Fossil Group Inc. (FOSL) Earnings Report: Q1 2016 Conference Call Transcript

The following Fossil Group Inc. conference call took place on May 10, 2016, 04:30 PM ET. This is a transcript of that earnings call:

Company Participants

- Eric Cerny; Fossil Group; Investor Relations
- Kosta Kartsotis; Fossil Group; Chairman & CEO
- Dennis Secor; Fossil Group; CFO
- Greg McKelvey; Fossil Group; Chief Strategy & Marketing Officer

Other Participants

- Omar Saad; Evercore ISI; Analyst
- Ike Boruchow; Sterne Agee & Leach, Inc.; Analyst
- Dorothy Lakner; Topeka Capital Markets; Analyst
- Cecile Origenes; Cowen and Company; Analyst
- Edward Yruma; KeyBanc Capital Markets; Analyst
- Christof Fischer; Piper Jaffray; Analyst
- Simeon Siegel; Nomura Securities Intl; Analyst
- Rick Patel; Stephens Inc.; Analyst
- Lindsay Drucker Mann; Goldman Sachs; Analyst
- Anna Andreeva; Oppenheimer Capital; Analyst
- Betty Chen; Mizuho Securities; Analyst

MANAGEMENT DISCUSSION SECTION

Operator:

Welcome to the Fossil Group FY16 first-quarter earnings conference call.

Today's call is being recorded.

At this time, I'd like to turn the conference over to Mr. Eric Cerny, Investor Relations. Please go ahead, sir.

Eric Cerny (Investor Relations):

Thank you for joining us. Welcome to Fossil Group's first-quarter 2016 earnings conference call.

I'd like to remind you that information made available during the 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 10-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 may listen to a live webcast or replay of this call by visiting fossilgroup.com under the Investors section.

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

Kosta Kartsotis (Chairman & CEO):

Thanks, Eric. 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 repaired remarks, Greg McKelvey, our Chief Strategy and Digital Officer, will join us for the Q&A.

With the first quarter of 2016 behind us, we are reporting financial results that are in line with our expectations coming into the quarter. But, more importantly, we are pleased to report that we are on track to achieve our larger goal for the year of advancing our many strategic priorities.

Specific to the first quarter, as we expected, results trailed last year, reflecting the challenging environment for the traditional watch category, foreign currency headwinds from last year's relatively strong first-quarter performance in the multi-brand portfolio.

As pressure on the traditional watch category intensified during the quarter, our wholesale partners, both in the US and Europe, experienced a noticeable step-down in sales trends from the last few quarters, learning to conservative inventory management for the category in anticipation of technology product delivering later this year.

Our experience during the first quarter has naturally impacted our outlook for the remainder of the year, but it has also reinforced our commitment to investing in the strategies we're pursuing to drive future growth for the Company.

Dennis will provide you with more specific details around our results for the quarter. But first I will update you on our progress towards the priorities we shared with you on the fourth-quarter call and how they align with our overarching goal of delivering long-term sustainable growth and improved profitability.

Brand building and innovation remain at the core of our business, and we are laser focussed on innovation in design, fashion and bringing new ideas to market, as well as introducing new technology and functionality to our accessories. During the quarter, we continued to drive to extend our leadership position in our core business as we introduced new and updated assortments and invest in and grow our wearable technology initiatives.

The team is working hashed to integrate the Misfit technology and platform across our portfolio of brands, as we anticipate launching new wearable products in eight brands later this year across several product categories. Relative strength in Fossil and SKAGEN, particularly in our international markets, despite our challenging retail environment, continues to give us confidence in our long-term strategy to grow our own brands and leverage our competitive and strategic advantages to return growth to our licensed portfolio.

We also continue to focus our efforts on advancing our digital and omnichannel capabilities, and enhancing our CRM initiatives, efforts we believe will position us to drive future growth as our customer continues to evolve and change the way they shop.

To review our strategic priorities, first, optimizing our portfolio of brands to extend our leadership position in watches. While the traditional watch category continues to feel pressure from technology-infused accessories and new product launches into the space, we are introducing innovative designs and styles, and bringing brands into our portfolio capable of driving future growth in our business.

With our longstanding brands, like Michael Kors, we are positioning the brand for improved performance and further international growth with innovative product, category expansion such as men's, creating an elevated jewelry assortment, and introducing an exciting connected accessories assortment later this year.

The addition of Kate Spade New York to our portfolio and its positive impact on our business continues to be a bright spot for us. As we embark on the second year of the partnership, we are excited about the potential for this brand, now operating with a full complement of Fossil Group resources, designed product development, and the ability to leverage our extensive global distribution network.

The team has also been hard at work over the last several months developing and producing the Chaps line of watches that just has just shipped into the market. As with all of our launches we expect the brand to start small as we learn from the initial assortment and position the brand for long-term sustainable growth. We believe this brand complements our existing brands in the portfolio, allowing for new distribution and price points across a unique assortment.

So, while we have plenty of headwinds making our business challenging at the moment, we believe these newer brands, combined with strategic advantages and our ability to optimize our portfolio, can help drive momentum in our business.

Additionally, the successful launch of our Fossil Q assortment and the acquisition and integration of Misfit's innovative technology and functionality further enhance our competitive advantage and leadership position in the watch category. More on that in a moment.

Second, igniting our own brands, Fossil and SKAGEN, and driving sustainable long-term growth. We believe the long-term value for Fossil Group lies in our ability to be strong lifestyle brand builders, and to leverage that strength to grow our licensed brands. For that reason we will continue to invest in our own brands, Fossil and SKAGEN, and are encouraged with the progress made during the quarter.

With 12% constant currency growth in SKAGEN, led by product innovation and a solid performance in watches, we continue to be excited about the opportunity this brand represents. Growth in each of our three regions demonstrates the global appeal of the brand.

