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DECK - Q3 2017 Deckers Outdoor Corp Earnings Call

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OVERVIEW:

Co. reported 3Q17 revenues of $760m and GAAP EPS of $1.27. Expects 4Q17 revenue to be down approx. 6-5% and non-GAAP EPS to range from breakeven to $0.10.

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PRESENTATION

Operator

Good afternoon, ladies and gentlemen, and thank you for standing by. Welcome to the Deckers Brands third-quarter fiscal 2017 earnings conference call. (Operator Instructions). I'd like to remind everyone that this conference call is being recorded.

I will now turn the call over to Mr. Steve Fasching, VP of Strategy and Investor Relations. Thank you, Mr. Fasching. Please go ahead.

Steve Fasching - *Deckers Brands - VP Strategy & IR*

Thanks and welcome, everyone, joining us today. On the call is Dave Powers, President and Chief Executive Officer, and Tom George, Chief Financial Officer.

Before we begin, I'd like to remind everyone of the Company's Safe Harbor policy. Please note that certain statements made on this call are forward-looking statements within the meaning of the federal securities laws which are subject to considerable risks and uncertainties. These forward-looking statements are intended to qualify for the Safe Harbor from liability established by the Private Securities Litigation Reform Act of 1995.

All statements made on this call today, other than the statements of historical fact, are forward-looking statements and include statements regarding our anticipated financial performance, including our projected net sales, margins, expenses, and earnings per share, as well as statements regarding our business transformation plans, product and brand strategies, market opportunities, and restructuring plans.

Forward-looking statements made on this call represent the Company's current expectations and are based on currently available information. Forward-looking statements involve numerous risks and uncertainties that may cause the actual results to differ materially from any results predicted, assumed, or implied by the forward-looking statements. The Company has explained some of these risks and uncertainties in its SEC filings, including in the risk factors section of its annual report on Form 10-K. Except as required by law or the listing rules of the New York Stock Exchange, the Company expressly disclaims any intent or obligation to update any forward-looking statements, whether to conform such statements to actual results or changes in its expectations or as a result of the availability of new information.

With that, I will now turn it over to Dave.

Dave Powers - *Deckers Brands - President, CEO*

Thanks, Steve, and good afternoon to everyone. Today, I'll begin with a review of our third-quarter performance, covering the successes and challenges we experienced in the business. I'll then discuss how we are continuing to streamline our cost structure and improve our long-term profitability. Finally, I'll review the impairment and writedown of goodwill.

Beginning with our performance in the quarter, we delivered revenue of $760 million and reported earnings per share of $1.27, which includes impairment, restructuring, and other charges of $128.9 million. Non-GAAP earnings per share, excluding these charges, was $4.11. Tom will walk you through more details on the financials in a moment.

The revenue and earnings shortfall was caused by weaker-than-expected wholesale sales. This was partially offset by a stronger-than-expected result from our direct-to-consumer channel, highlighted by a 4.7% comp increase.

Beginning with the miss, our wholesale and distributor business was challenged globally by lower-than-expected reorders and a few limited cancellations. Domestically, we believe the warm temperatures at the start of the key selling season impacted sellthrough in November. The slow start heightened retailer caution, especially since they carried over product following last year's warm winter.

Sellthrough accelerated as the weather turned colder; however, it was too late to get retailers to commit to taking additional orders. Retailers instead were focused on selling through their inventory and not reorder for sales upside. While our net sell-in results were disappointing, retailers ended December with cleaner inventory levels compared to a year ago.

On the international side, wholesale and distributor sales also fell short of our expectation. While sales this year were higher than last, international demand was weaker than expected and the shipping delay experienced in Q2 with our new European 3PL caused a missed reorder opportunity.

While we fell short of our expectation, overall we understand many of our wholesale partners were pleased with their sales performance of the UGG brand and especially with the full-price sellthrough of the Classic II.

Collectively, our key wholesale partners had a solid season with UGG and this underscores the brand's importance to their business. Now that the retailers' inventory is in a clean position and we have transitioned the market to Classic II, we can move forward with the ability to drive more full-price selling.

Looking ahead, we are focused on delivering high-quality sales through developing more compelling segmented product, better inventory management, appropriately managing the amount of Classics in the marketplace, diversifying and reducing the seasonality of the UGG business, and finding growth in other full-price opportunities, such as men's, kids, and apparel.

To that end, we are very pleased with the performance of UGG for Men. NPD retail tracking service ranked UGG as the number seven men's fashion footwear brand for the quarter, breaking into the top 10 for the first time ever, largely driven by the success of the new male style. At the same time, UGG Men's was up 34% versus last year in our key account.

