last year. Interest expense increased $3.6 million to $11 million due to higher interest rates.

Income tax expenses were $121 million in the quarter, which included a $107 million additional charge due to the Tax Cuts and Jobs Act that was signed into law in December, and a charge related to a valuation allowance on our deferred tax assets. The new tax legislation includes significant changes to various areas of U.S. federal income tax laws, including reducing the tax rate on U.S. earnings to 21% and moving from a global taxation regime to a modified territorial one. In terms of the impact, I won't touch on every element, but I will cover the most significant ones.

The tax reform charge totaled approximately $63 million and is comprised of $29 million for the revaluation of our deferred tax assets, using a 21% future U.S. tax rate versus the previous U.S. tax rate of 35%. Also included in the charge related to tax reform was a net expense of approximately $34 million for the onetime repatriation tax. Note that due to foreign tax credit carryforwards and the current year net operating tax loss, the actual cash repatriation tax liability is about half this amount or about $16 million payable over an 8-year time period.

In addition to the tax-reform-related charges, we recognize a non-cash charge of $44 million to establish a valuation reserve on our deferred tax assets. Given our recent operating losses, we reserved against all of our deferred tax assets in the U.S. and certain international subsidiaries. As Kosta highlighted, we are pursuing an aggressive series of actions to expand and further accelerate our New World Fossil initiative to significantly transform our business model to address the continued challenges and changes in our markets. As we generate taxable income in the future, these deferred tax assets could be realized over time. The impacts from the tax reform and valuation allowances resulted in combined charges of $107 million or $2.20 per share and were not contemplated in our guidance for the fourth quarter that we've provided back in November.

The actual amount of tax reform charges that I just highlighted may differ from our estimates due to, among other things, a change in interpretations of the applicable revisions to the U.S. tax code, changes in assumptions made in developing our estimates as well as regulatory guidance that may be issued with respect to the new tax laws. Our accounting for the tax effects of the new tax laws will be completed in 2018.

Our review of income tax projections for future periods also continues in light of the changes imposed by the new tax legislation, particularly the GILTI provisions that target low taxed foreign intangible earnings. Because of the complexity of these new GILTI provisions, we are continuing to evaluate this provision. We are not yet able to reasonably estimate the effect of the GILTI provisions, and we have not made any adjustments related to potential GILTI tax in our financial projections. As a result, we are providing a range of 2018 income tax expense estimates, excluding any impact from GILTI.

Now turning to our cash flows and balance sheet. Our ability to generate cash flow remained strong even in a disruptive environment. During the quarter, we generated operating cash flow of approximately $120 million, invested $8 million in CapEx and reduced borrowings by $41 million. We improved our net debt position by roughly $121 million compared to a year ago. We ended the quarter with $231 million in cash, compared to $297 million last year and debt of $446 million compared to $636 million a year ago.

Inventory levels at year-end increased 6% versus a year ago, driven entirely by our connected business. We have significantly reduced our inventories of traditional watches. We are working to clear the previous generation connected products over the next few quarters.

Accounts receivable decreased by 2% to roughly $357 million, and wholesale DSOs increased by 2 days compared to the prior year due to shifts in customer mix and the elimination of an early pay discount from customer programs and selected parts of Europe. Depreciation and amortization expense totaled $19 million for the quarter.

In January, we amended and extended our credit agreement with our banks. This amendment extends to the facility until December 2020 and provides us with ample liquidity and greater covenant flexibility, especially during our peak working capital periods. We also reduced the bank facility to $750 million from roughly $1 billion given the significant progress that we've made to reduce our net debt position.

Structurally, the amended facility includes a $425 million term loan with scheduled pay downs through maturity and a $325 million revolver with a borrowing base covered mainly by our accounts receivable inventory balances. The amendment also includes a higher fee structure. We're pleased to have the support of our banking partners as we work through the transformation of our business and navigate a challenging retail environment.