Fossil's performance for the quarter was slightly better than our expectations, given the strong quarter last year.

We are very encouraged by the growth in Europe and Asia, as well as the strength in women's leathers, a category we have been focused on improving, adding innovative designs, colors and unique assortments.

Our brand-building activities, social media efforts, elevated websites and CRM initiatives are all contributing to increased customer engagement, enabling better interaction with our brands. And we expect to continue to see results from these investments.

Which leads me to our third priority for the year, which is leading in digital through enhanced omnichannel and eCommerce capabilities. These efforts are very much in support of growing our own brands. As shopping patterns continue to evolve and all traffic declines, our investments in digital, CRM initiatives and eCommerce platforms should continue to support growth in Fossil and SKAGEN.

Being in touch with our customers and providing them with an enjoyable online shopping experience and a platform to learn more about the brands and product offerings is essential for the future.

The insights we gain through CRM efforts and creating deeper and more meaningful connections with our customers should drive repeat customers and support future growth in our brands. The investments made in our omnichannel road map proven to be beneficial, resulting in double-digit growth in the eCommerce channel through last year, a trend that continued during the first quarter.

Finally, building our presence in the connected accessories market. This is a strategic priority that extends across our entire portfolio of brands and is top of mind for all of us at the moment. Technology is driving innovation in watches. It is the fashion trend of today and adding incremental functionality to watches and jewelry is a consumer-driven trend.

Our ability to provide that functionality into great-looking accessories with various lifestyle brands that customers can identify with is clearly a strategic advantage for us. This was very clear to us at the Baselworld Watch Show in Switzerland earlier this spring.

In light of the current challenging environment for traditional watches, we presented a road map to our partners and our customers around competing in this new environment.

Providing innovative functionality in watches and jewelry, and combining that with our design and branding expertise, we will lead the way in this category. The feedback from the trade and the media was very positive in this regard. We are uniquely positioned to lead the convergence of style and technology given our design, production and global distribution capabilities. And now layering in the Misfit technology platform, provides an alternative to the customer, adding functionality that will make the category more relevant to consumers.

At this event we announced the launch of connected devices in eight of our brands, xix of which will be new in 2016. While each of these brands -- Chaps, Diesel, Emporio Armani, Kate Spade New York, Michael Kors, and SKAGEN -- will announce their own details regarding product launches, we are looking forward to launches across multiple categories in time for the fourth quarter.

From our brand partners' perspective, they are extremely excited to be participating in the space given the demand for connected devices from their customers, and are also looking forward to the incremental customer engagement the platform will provide them. Our wholesale partners are also excited about the opportunity to drive new customers to their stores and providing the technology devices their customers have been asking for.

Beyond the licensed portfolio, we remain very pleased with the performance of the Fossil Q assortment and the updated styles introduced following our Q4 2015 product launch. During the quarter the Fossil Q display smart watch was again our top-selling SKU in all of our full-price retail stores. We are now working towards integrating the Misfit platform into the Fossil assortment, just as we are with our licensed brands, and rolling out new product in the second half of the year.

Looking to the remainder of the year, while our focus remains on the long term and executing against our strategic priorities, we expect a challenging retail environment and pressure on the traditional watch category to persist.

Given those pressures on the business, we will continue to be mindful of our areas of investment and prudently manage our expense structure in order to direct our resources to the areas of greatest opportunity, and pull back where we see less compelling opportunity for immediate impact.

As we did last year, we will continue to evaluate our infrastructure and investment needs, insuring an efficient organizational structure and one that is well-equipped to compete in this evolving retail environment. As retailers remain around the world remain cautious and are managing inventory tightly, we believe the advantages of our nimble manufacturing and operating platform have us well-prepared to capitalize on opportunities as we head into the back half of the year.

We continue to expect 2016 to be a year where we can see our momentum improve as we deliver our wear-ables product across our portfolio of brands. And we look forward to updating you on our progress as we move through the year.

Although the business is tough right now it is clear to us that our advantages of creativity, scale and our portfolio of brands, now combined with our technology platform, puts us in position to increase share in the traditional watch business and also to capture share in the rapidly growing wear-ables business. The combination of these two strategies, we believe, will dramatically improve our long-term sales growth and profitability.

And now I'd like to turn the call over to Dennis for more detail.

Dennis Secor (CFO):

Thanks, Kosta. Good afternoon, everyone.

Our first-quarter performance, while below the prior year, was in line with our expectations as we anniversaried a relatively strong performance in Q1 2015, continued to face a challenging retail environment, and navigated ongoing headwinds in the traditional watch category.

Overall, first-quarter reported net sales decreased 9% to $660 million and on a constant currency basis declined 7%. Sales declined in each of our regions, which also reflects the relatively strong first-quarter performance last year.

You may recall, constant currency and comparable calendar results increased 5% last year with a very strong performance in Europe and growth in most of our portfolio brands, particularly our larger brands.

We continue to be encouraged by the performance of Fossil and SKAGEN, particularly in light of the strong performance last year in both brands. While Fossil's first-quarter sales were flat compared to last year's 6% first-quarter growth, SKAGEN grew 12% compared to last year.

For the quarter, we delivered diluted earnings per share of $0.12 compared to $0.75 last year. The comparison to last year's results was largely driven by sales, given the challenging retail environment and pressure on the traditional watch category.

Gross margin also declined as our pricing initiatives were offset by changes in foreign currency, higher markdowns, and more promotional activity in outlets than we had planned, part of our effort to stimulate sales. The sales and margin headwinds were partially offset by a decrease in infrastructure expenses. And we had fewer gains on foreign currency contracts compared to last year.