To capitalize on these opportunities, we must further strengthen our wholesale relationships so that we are even more strategically aligned. Our leadership team, including myself, has been meeting with the management teams of our top wholesale accounts to align on our strategies. Together, our goals for the UGG brand are very similar. They are reaching a younger consumer, growing the men's business, creating a compelling and segmented year-on offering, all while preserving the classics franchise and ensuring core classics brand position.

In order to accomplish these goals, we are continuing to optimize our wholesale distribution in order to drive more business and improve profitability. We are also continuing to test and selectively open new accounts that share the same philosophies of the UGG brand. We are on track towards having a stronger, more diversified wholesale business, marked by healthy margins and fewer closeout sales.

Now moving on to the performance of our DTC channel, as I mentioned, we were very pleased to report a positive 4.7% comp. The positive result was driven by stronger-than-expected e-commerce results and improving trends in our retail store comp. Our e-commerce business delivered our largest volume quarter ever, benefiting from the utilization of UGG Closet, which provides a controlled, high-margin way to close out UGG product.

In addition, our omnichannel initiatives, like Click & Collect, Infinite UGG, and our newly launched UGG Rewards loyalty program, are helping us better engage with consumers and drive traffic through all channels.

Unfortunately, brick-and-mortar traffic remains challenging and we expect our stores will continue to face headwinds for the foreseeable future. So while our stores remain an important component of servicing our consumer, testing product, and showcasing the breadth of the UGG brand, we believe it is prudent to further reduce our global brick-and-mortar footprint.

Now to an update on the progress we are making to streamline our organization. As I indicated when I first took over as CEO, fiscal 2017 is a transition year for Deckers. Since assuming the role, I've been evaluating the organization to make the right refinements in our structure and strategy that I expect will make us a stronger company and more competitive in the marketplace. This includes strategic spend reduction as we are realigning our organization to better engage and service our global omnichannel consumers.

As part of my assessment to improve our operating model, we've been working with a top-tier consulting firm. The focus of our combined efforts has been on right-sizing our operations and optimizing our omnichannel structure and reducing inefficient spend. So far, our work has identified a total of $150 million of cumulative annual cost savings. This includes $60 million of previously announced improvements and $90 million of newly identified savings. The previously announced savings include the closure of 24 retail stores and office consolidations, which we said would reduce operating expenses by $35 million. It also includes 150 basis points' improvement in our gross margin that we had guided to this year, which equates to savings of more than $25 million.

The newly announced savings of $90 million will also be a combination of further SG&A savings and cost of goods sold improvement. On the SG&A side, we are committed to saving $60 million through organizational changes, which includes a headquarter staff reduction; reducing and reallocating our marketing spend; further retail store consolidation, including store closures and converting international-owned stores to partners; driving omnichannel operations efficiencies; and improving indirect spend.

These SG&A reductions will free up nonproductive spend, eliminate layers within the organization, and allow us to be faster and more agile. The contraction will help us realign organizational costs against the rapidly changing environment, aligning the Company's skill set and better positioning it to confront the challenges of the current environment, and the evolving consumer preferences in distribution and digital marketing.

We also believe we can drive an additional $30 million in COGS savings through further improvements in sourcing of materials, shortening of our product development lifecycle, focusing on automation, moving production outside of China and, consolidating our factory base.

The total of $150 million in announced savings excludes any reinvestment we may continue to make to diversify the UGG brand, profitably expand our international business, and grow the HOKA brand. With HOKA, we see further opportunity to expand the North American presence with product extensions and category expansion that appeals to a broader consumer base. On the international front, we have just begun to scratch the surface with HOKA and see significant potential for growth.

We ended 2016 with over 20 awards, including Editor's Choice by Runner's World. Global media impressions exceeded 2.2 billion as we continue to gain eyeballs on the brand.

For this year, HOKA has introduced two new styles, the Arahi and the Gaviota, that are in the stability running category, which represent upwards of 35% of the total running market. HOKA has never had a traditional stability shoe and these styles will help continue to gain share in the market. We are very happy with the launch and the Arahi is quickly becoming a top-selling style.

We will give more specifics on the timing of the savings and reinvestment when we provide our annual outlook on our next earnings call. In the meantime, the Company continues to be focused on implementing a strategy aimed at meeting the changing needs of our customers in the industry, and we will continue to drive towards these initiatives and believe they will help us win with consumers and drive improved profitability.

This organizational self-evaluation, in conjunction with the annual assessment of goodwill related to the Sanuk acquisition in 2011, has resulted in the impairment charges for Sanuk. This was determined based on a more limited view of expansion opportunities, given the changing retail environment. We are confident that Sanuk will continue to be an important brand in the sandal and casual canvas category.

And with new leadership now in place, we have been able to reduce costs and also improve product design and marketing through leveraging innovation and collaboration across our brand.