Now let's move to our 2018 outlook. Over the next several years, Fossil Group will continue to transform the company's model to address changes in consumer behaviors and their purchases of traditional watches and connected devices as well as jewelry and leathers. During the company's ongoing transformation, we believe certain operating metrics are the most appropriate performance measures. These metrics include sales, gross margin, operating expenses, operating margin, interest expense, adjusted EBITDA and cash taxes. Therefore, we'll focus our guidance discussion on these metrics.

As Kosta said earlier, as we look ahead to 2018, we continue to focus on our customers by bringing exciting new product innovations and great storytelling to the market. We're moving quickly to expand our capabilities in the digital world as we see consumers continue to adapt their shopping patterns and demand more from digital experiences. By focusing on our key strategies of innovating our product offering, expanding e-commerce and digital marketing and transforming our business model, we are positioned to improve our profitability in 2018 even as we face near-term top line headwinds.

Our traditional products, including traditional watches, leathers and jewelry, continue to represent a significant market opportunity. Great brands and innovative products continue to command significant market share even in the disruptive retail environment. Our teams continue to innovate with exciting new designs, distinctive uses of colors and materials and unique features across our products. This innovation along with the breadth of our great brands remains a significant competitive advantage for Fossil Group.

Our success with wearables this past year gives us confidence that wearables will continue to be a growth driver in 2018 and beyond. The wearables market is an exciting and growing market, and we continue to believe our ability to bring great brands, designs and fashion together with exciting new technology features will drive growth in this category.

We have a number of exciting technology innovations in the pipeline and look forward to sharing those with you as we get closer to product launch dates during the year. Given the significant launch activities in 2017 and the current size of our wearables business, growth rates will naturally slow. That said, we do see strong double-digit growth in this category in 2018.

While we're excited about both our connected and traditional innovations in 2018, the retail sector continues to be challenging as consumer behavior and shopping patterns evolve. We expect these patterns to continue in 2018, particularly in our traditional categories in the wholesale channel, where the traditional retail model is under pressure and technology is driving further disruption. We are planning our traditional business prudently and expect 2017 trends to continue in 2018. And this represents the higher end of our sales guidance.

The lower end of our sales guidance contemplates further disruption to traditional watches, primarily in the wholesale channel. That said, we are working aggressively to reverse these trends.

Importantly, we're adapting our business model to deliver profitability in this new environment. We continue to take action to adjust the size of our retail store fleet to improve profitability, and we expect to further reduce our retail store count in 2018. Retail stores are an important part of our brand experience, but given the changes in consumer shopping behaviors, reducing our store fleet to improve profitability and working capital while focusing our store teams on brand building experiences will be important. In addition to retail store closures, we're also refining our wholesale and concession distribution in certain geographies, which will help our teams focus on the most significant opportunities while also improving profitability.

We also face a further top line headwind in 2018 given the Burberry and adidas license contracts, which ended in December. In total, store closures, business exits and the impact of Burberry and adidas licenses will have an approximate 550 basis points negative impact to our top line growth rate in 2018. Given the phase-in impact of these actions, we expect the negative top line headwinds to have a more modest impact in Q1 and then intensify as we move through the year.

In addition to these business drivers, currency continues to impact our business. Over the past 2 years, fluctuations in foreign exchange rates have had a significant impact on our financial performance. We established the currency rate used on our guidance earlier in January with the euro and the British pound, 2 of the currencies most impactful to our results, at approximately $1.20 and $1.40, respectively. Based on the foreign exchange rates embedded in our guidance, we expect currency to be a net tailwind to our performance in 2018, driving a modest benefit to sales and operating earnings, partially offset by the negative impact of foreign currency hedge contracts in other income.

Of course, the actual impact of currency may differ as exchange rates continue to move throughout the year. Therefore, for the full year, we expect sales to range from negative 14% to negative 6%. For the first quarter, we expect sales to range from negative 12% to negative 6%. Note that these sales estimates are inclusive of the negative impact of store closures, business exit and licensing terminations discussed earlier.