From a sales perspective, the Fossil brand was flat to last year in constant dollars. We were particularly encouraged with growth in the quarter for the leathers category, led by women's handbags. Growth in leathers was offset by a decline in jewelry and a slight decline in watches in the Americas. Sales growth in Europe and Asia was offset by a decline in the Americas.

Globally, our retail stores delivered a 3% comp decline with a strong comp in Europe partially offsetting declines in the Americas and Asia. At our full-price stores, our marketing message and the buzz around Fossil Q are helping to drive traffic to our stores and drove a positive comp. Our performance was different in our outlet stores where promotional activity drove improved conversion but was not able to offset the decline in traffic.

SKAGEN sales grew 12% in constant dollars with growth across all three categories, led by watches and growth in each region. In constant dollars our multi-brand watch portfolio declined 8% compared to last year. As the traditional watch category continues to be challenged from technology-enabled devices, wholesale sell-throughs declined and our wholesale partners have reacted with tighter buys, putting pressure on our top line.

While we continue to benefit from the addition of newer brands to the portfolio, the majority of the brands in the portfolio declined compared to last year, and larger brands in the portfolio continue to be hindered by strong historical growth.

In the Americas, first-quarter reported sales decreased 8% to $336 million, a 7% constant dollar decrease. The decrease was driven by watches, with jewelry and leathers also contributing to the decline.

Across brands, we continued to benefit from the addition of Kate Spade New York to the portfolio. And constant dollar sales increases for Armani were offset by declines in nearly all of the brands in the portfolio.

Within the region, our full-price stores performed well and delivered positive comps with strong performances in wear-ables and women's handbags. This strong performance was more than offset with weaker outlet sales where traffic continues to be down. Constant currency growth in Canada and Mexico was offset by a decline in the United States.

Constant dollar wholesale sales declined during the quarter, largely driven by further pressure on the watch category in US department stores.

After three consecutive quarters of fairly stable watch sell-through headwinds, we observed a significant step-down in that trend that sustained itself throughout the first quarter, affecting most of our portfolio brands. Our business also softened in Latin America, particularly in travel retail, where sales fell well short of expectations. We did shift some, though not all, sales to off-price partners, which obviously impacted both sales and our margins.

In Europe, reported sales decreased 10% to $210 million. Constant dollar sales decreased 8%, with a decline in watches and jewelry partially offset by an increase in leathers. Within the region growth in Fossil and SKAGEN was offset by a decline in the licensed portfolio.

By country, modest constant currency growth in France and Germany was offset by a decline in the UK and in our distributor markets, which include the Middle East and Russia. Similar to what we experienced in the US, the data we received from many of our wholesale partners in Europe showed a significant decline in sell-throughs.

The retail channel grew in the quarter supported by a strong comp store sales increase, with promotional activity in outlet stores driving improved conversion despite ongoing traffic declines. Full-price stores also delivered positive comps in the quarter.

In Asia, reported sales decreased 8% to $114 million, while constant dollar sales decreased 4%. The decrease was driven by watches and jewelry, partially offset by modest growths in leather. Solid growth in India was offset by declines in most markets in the region, particularly Hong Kong and China, where our business continues to be challenging.

Growth of Fossil and SKAGEN and the addition of Kate Spade New York were offset by declines in most of the other brands in the portfolio. Comp store sales declined slightly in the region.

In the quarter, gross profit decreased to $348 million, and gross margin declined 250 basis points, 52.8%, roughly 160 of which was related to the stronger US dollar. Our gross margin rate was lower than we expected coming into the quarter, given increased markdowns and promotional activities in our outlet stores. A higher level of off-price sales compared to last year and an increased mix towards leathers, a lower margin product, contributed to the rate decline and was partially offset by our pricing initiatives.

First-quarter operating expenses decreased 3% or $11 million to $334 million compared to $345 million last year. A reduction in infrastructure costs and lower store expenses were partially offset by an increase in expenses associated with Misfit, including roughly $7 million in purchase accounting costs, and strategic marketing investments.

Excluding the favorable impact of currency and the $12 million in restructuring costs that occurred in 2015, expenses increased 2%.

Our first-quarter reported operating expense rate was 56.6% compared to 47.5% last year. Operating income decreased to $14 million, including a $13 million unfavorable currency impact, and operating margin decrease to 2.2%, including a 180 basis point headwind from currency. Interest expense increased to $6 million, given our higher debt levels. First-quarter other income decreased $5 million to $2 million, due to lower gains on foreign currency contracts compared to the prior year.

Our effective income tax rate for the quarter was 30.7%, compared to last year's 31.3%. First-quarter net income decreased to $7 million due to lower operating income given the sales and gross margin decline, as well as a reduction in other income due to the prior-year benefit from hedging activity.

Now turning to our cash flows and balance sheet, for the quarter we generated operating cash flow of $35 million, and drew down a net $14 million on our revolver. We invested $20 million in CapEx, $4 million in our share repurchase program, and expect share repurchases this year will be minimal.

We ended the quarter with roughly $307 million in cash, compared to $237 million last year, and debt of $823 million compared to $643 million a year ago. We ended the quarter with inventory of $630 million, in line with last year. We believe the composition of our inventory is in good shape, with increases in newly launched categories and brands and significant reductions in traditional watches and jewelry.

Accounts receivable decreased by 11% to $237 million and wholesale DSOs were flat for the prior year. Depreciation and amortization expense totaled $25 million for the first quarter.

Moving on to our outlook, let me provide an update on trends in the business and how we expect that they will impact our operating results this year.

First, our strategic initiatives to drive growth in the Fossil brand supported by our digital investments are working. They began delivering results last year and we believe will continue into this year. We are seeing momentum in the brand, including positive comps in our full-price stores and a solid online performance.