With that, I'll now hand the call over to Tom to provide more details on the financials.

Tom George - *Deckers Brands - CFO*

Thanks, Dave, and good afternoon, everyone.

Today I will take you through our third-quarter results in greater detail, break out the restructuring and EBIT charges recorded in the quarter, and provide an outlook for the fourth quarter and update on fiscal 2017. Finally, I'll provide some additional details on the Company's projected cost-savings program.

Please note, throughout this discussion where I refer to non-GAAP financial measures, I am referring to results before taking into account restructuring and EBIT charges. Also note, our non-GAAP results are not adjusted for constant currency. A reconciliation between our reported GAAP results and the non-GAAP results can be found in our earnings release that is posted on our website under the investor information tab.

Now to our results for the third quarter. As Dave mentioned, revenue was $760 million, which was below our projections for the third quarter, primarily due to lower-than-expected global wholesale sales, partially offset by strong sales in our DTC segment. While sales were below guidance for the quarter, gross margins met our expectation and improved year over year. Gross margin for the quarter was 50.5%, compared to 49.1% last year. The improvement versus last year was driven primarily by improved input costs and a higher proportion of DTC sales.

Reported SG&A expense was $330.3 million, and this includes the $128.9 million restructuring, impairment, and other charges. The breakout of these charges are $118 million for the Sanuk brand impairment, $9 million for retail-store closures and impairment, and $1.9 million of other restructuring costs.

On a non-GAAP basis, SG&A expense was $201.4 million.

For the quarter, GAAP earnings per share was $1.27 versus $4.78 a year ago. Our non-GAAP earnings for the quarter were $4.11, which was below our guidance range of $4.16 to $4.28. The year-over-year decline on a non-GAAP basis was driven by lower sales and higher SG&A, partially offset by a 140 basis-point increase in gross margin.

Inventories at the end of Q3 were $373.5 million, an increase of just under 1% over the same period last year. The increase is primarily due to the lower-than-expected level of wholesale sales. Going forward, we recognize the need to manage our inventories more effectively; however, at this point, rather than close out inventory quickly to achieve a revenue target in Q4, we want to manage inventory in a way that is healthy for the brand long term. We will adjust our inventory buys for fall 2017 accordingly, but recognize that inventories will remain higher than optimal in the immediate term.

During the third quarter, the Company repurchased approximately 222,500 shares for a total of $12.6 million at an average price of $56.51. As of December 31, 2016, the Company had $65.3 million remaining under its $200 million stock repurchase program.

Now moving to our outlook, for the fourth quarter we expect revenue to be in the range of down approximately 6% to 5% compared with the same period last year. We expect non-GAAP earnings per share to range from breakeven to a loss of $0.10 compared to non-GAAP earnings per share of $0.11 last year. We now expect lower revenue in Q4, due primarily to a strategic reduction in UGG closeout sales, coupled with a weaker retail environment and reduced expectations for Sanuk.

As Dave alluded to earlier, one of the reasons the domestic reorder business did not materialize in Q3 as we had anticipated was due to retailers carrying over product from the year before. Now that retailer inventory is in a healthier position, we are going to be more pragmatic about our closeout strategies so that we are entering fall 2017 with less promotional carryover inventory in the channel.

For the full fiscal year, we are lowering our guidance range. We now expect revenue to be down approximately 5% and non-GAAP earnings per share to be in the range of $3.45 to $3.55 on a share count of 32.3 million.

Moving on to the tax rate for the full year, we expect a tax rate of approximately 27% versus approximately 22% last year. As a reminder, our earnings-per-share guidance for the fourth quarter and full year exclude any pretax charges that may occur from any further restructuring charges. We expect fourth-quarter restructuring charges to be approximately $20 million.

Now moving to the savings plan, we anticipate $150 million in cumulative annual savings by the end of fiscal-year 2019, with a portion coming in the current fiscal year and then accelerating over the next two fiscal years. As Dave mentioned, the $150 million is comprised of $60 million of previously announced savings and $90 million of newly announced savings initiatives and excludes any reinvestment we may make.

The current guidance for fiscal-year 2017 includes $34 million of savings, of which $27 million is cost of goods sold from improved input costs and supply-chain efficiencies and more than $7 million of SG&A savings related to the office consolidation. This leaves approximately $116 million of savings that we plan to begin to realize over the next two years.

While it is still early and we are working hard to reduce our SG&A, it will take some time for these savings to be fully implemented. Therefore, when taking into consideration some of the additional reinvestments we anticipate to make in the business, the bulk of the net SG&A savings won't begin until fiscal-year 2019, with more net savings continuing beyond. We do expect that once implemented these savings will reduce our SG&A run rate on an absolute dollar basis. We will provide more specific details on timing when we give fiscal-year 2018 guidance on our Q4 earnings call.