While the challenges across the retail sector and within our categories will lead to a smaller revenue base in the near term, we expect our continuing innovation and New World Fossil initiative to deliver more profitability on this smaller sales space. We launched our New World Fossil initiative late in 2016 and are well on our way to deliver our $200 million savings target.

Our teams across the globe have done a tremendous job of rallying behind these significant opportunities. Moving into 2018, we are looking to aggressively expand those efforts to further drive efficiencies in our model and be more focused on our consumers. While we delivered significant savings in 2017, 2018 will bring even more improvement as we lap investments from the prior year and continue to accelerate these initiatives throughout the coming year with a particular focus on improving gross margins through product offerings with improved design to value economics, stronger pricing and enhanced product cost reduction programs with our vendors.

Given the experience we now have with the connected business and our improved ability to manage this inventory, we do not expect to repeat the connected liquidation reserves recorded in both the third and fourth quarters of 2017, providing additional margin expansion in the coming year. The weaker U.S. dollar provides an additional benefit to gross margin rates. Considering these factors, we expect approximately 200 to 400 basis points of gross margin expansion for the year with first quarter gross margin expected to be flat to up 200 basis points over Q1 2017. Overall, Q1 will see the most modest benefit with some acceleration in Q2 and further expansion in the back half as our New World Fossil initiatives continue to drive improvements.

In 2017, our New World Fossil initiatives also drove meaningful reductions to our operating expense model and we'll annualize those changes moving into 2018. In addition, further store closures and continued New World Fossil savings will benefit the coming year. We'll also see some expense reductions from variable savings on a lower revenue base.

Given that we're continuing and accelerating our New World Fossil initiatives, our 2018 expense plans include a similar level of restructuring charges as incurred in 2017. For the full year, we expect restructuring charges to be approximately $50 million and Q1 restructuring charges to be approximately $20 million.

Due to the phase-in of our quarterly revenues and expansion of savings initiatives as we move throughout 2018, our operating expense rates will increase in the first quarter, neutralize more in the second and third quarters and then leverage in the fourth quarter. Therefore, for the full year, we expect operating income margin in the range of flat to 4%, and for the first quarter, we expect operating income margin in the range of negative 11% to negative 6%.

As discussed earlier, the credit facility extension does carry a higher fee structure, which we expect will drive an overall increase in net interest expense of approximately $10 million compared to 2017. Interest expense is expected to be relatively flat sequentially throughout the year.

Other income and expense, which is primarily related to hedge contract gains and losses was a benefit in 2017. Looking forward to 2018, based on the foreign exchange rates used in our planning assumptions, other income would turn to a negative or expand in 2018, though this will vary as exchange rates move. The magnitude of the net other expense is about $10 million annually, and it is expected to be roughly consistent across quarters based on the foreign exchange rates used in the model.

As I said earlier, based on our current interpretation of tax reform and the profile of our geographical earnings, including a tax loss in our U.S. companies, we expect tax expense to range from $20 million to $30 million for the full year. We expect Q1 tax expense of approximately $3 million. We're planning diluted share count at approximately 49 million shares.

In addition to driving increased profitability in 2018, we're also focused on continuing to drive significant working capital improvements and strong positive cash flow. We see significant opportunity to drive additional efficiency and working capital through tighter management of inventory and improved turns.

Given the seasonality of our business and need to reduce our level of connected inventory, working capital benefits are expected to accelerate as we move through the year. We expect adjusted EBITDA in the range of $150 million to $200 million. We're planning to invest approximately $25 million in capital expenditures in 2018.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) We do have several questions in the queue, and the first question comes from Ed Yruma from KeyBanc Capital Markets.

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

I know there are lots of puts and takes around the release of wearables last year. There were the liquidation. How should we think about these shipments for wearables this year and your ability to kind of have a longer product life cycle than maybe you had last year given some of the early schedules?