Second, our confidence has been bolstered by a strong performance in our wear-ables assortment that began with a product launch in the fourth quarter and continued into this year. We expect to build on that momentum as we quickly develop more connected products and launch more brands incorporating our Misfit platform. We remain extremely bullish on our ability to gain share in the fast-growing wear-ables market as we leverage our unique position to fuse technology with brands and fashion.

We are on track to deliver a wide assortment of new products that will be available in the second half of this year. So, with one quarter behind us, we believe those initiatives remain on track.

Third is the performance of the traditional watch business and the wholesale channel, which is certainly the biggest change in our business. As we exited 2015, we expected continued challenges in the traditional watch category, though based on our fourth-quarter performance and the sell-through trends our partners were reporting for some time, we anticipated some level of stabilization.

Overall for 2016 we expected top-line headwinds would persist in the first half with the opportunity to return to growth in the second half as we launched more connected products.

That stabilization in the traditional watch category in wholesale does not appear to be holding. During the first quarter the data we received from our wholesale partners indicated a meaningful sustained deceleration in wholesale sell-throughs, not only in the United States, but also with wholesale partners in Europe. All traffic remains difficult and many of our wholesale partners have announced transitions in their own businesses.

Our Latin America business also did not perform as we had anticipated. With the lack of visibility in this part of our business, we believe it is prudent to adjust our outlook to reflect these new trends and to provide for further wholesale softening. We are adjusting our forward inventory buys and expect, as we did in the first quarter, to rely more heavily on off-price partners to manage inventory levels appropriately. The first quarter we also invested more in promotions in order to drive sales in our European outlet stores, and expect that we will maintain this level of activity to drive business in those stores.

Given those factors, we expect these intensified headwinds will result in both lower sales for the year and tighter gross margins, with the wholesale softness representing by far the most significant driver of the change. As we manage our wholesale traditional watch business in 2016, and anticipating lower sales now than we had originally planned, we have once again reviewed our infrastructure and investment plans and identified areas where we can reduce and delay.

We will continue to look at opportunities to optimize our overhead structure for the longer term. In addition, we have reevaluated and reprioritized our marketing investment for the year, reducing investments where we don't believe we will see immediate returns, but continuing to invest in initiatives that are already working, like Fossil , our digital initiatives, and supporting our second-half wear-ables launches.

Therefore, for the full year we now expect constant dollar revenues to decline between 0.5% and 4%, which includes a 100 basis point headwind due to currency. Our biggest obstacle this year to quarterly growth will be leveraging our wear-ables launches to offset the headwinds in our wholesale traditional watch business.

We expect gross margins to decline this year given an anticipated increase in outlet promotions as well as a greater reliance on off-price partners. Our margins will be further compressed due to the lingering impact of the strong US dollar.

With the further reduction to expenses, we are now planning that our full-year operating expenses will be flat to slightly down this year. We are planning higher marketing investments to support strategic initiatives in our wearable technology infrastructure, including the addition of Misfit expenses and the related purchase accounting costs. These increases will roughly offset a reduction in our base infrastructure costs as well as the impact of last year's restructuring charges. This will result in an overall expense rate that is higher than last year given the decline in sales of traditional watches.

For the full year we now expect reported operating margin in the range between 5% and 7%. This includes about a 90 basis point decline due to the impact of currencies. We now expect earnings per share in the range between $1.80 and $2.80 per share, and this range reflects the challenges we are facing with forward visibility.

The currency environment has not changed materially from our initial guidance but we are still expecting significant translation and margin headwinds, as well as far fewer net currency contract gains. We now estimate the net impact of those items is roughly $0.87 per share. We continue to expect that this year's results will be negatively impacted by $0.36 per share resulting from the amortization of Misfit intangibles and contingent equity grants.

The year-over-year comparison will continue to be impacted by last year's foreign tax credit, resulting in a $0.24 EPS headwind this year, as well. We continue to plan this year with a 30% tax rate.

For the second quarter we are planning a reported sales decline between 8% and 10%, including about a 160 basis-point headwind due to currencies. We are planning with lower gross margins, and expect increases in our strategic marketing funding and wear-ables will slightly offset declines in our base infrastructure spending. We expect reported operating margin between 1.5% and 3%, which includes a 120 basis point currency headwind. And we expect EPS in the range between break-even and $0.15 per share. We continue to plan CapEx in the range between $75 million and $85 million.

And now we'll open the call up to your questions. And to be fair to everyone, please ask only single-part questions.

If you have more questions, please requeue after others have asked theirs.

QUESTIONS & ANSWERS

Operator:

(Operator Instructions)

Omar Saad, Evercore.

Omar Saad (Analyst - Evercore ISI):

Thanks, good afternoon.

I was hoping you could help us understand the back half, how you're thinking about the back-half revenues guidance and the change in trend. I understand the traditional watch business has really dropped off in the first quarter, original wholesale watch business. But how do you think about integrating all the new products you have coming into the new market, both from the wear-ables side, tech side, but also from the fashion side?

My understanding was you guys have a lot of new stuff coming into the market. Are you getting feedback from your retail channels that they don't want to order into those areas strongly? Or is it really wait and see from the retail accounts?

Help me understand why -- I understand why maybe sales are slower now in 1Q, 2Q, but with all the newness coming why don't you expect sales to rebound in the second half, constant currency?

Thanks.

Greg McKelvey (Chief Strategy & Marketing Officer):

Let me take maybe a deeper dive into guidance and then we can fill in with some of the discussion about wear-ables for the back half. But just to double-click on how we're seeing the year, and just to echo what we said, first, the change in guidance is virtually all related to what we saw in the wholesale watch business, which reflects both the step-down sell-throughs that the channel reported to us in the quarter and, frankly, to reflect yet further risk in a channel where our visibility is very limited right now.

You remember back to the last fourth quarter, we guided to a pretty wide range that accommodated a big step-down at the time, even though sell-throughs had been fairly stable for the prior couple quarters, and that was principally to reflect our lack of visibility. Fortunately in the fourth quarter we didn't see that step-down and our performance came in near the top of the range. So, we've maintained that same approach coming into 2016, guiding to a pretty wide range with wholesale sell-throughs that have actually been pretty stable for three quarters.

What has changed is, unlike the fourth quarter, in the first quarter that just passed, that we reported, we did see that wholesale step-down and it was substantial, larger than we had seen before. And it was pretty much across the board. The data we received from partners reported sell-through declines here in the United States, Europe. And, as we mentioned earlier, Latin America where market intel is pretty challenging, that business fell well short of our sales plans. And even external sources like NPD also repeated a very significant step-down from Q4 to Q1.

So, where that leaves us is the top of our guidance now generally reflects the current trends that we're seeing, and in the low end reflects that further step-down to account for lack of visibility. We also may be able to manage and shift some sales further to off-price. That would impact, obviously, our margins. And we reflected in our guidance the impact of further expense cuts that we've made. That includes cutting some marketing investments in areas of business that really aren't paying off right now.

What hasn't changed, and this is really what supports the growth in the back half, is our confidence in Fossil and our confidence in wear-ables. The marketing buzz, the buzz around Fossil Q, as we said just a minute ago, we've nearly eliminated drafty headwinds in our US full-price stores. We've got positive comps.

So, we are continuing to invest behind that and we think that can drive performance in the back half of the year. We have confidence in the products that we're bringing to market, and believe that the customer is there. You heard what Kosta said just a minute ago, talking about Basel and the excitement around our strategy for the category. So, we're going to continue to invest in that.

Kosta Kartsotis (Chairman & CEO):

Omar, you are right, on the product side we are launching a lot of wear-ables back half of the year. Everything looks great, looks very exciting. The stores are really excited to change their departments.

In addition to that, as you mentioned, we are putting into the market a lot of new innovative material, ideas, shapes, et cetera. We're seeing a strong response to that across the platforms. We're adding more of it in the second quarter. When times get tough like this, innovation is always a driver and we expect that will be continuing.

But you look at our entire analytics and our data right now, we seem to be in a lot of turbulence in terms of the traditional watch business. We feel it is prudent to give the guidance we have given, but we think the combination of wear-ables and all new product, that at some point this is going to turn around and be a pretty exciting prospect for us.

Operator:

Ike Boruchow, Wells Fargo .

Ike Boruchow (Analyst - Sterne Agee & Leach, Inc.):

Hi, everyone, thanks for taking my question.

In terms of your own connected technology products you plan on rolling out in the back half of the year, can you just help us understand maybe what level of commitment your department store partners have discussed with you? I'm trying to understand, at this time how are you internally planning the launch, given it is a brand new category that you guys have never sold through, and the fact that they seem to be buying the traditional watch business much more cautiously today. Thanks.

Kosta Kartsotis (Chairman & CEO):

First of all, the stores obviously have seen their watch business decline. If you go back seven years ago, the watch department is very much larger than it was then. It has grown in multiples. It has actually, with the decline in the watch business, probably come down a bit, obviously, in productivity but still one of the most productive areas of the store.

The stores are actually very excited. There's so much consumer interest in wear-ables. It's very top of mind. It brings a younger customer in their store. There's a bunch of excitement around it. We think this is an opportunity to change the entire watch department from a typical watch department to a wearable technology department. Obviously millennials overspend on technology so it is very exciting.

We are in the process of getting plans in place for the back half of the year in all of the brands we're launching, especially Fossil and Kors, getting point of sale, visual presentation, fixturing in place, getting a lot of marketing PR. There's probably going to be TV campaigns on both brands. We're getting everything in position.

There are commitments we've made in products we're going to be launching in the third quarter this year. There is a potential even for us to reorder for holiday. We already know that probably about 50% of wear-ables are sold in the month of December. So, it could be an additional amount of commitment there.

To answer your question about commitment, the numbers are changing almost every week. There is a lot of excitement and we're putting plans in place to have a strong execution. But one thing that is clear is, just from our launch at Basel, we got more press and page views than anything we've ever done before. And we are seeing already, just looking at numbers, purchase intent on Fossil smartwatches. It is still a very small business for us. It shows to be a pretty significant number and we don't have a lot of product on the market yet.

So, all our analytics look strong. The customers are excited about them. The actual commitments from them and our numbers are moving every week.

I'd add one other thing to that. Founder, which is our display smartwatch for Fossil , was our number one selling SKU, and has been. So, we're very bullish on that category. But one of the most exciting things coming out of Basel was the reception we got from customers, from integrating technology from Misfit into the existing watch business, as well. We're already on generation two and three in development of these things.

But the ability to have added functionality like time that automatically changes with time zone changes or daylight savings, press a button and have where is my phone feature, these are all added value to existing watches that is driving a lot of customer interest that is beyond what we even expected when we showed people at Basel, so, really on all three categories, those two plus trackers.

Operator:

Dorothy Lakner, Topeka Capital Markets.

Dorothy Lakner (Analyst - Topeka Capital Markets):

Thanks, everyone. And good afternoon.

I don't want to beat a dead horse here, but just to go back to what you're hearing from your wholesale partners, you did see the significant step-down in traditional watches. Are they stepping up to the plate on the new watches, on the wear-ables? Are you seeing some commitment there, or is there just a lot of reticence around the entire category? How confident are you in seeing this growth in the second half of the year from all that you're doing on the wear-ables side?

Kosta Kartsotis (Chairman & CEO):

A couple things. First of all, I'd say overall, I think, in the first quarter this year there has been a step-down just in overall traffic and consumer activity. So, that is one thing. And in addition to that, I think especially in watches -- we attribute this really to all of the press and PR and excitement around wear-ables -- there seems to be somewhat of a lack of interest in watches relative to last year. We actually had a pretty good first quarter last year in watches.