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

Thanks, Ed. One thing I would say is we -- through last year -- through last couple of years, we learned, obviously, a lot about the cadence in delivery and launching on these wearables. We also learned, for example, that a huge part of the sales are in December, so it's just quite a different profile in terms of timing. So through last year, as you know, we were moving as aggressively as we possibly could. We wanted to get critical mass quickly, so we can get awareness out there and also, get our costing down. We did that. We didn't have our timing right on the styles. And the way we launched and the cadence was not correct. So having gone through all that, we've taken the reserve on the inventory. We're now in position -- we are -- made a huge amount of progress on wearables. We've learned a lot, and we're in position now to be more opportunistic and more balanced about how we approach it. We do not expect to have inventory issues again this year. The one thing I would add is just we were surprised quite a lot. I would say the #1 thing we're surprised about is the size of the wearables market. The watch business is about $65 billion globally. Our part of it that we participate is about half that. Swiss is about half, so say, $32 billion addressable market. Last year, in wearables, it was a $17 billion market, and it's expected to go to $32 billion in 2020. So we're surprised that it's that large. And the reason is, is it's largely female. We see that in our own business, are in both Fossil and Kors. Our analytics show is clearly largely female, aspirational customer, fashion. And anecdotally, what we see in the rest of the wearables market, it is also largely female and fashion and aspirational. We also see this in our sales numbers in traditional watches. The brands that we are getting hurt the worst in declines is really our fashion brands and mostly in the United States. So the fact that this is largely female puts us in a unique position, I think, ongoing to capture a larger share of the market, that wearables market as we put more and more products, put ourselves in a position to capture a bigger share of that with our brands and lifestyle and with our interesting materials. The only thing I would add is that, interestingly enough, is health and wellness is driving a lot of that. A lot of our launches this year will be based on that. And the other thing I think that will accelerate all this, obviously, the technology is going to get better and better. This year's products are much improved. But incoming I think, what we mentioned on the notes, was that -- the use of voice. So Google's digital assistant, we think, is going to add a lot of emphasis to this not just this year but ongoing. So we think, overall, we're in a good position to continue to grow in this market.

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

I'd just add one other key message, which is we spent the last 2 years off of the acquisition of Misfit, building out a wearables business model. We're not launching products, we've installed the business model. That business model is in place, proven and is scaling and driving meaningful growth in the business. So we are -- we now have the flywheel going, and we're going to prudently plan the business, but we expect this to be a long-term growth driver. And just, really, we're congratulating the teams across the world that have made that happen.

Operator

The next question in the queue comes from Omar Saad from Evercore ISI.

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

I wanted to just ask a couple more questions on the wearables front. Could you guys talk a little bit -- just a little bit more detail on the inventory reserves and where you are with that and why you're comfortable that you're done with that process? Also maybe a little bit more learnings in the categories, '17 -- 2017 versus '16, especially with the inventory reserve situation. And then I thought it was interesting that you mentioned the wholesale versus retail. You're seeing a pretty different dynamic. And maybe you can expand upon that and maybe what the read-through is for the strategy going forward.

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

This is Jeff. Omar, thanks for the question. I'll answer the inventory reserve question. Let me kick it over to Greg on some of the learnings on it. From the inventory reserve question on it, we did get an excess inventory position, but we have been very conservative and looking at our sell-through estimate going into FY '18. We've got good experience in the fourth quarter in moving through some products. We've got a pretty good handle at what price point we did sell product through. We know the quantities we own. Obviously, we know the generation we've got to sell through. So we got a pretty solid plan to sell through the product. I would tell you, at the appropriate profitability, we could really liquidate quickly, but that's not the best way to do it. So we're going to liquidate the product through the next 3 quarters, be essentially out of it by the time we get into the fourth quarter as new products hit. But we feel very good based on our history of what we sold at price points in the fourth quarter this year.