I think another piece of this is the stores saw in the fourth quarter relatively slower sell-throughs on watches, so they didn't fill back in the first quarter as they normally would have. Typically that means, as you know, the larger doors don't get filled back in. They may impact their sales so it has a multiplier effect in there. So I think there is just a malaise in watches.

Our biggest objective in all of this technology stuff is really to disrupt the watch business. We think, as Greg mentioned, to put additional functionality in traditional watches -- as we've said before, our mission is eventually we want to put connectivity in every watch we make, without adding a lot of additional to the retail price. With the Misfit technology and all our engineers, et cetera, the mission is really to take the existing watch business, add functionality, innovation and connectivity, and make that category more relevant to consumers that increasingly overspend on technology.

We think that is a very exciting prospect. Largely millennials have not worn watches because they grew up with smartphones. So, just taking the existing core business and all the activities we've got with our smart analog movement -- which is a just a regular analog watch, great looking watch, that is heavily designed and branded, and it's got connectivity in it with not a lot of additional price -- we think that is going to make the category very strong. We think we'll gain share. We'll have differentiation. We think that is a very strong prospect for the traditional watch business.

Having said that, that is not going to change totally this year. We're going to be launching in, I think, eight brands, these smart analog movements. It is not going to penetrate the overall assortments to a large degree until the next couple of years. So, this is starting off pretty small.

In addition to that traditional watch business, we're launching, of course, trackers in many brands, which we think can be a new accessories business. Imagine trackers as connected jewelry with branded story-telling and engagement with different brands. We think it can be -- just like a handbag business or something else -- a branded accessories business. And we're going to add design, color, branding, emotional attachment, et cetera, to that category.

And then the third piece is the smartwatch, which is a digital display Android watch. If you just look at the wearable technology, the tracker and the display watch, the projections are, from research groups like IBC, that in 2019 that is a $54 billion business that we are going to participate in. I think they mention that in 2019 there's going to be 88 million smartwatches sold. And we've got our toe in the sand now, we've got a lot of activities coming, we're going to participate in that in a very large way.

So, we feel like there's two things. We're going to disrupt the existing watch business and take a bigger share and make it more relevant. And then we're going to participate in a strong way bringing branding design, our distribution power, and all our resources to bear on that wearable technology market and make it a fashionable business. We think it is a very exciting prospect for us to add that much more addressable market to our Company. And all of these are adjacent businesses. With the Misfit technology and our capabilities now, we're in a unique position to capture a much larger market.

Operator:

Oliver Chen, Cowen & Company.

Cecile Origenes (Analyst - Cowen and Company):

This is Cecile Origenes for Oliver Chen.

Thank you for taking my question. I actually wanted to just ask you a little bit more questions about your CRM and digital initiatives. It is very encouraging to hear about some of the positive results you're seeing from your investments so far in that area. Could you just speak to some of the opportunities that remain in FY16 and what you're most excited about?

Greg McKelvey (Chief Strategy & Marketing Officer):

Yes, this is Greg. We're actually getting, just in the last couple of months, a lot more highlights from the successes that we had in Q4. So although Q1 this year 2016 wasn't a big step up in marketing for the Fossil brand, some of the highlights that we saw in Q4 were very good ROI, significant increase year on year, very strong millennial response. So, bring a lot of new customers into the business that are not just wear-ables-driven but are actually coming in and buying wear-ables, plus other products.

Saw, not just branded just growing across social channels and search channels, but omnichannel traffic, and that's measured by our own e-Com channels, our own direct-to-consumer channels and what we are seeing in traffic and searches broadly. So, really, all channels we're seeing increase in interest in Fossil brand.

So, that is where, as we look through the back half of this year, we are going to continue to fine-tune the mix, and continue to lean in on the vehicles that have been working to date, and then plus-up a significant amount of spend against the wear-ables launch in particular, so that we're getting the right push on the brand into direct-to-consumer channel on the products that are working.

Operator:

Ed Yruma, KeyBanc Capital Markets.

Edward Yruma (Analyst - KeyBanc Capital Markets):

Thanks for taking my question. On the department store front, anecdotally it seems like some department stores are pulling out of one of your major brands. Has that been impactful to your numbers? And are you expect that? And then as a follow-up to that, do you think that they're selling down in anticipation of wear-ables or do you think they're selling down in anticipation of lower sell-through? Thank you.

Greg McKelvey (Chief Strategy & Marketing Officer):

I think it is a combination of factors. Traffic is off in general. Watch category is slowing down.

The other thing to consider, and we've talked about this before, is that during the first quarter it is a relatively small time of the year for watches, so there is not a lot of companies out there trying to fill back into watches right away because the sell-through is relatively slow. So, all of those things are playing into that.

And then the stores are obviously very excited about wear-ables. There is going to be a conversion over the next couple of years from traditional watches, adding more technology to them. There may be some conservatism on the inventory from that regard, as well.

Operator:

Erinn Murphy, Piper Jaffray.

Christof Fischer (Analyst - Piper Jaffray):

This is Christof Fischer on for Erinn.

I was hoping if you would speak a bit more about the Michael Kors brand and what role you see it playing in your portfolio. May any type of information on performance during the quarter and what you see as the key drivers going forward for the brand's performance. Thanks.

Greg McKelvey (Chief Strategy & Marketing Officer):

Last year, I think in the first quarter, we had a very strong watch business and Kors was a big part of that. We had over the last couple years seen very significant growth. That business is very large, as you can imagine. So we've seen a moderation of that.

But we're moving forward. I think probably the most exciting thing for Kors this year is a couple things. One is, we're going to have a huge launch. They actually had a press conference in our Basel fair, and out of that press conference there was a billion page views from it. The consumer interest on the Kors smartwatch is very significant. There's going to be very significant amount of activity around when it launches. So, we think that is going to be very exciting.

We also, as we mentioned, have been changing the product line quite a lot. It looks a lot different. We're seeing a lot of new ideas sell through in there. We think that that is going to improve over time.

We also still have a relatively large opportunity, both in men's and in jewelry. We're continuing to build shop-in-shops. One thing, even though the business has come down some, it is still by far the most productive watch brand we have, and it's one of the most productive in the world just in terms of sales per square foot.

Of course, Asia is just getting started. It is still a relatively small business. The brand is getting a lot of traction there. And in all those markets, especially Asia, the smartwatch is going to be a big player because there's a lot of interest over there. So, all in all, I think we still have a lot of growth ahead of us long term in the Kors brand.

Christof Fischer (Analyst - Piper Jaffray):

Great. Thank you.

Operator:

Simeon Siegel, Nomura.

Simeon Siegel (Analyst - Nomura Securities Intl):

Thanks, good afternoon.

Just given the wholesale commentary, any thoughts on just how large that North American business should be, in your opinion, looking further out? And then, Dennis, maybe just a similar question around margins. What is the right EBIT margin for your business? Can you talk about the moving pieces, be it product, geography, channel dynamics, anything within there. And then how are connected margins versus traditional watches? Thanks.

Greg McKelvey (Chief Strategy & Marketing Officer):

I think, as we mentioned, the watch business globally is about $65 billion. Wearable technology is expected to be an additional $54 billion in 2019. We think through this process we can gain share in the traditional watch business, with all our activities. In addition to that, we're going to capture a share in the wear-ables business.

So, to us, there is no reason why we shouldn't have a much larger wholesale business in the United States. There will be, with our activities with the Misfit brand and other items, additional distribution for us, as well. This is going to put us in the CE channel and other distribution. And obviously distribution channels are changing globally.

I think the one thing that's clear is that wearable technology is very much skewed towards eCom, and this is going to open up a lot of doors for us globally. It could be, actually, a catalyst for us not only in the United States but in Asia, where it's difficult to penetrate the Asian market, especially China with shop-in-shops at concession. But eCom may be the answer and wearable technology may be the catalyst.

So, a lot of great stuff out there. We do think that we're going to have a much larger wholesale business in the US, though.

Dennis Secor (CFO):

In terms of the margin structure, last call we went through this quite a bit, but nothing really fundamentally has changed. We fee that, and said before, 2016 is an inflection as we go through this transition. There is headwinds in the wholesale business and we've got growth opportunities. And the steepness of that inflection point is part of what's masked right now with the lack of visibility.

But we still see growth drivers coming out in the back half of this year, and beyond. That can accelerate as we bring more brands onto the platform and even add new brands. The biggest risk remains if we can replace any weakness in the traditional watch business with these new growth drivers.

In terms of operating margins and gross margins, you see some near-term dilution. Wear-ables margins right now are a little tighter than the traditional business. But there is opportunities to offset those with scale, innovation. And then, as we have proven to ourselves, we think there is opportunities for additional AUR. When our best-selling product in the stores right now is coming at a very substantial price tag, that bodes well for our ability to add AUR, as we add features into our product.

We said, and our strategy remains, that as we come out of this year we would expect to moderate. We had some headwinds as we have been investing in marketing, and our goal going forward is to invest more consistently with our top line. We're getting good returns on those investments now.

The biggest opportunity for us in terms of margin expansion is on the overall structure, which we will always every year as we look at our plans we look to see what we think revenues could be and size that appropriately. But as we look forward, largely everything that we need to run this business is already in place to any material extent. So, that remains an opportunity for us to leverage.

Probably the one big factor that remains to be solved is the impact of currencies. Over the last two years, based on our numbers right now, currencies have taken almost 4 full points of operating margin. And that's going to be difficult to get back quickly absent a weakening of the US dollar.

Operator:

Thank you. Rick Patel, Stephens.

Rick Patel (Analyst - Stephens Inc.):

There seems to be a lot of excitement about the features your wear-ables will have, thanks to Misfit. Can you give us some examples of the types of things that will change, or the features that can be improved upon that consumers would take notice of? And, as you leverage these new capabilities, will that change your relationships with Google and Intel ? Thank you.

Greg McKelvey (Chief Strategy & Marketing Officer):

I'll address first the adding technology to existing watches. We sell 30 million watches today. All they do primarily is tell time. And now we've got the capabilities to add a lot of features to a product without compromising the style, the branding, and all the reasons people purchase these products and love these products today.

Some of the features you'll see this fall, the time will be automatically updated with time zone changes or daylight savings. You'll have a feature we call link which is the ability to control Internet of Things around you off of your device. So, you'll have a push button on your watch, you'll be able to push it and it will ring your phone. So, it is a where-is-my-phone feature. We're getting very strong initial feedback from our initial customer research on even that as a very valuable feature.

In addition, activity tracking, sleep, smart notifications, these are all things that are value-adds to the existing products we have today. Substantial upgrade. And also, as Dennis mentioned, a significant increase in averaging at retail.

Over time, we believe that the cost -- think of that as a new type of watch movement -- of that will get closer and closer to a quartz movement. And when that happens, there is no reason that we won't be able to add those features to literally every watch we make. And now we've got the entire, what we call software stack -- the cloud and the cloud ecosystem, the whole app infrastructure -- to be able to not only bring those products to market successfully but scale them across the breadth of our branded portfolio, across most of the countries we're in, and across all the languages. This year it will be eight brands, 40 countries, 20 languages. And that's what the Misfit acquisition allows us to bring to market.