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

I'd just add, as you mentioned, the business model's in place. And by that, I mean it's large. We scaled across 14 brands. We're delivering consistently on time, high-quality product with dramatically lower costs. And sustainable margins are now getting nearer and the teams are over delivering. But as we look to next year, what's happening is that the product and consumer trends are now becoming very clear. We launched the Fossil and Misfit products that had fitness and health. At the very end of the year last year, those immediately became bestsellers. We also saw tremendous response from customers on our marketing that -- the future Google Assistant. So the product trends of health, fitness and wellness and then voice search and voice integration experiences into these products are what's going to drive these categories over the next several years. So our teams since have positioned ourselves and our new product innovations to deliver this across a variety of brands and product formats. And then the second is, as Kosta mentioned, is that female fashion customer, we are seeing the adoption that we need to know that this is -- that we are not only well positioned in the category but with our core customer. And that's critical because that's where our design and branding and our distribution sets us apart.

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

And then on the wholesale versus retail dynamic, would you mind just addressing that? I thought that was interesting.

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

Yes. What we've found, and we mentioned this before, which is, as you'd expect, these products are new and there is some training that goes with it. So they're actually selling better on our own environment. So on our own website and in our own stores, they're selling better. Especially, you can expect better than our typical wholesale. The other thing I would add though is that we have seen increasing knowledge and awareness and adoption on this merchandise, so there's less and less training at the point of sale now. In fact, we're seeing something like 50% of the sales on wearables globally was done on e-commerce, both our e-commerce sites as well as our partners. So it's clearly becoming more understood. One other thing I would mention on the hybrid issue is we -- hybrids are actually doing very well and increasing in our stories. And when we communicated well, it's doing very well. I think the immediate adoption of display smartwatches, I think, has really taken some of the oxygen out of the hybrid market, but it's doing very well. It's got a lot of fans. We're going to expand it. We think, long term, that's a very significant business, and it will have a large impact on the overall watch business. So we're continuing to do that. And as more and more awareness gets out about these products both at wholesale and at retail, we think they're both going to grow.

Operator

The next question comes from Simeon Siegel from Nomura Instinet.

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

Can you talk about what categories and I guess, the amount of storage you are planning to exit? Maybe what are the sales loss and expense savings you'd expect from that? And then sorry if I missed it. But just to elaborate on the product reserves, just to clarify, sorry, are you taking reserves on product you're expecting to clear later on? Or is this product that you've already cleared through this quarter?

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

On the reserve, that's product that we will be clearing through on it. It's effectively a lower cost for market reserve that we take on it. So we can identify what we're going to sell this product through to our wholesalers and to our retail channel and recognize what that loss is. So it's a future-looking reserve for the economics that we're going to lose on it, let's say, requirements you have from an accounting standpoint. So that's going into the future. In terms of the sales loss from store closures, we have about 60 stores or so that we're going to close this year, and it's about $1 million [or so on average]. It's about $60 million of sales loss from that. When combined with the licensing terminations that we have as well as some smaller businesses that we're exiting that were unprofitable, we commented it's about 550 basis points of sales hit that we have headwinds and so we have on it. From a profitability on the store side, these stores are unprofitable as about $10 million of net profitability were underwater on those stores. So we're going to be more profitable by about $10 million for those closed stores.

Operator

The next question in the queue comes from Dana Telsey from Telsey Advisory Group.

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

On the product you're taking reserves for, how will you get rid of that product? Any way different than you've done in the past? What are you seeing there? And then also, if you think of a smaller yet more profitable company, what do you think of as the baseline revenue, baseline margins for this new business?

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

On the wearables product that we're liquidating, we have quite a lot of demand both in our own outlet stores, which are the number of Watch Station stores around the world, in addition to that, other third-party liquidation companies. So there's a significant demand out there that we've planned this out over the next several months, so we don't see it being a -- we don't foresee it being a problem.