On smartwatches, which is effectively the Apple watch competitive set, we are committed to the Google Android wearer operating system. So, the Michael Kors access watch and the Fossil Q watches and the lines that are coming out this year, those will always continue to be based on the Google Android wear operating system. We are continuing to be very bullish around where Google's taken that operating system, and have seen some of what they're bringing into market later in the year in operating system upgrades. And it is just going to continue to significantly advance in capabilities. Google will take the lead on announcing exactly the functionality that is being enhanced there, though.

Operator:

Lindsay Drucker Mann.

Lindsay Drucker Mann (Analyst - Goldman Sachs):

Thanks. Good evening, guys. I wanted to ask again on the US wholesale business, could you help us understand, first of all, your channel mix -- department stores and any other buckets? So, how much of the US wholesale business is in department stores?

And then, as you talked about that step function change in sell-through, could you help give us some specifics on maybe order of magnitude what sell-through was running in the preceding three quarters, and what it is running now? We heard from you in mid February. Did that dynamic happen later in February and into March, or was it already under way?

And then, just lastly, as I square your earnings guidance the back half of the year, the implied revenue guidance I think is up 1% to 2%. And I wanted to understand what growth or how you were thinking about the trend for the Americas in the context of the back half of the year. Thanks.

Dennis Secor (CFO):

Just quickly, the makeup of the American business, the US department stores is probably the largest part of that. You also have a significant number of boutiques. Some of our brands that have their own stores, they can be significant businesses and customers for us. Latin America is a big business for us, as well, all wrapped up in the Americas region, as is Canada and Mexico. So there is a lot of components that make up that business.

In terms of the back second half of the year, what we've said about in the guidance is that you should think about the top end of the guidance generally reflecting the current trends that we're seeing right now. And we've stretched that to accommodate in the lower end some further deterioration, just given the lack of visibility that we had.

In terms of what we saw in the channel, the step-down in the business was fairly consistent throughout the quarter. You get reads throughout different parts of the business at different times, and there is differentiations in terms of the sophistication of the channel. It really pulls together throughout the quarter. But some parts of the business the step-down was pretty quick. And, significantly -- there is always some choppiness to the data -- but the significant thing is that it was sustained throughout the entire quarter in a lot of places.

Operator:

Anna Andreeva, Oppenheimer.

Anna Andreeva (Analyst - Oppenheimer Capital):

Good afternoon. Thanks for taking our questions. We were curious on either Misfit or Fossil wear-ables, dollar or unit sales in 1Q. How did that number come in versus expectations? I'm just trying to assess the opportunity for 2016 as you have the additional launches in the back half.

And we noticed you talk AUR down to, I think, $95 on the activity trackers. What drove that decision? And any additional tweaks we should expect with pricing? Thanks.

Dennis Secor (CFO):

Let me just start with the numbers. We're not separately disclosing the Misfit numbers or the Fossil wear-ables. We can tell you right now the numbers are still fairly modest for both of those brands. The bigger opportunity comes as we bring more brands into the back half of the year.

Kosta Kartsotis (Chairman & CEO):

And on price point, we think the tracker business is clearly having a lot of unit sales across multiple channels with the success of some of the competitors that are out there. We think that as we bring fashion and the feature-rich functionality that Misfit brings us, at a killer price point -- so, that $95 to $99 price point across eight brands this year -- we think we have the ability to drive a lot of unit sales. And then we can ladder up in averaging at retail as we add accessories that are more fashion oriented, from sport band to leather and other products that are brands that might command a higher premium. But that under $100 killer price point with breadth of brand is what we're going for.

Operator:

Betty Chen with Mizuho Securities.

Betty Chen (Analyst - Mizuho Securities):

Good afternoon, everyone.

I was just curious, as we get into the second half, is there any color you can give us on the inventory commitment for the smartwatches and trackers and wear-ables? I know that you mentioned exiting Q1 the inventory composition is very healthy. Just thinking about how we should expect that in the back half.

And then in terms of the wear-ables having slightly lower margin than traditional watches for now, when should we expect the margin profile to be much more comparable? Is it going to be 2017 or perhaps even further out just because of the way the business may ramp up? Thanks.

Dennis Secor (CFO):

On the margins, right now if you look at our connected products, there is compression relative to the total. The volumes, certainly right now they're still relatively small. They'll get bigger, but still, relative to the total, they'll be smaller. It is over time as we bring more brands on to the platform and produce more units, it is the benefits of scale as well as improved technology, that we think ultimately can drive those costs down and, with a feature set, provide us an opportunity to add AUR.

Kosta Kartsotis (Chairman & CEO):

Scale matters a lot on these products, more so than our traditional business, a highly depreciated asset base that supports it. So we've got to make a lot of up-front investments in engineering costs to get product to market. That requires, for each major product line, over 1 million units to really reach scale.

We're investing heavily on the supply side of our business to get our own captive manufacturing facilities to test, assemble and bring these products to market. And then we've got a large fixed cost base in the engineering resources and the software platform we've acquired with Misfit. On all three of those dimensions we've got to get to scale to get to fully loaded margins, or really good margins. There is no reason long term why we shouldn't be at our traditional margin structure, the way that we see it.

Greg McKelvey (Chief Strategy & Marketing Officer):

On the inventory commitment, we're in the middle of this right now, getting projections from our customers, doing forecasting, looking at the supply chain, really measuring all this right now. So, it is still early to tell. As I mentioned, there is a potential that we could do a reorder for holiday, as well. So, it is a moving target right now.

Operator:

At this time I'd like to turn the conference back over to Dennis Secor for any additional or closing remarks.

Dennis Secor (CFO):

Thank you, all, for participating today, and we look forward to reporting on the second quarter in August. Thank you very much.

Operator:

Thank you.