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

On the second question, Dana, regarding the size of the business and the margin structure, really, FY '18 is probably the major step down we have in overall sales. We've moved from a couple of years ago being north of $3 billion. You can see the range is about $2.5 billion. This is the range for next year's sales. My comments are -- or Kosta's comments was a little bit of stabilization in '19, so there could still be a bit of a drag in '19. It could be a little bit smaller, but we're really thinking we're hitting a little bit of that inflection point as connected business starts to grow, as the traditional business starts to stabilize somewhat. On the margin side of it, we do think, from New World Fossil initiatives, we have a lot of tailwinds in that initiative. I know we're going back into that again, into a second phase. We think there's a couple of years' worth of a couple hundred basis points. So if you look where we're at right now, at roughly -- and the range we gave you at 200 basis points of operating income, hit another couple hundred basis points the next few years, you're going to easily get to about a 600 basis point, 6% operating margin as a company. And at some point in time, those restructuring charges will start to mitigate as well. So you can get to a high single-digit margin structure at rough numbers of $2.4 billion to $2.6 billion in sales, small and more profitable and kind of grow from there. So there's a good potential here for value creation and driving the business pretty well.

Operator

The next question in the queue comes from Anna Andreeva from Oppenheimer.

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

Two quick questions from us. A question on wearables. I guess, can you elaborate what drove the 4Q '17 sales miss versus what you guys laid out in November? And then secondly, on gross margins, how much of the 400 basis points of expansion is the New World Fossil? And did you say how much benefit we should expect from that in '19?

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

On the sales, we didn't miss sales in Q4. So I'm a little confused about that question. I think we actually came in about where we thought. Actually, connected came in a little bit better. Where we missed sales was earlier in the year, forecasting way back in Q1 and coming out of '17 -- coming out of '16 -- goodness, '17 with expectations that, in general, be much bigger business. So that's probably where that reference is coming from, Anna, on it. So it was a call we had to make over a year ago on the size of the business, read the tea leaves early in -- late in 2016 and had some high sales expectations and have proved to be a little bit too ambitious on it. In terms of the margin performance, 400 basis points of margin performance improvement, and you were referencing, which line item on the P&L again, Anna, on that?

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

On the gross margin line, the 400 basis points of improvement for the year.

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

Yes. It's probably -- I think we said 200 to 400, so -- and that's about 300 overall. And it's really a combination of a number of drivers on that. The absence of those inventory reserves gets you about 150 basis points on it. Our New World Fossil initiative gets you about 150 basis points as well. So you're about that 300 basis points right there between the 200 and 400. Could be some currency favorability that helps as well if we get some currency favorability, be offset a little bit with the typical mix pressure we get because connected is a larger -- is -- I'm sorry, is a lower-margin business than the traditional business. So it's those -- the biggest drivers are the absence of the inventory reserve and the New World Fossil initiative to drive about 300 basis points, then some offsets between mix and connected and currency.

Operator

The last question in the queue comes from Ike from Wells Fargo.

Tom Nikic ***Wells Fargo Securities, LLC, Research Division - Senior Analyst***

It's Tom Nikic on for Ike actually. I just wanted to have a clarification about the operating expense guidance. For the year, I think you said about $50 million of restructuring cost, and if we strip that out, I mean, I'm getting SG&A dollars down, let's call it down 10%, plus or minus a couple of percentage points. I mean, I just want to make sure I'm thinking about that correctly. And that seems like a pretty aggressive cost cut. I know you mentioned more store closures in the year before. I guess, just how do we think about what costs you're taking out of the business and how that could potentially impact your ability to sort of reinvigorate the top line?

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

Yes, yes. No, a lot of the cost reduction, expense reductions, are in fact, I would call them structural around things that we're doing. Store closures is almost $40 million, $50 million of OpEx coming up from store closures. Our New World Fossil initiative is close to $60 million of savings on it. We do get some variable benefit from the sales decline. Our marketing expense goes down because we're not paying royalties and have marketing expenses on that. And that's easily another $20 million. So your math is right, but a lot of it is initiatives we have in place for New World Fossil, store closures and just the variable sales decline that we have.

Operator, we're going to be taking some additional calls after this conference call, so we'd like to close the call up at this point in time and thank everybody very much for joining us. We look forward to speaking with everybody when we report the Q1 results later on this year. So operator, please close the call.

Operator

Thank you, sir. We will now end the conference. Thank you for participating, and you may now disconnect.