With that, I will now turn it back to Dave.

Dave Powers - *Deckers Brands - President, CEO*

Thanks, Tom.

The pace of change in consumer shopping behavior continues to accelerate and we must evolve to keep up. This requires us to improve our product offering and how we go to market, but also requires us to right-size the organization and reallocate our spending to the most productive areas of the business.

The savings announced today puts us on the path to operational improvement, while also freeing up resources to attack areas of opportunity. We are proactively right-sizing this organization with an eye to the future and a firm commitment to improving profitability and increasing value for our shareholders.

With that, we are now ready for Q&A.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Randy Konik, Jefferies.

Randy Konik - *Jefferies LLC - Analyst*

I really appreciate you taking my question. I guess, Dave, I asked this on the last quarter call; I want to ask it again. How do you think about what the long-term distribution model has to look like for this Company? Obviously, it's been historically more wholesale dominant. We went through a period of time when we went more towards a retail centric -- or going towards a retail-centric model, and then pulled off that a little bit and exploring some Amazon. So I'm just kind of curious on how we should be thinking about not what happens next year, but what kind of the long-term thinking around how you want to distribute the products, specifically UGGs, let's say five years out, and how do you get there and so forth. Thanks.

Dave Powers - *Deckers Brands - President, CEO*

Sure, Randy, it's a great question, and obviously I think the results of the quarter indicate the urgency that we need to shift our distribution strategy both in the short and long term. This is something we've been working on for the past 18, 24 months as we have established our omnichannel infrastructure to be able to shift channels.

Some of the testing that you saw in new channels this past quarter, i.e., Macy's, into Foot Locker, and going into Amazon, we're anticipating a broader shift in the distribution long term. For me, it comes down to controlling our distribution as best we can, so continuing to work with the partners who are going to continue to win, continuing to work with partners that are going to showcase and present our brand in a quality way, and then bringing on even more so partners that are working closer to the consumer, and, most importantly, our e-commerce business. I believe the more consumers we can bring into our DTC channels and our e-commerce business, the better off for us and for them. It's a high-profit distribution and that's where they want to shop, especially the younger consumer.

As we've talked about over the last couple calls, we're also cleaning up and right-sizing our distribution in North America, so closing unproductive accounts and creating more opportunity for our top key accounts to do business with us in a quality way.

So I think longer term you are going to see us control more of our distribution. You are going to see more distribution done through online channels, whether it's through our online channels or our top partners, and we're right-sizing the organization to be able to help them be successful that way. But really, the ultimate goal for us is fewer key accounts across the distribution marketplace, more through online, and more through direct channels.

Randy Konik - *Jefferies LLC - Analyst*

So I guess two more on that, then. Is there any type of target that you could kind of give us that we can think towards, saying we want capital X percent of the business to be retail versus wholesale, something like that?

And then I guess the second question around wholesale is, are you seeing varying big differences in the sellthrough rates at, let's say, the large department-store accounts relative to the sellthrough rate at the independent or smaller kind of accounts? I'm just curious on what you're seeing because, obviously, what we see in the public world is Macy's misses, Target misses, and so forth, so there's a never-ending drumbeat of negativity out there. I'm just curious on if what you are seeing is different across those two different types of wholesale channels, if you will, and, importantly, how should we be thinking about long-term mix around wholesale versus retail versus Internet, et cetera, trying to wrap our arms around what the ultimate final distribution model should look like for the Company? Thanks.

Dave Powers - *Deckers Brands - President, CEO*

Great questions, Randy. I think to speak to the long-term mix, it's something we're still evaluating after coming out of this quarter and realizing that the shift in the channels are accelerating at a faster pace than ever.

I think the strength of our DTC channel in the last quarter and the amount of business that we did to that channel, I believe, was roughly about 45% of total business, if not higher, done through DTC. I think that's probably closer to what the future looks like, but I think we'll have more insights and information to share on the long-term distribution strategy on the next call. But it is something that we are aggressively taking a good look at in right-sizing, as I said, the distribution.

With regards to sellthrough, we're not seeing dramatically different rates of sellthrough between the majors and the independents. Generally speaking, everybody had a healthy sellthrough results with the UGG brand in the last quarter and they have cleaner inventories as a result of that, so we're pleased with that. But with regards to differences by account sellthrough, we haven't really seen any major differences.

Randy Konik - *Jefferies LLC - Analyst*

Great. Very helpful. Thank you.

Operator

Scott Krasik, Buckingham Research Group.

Scott Krasik - *Buckingham Research Group - Analyst*

A few questions here, thanks. So I just want to understand, first, in the third quarter you gave back probably 200 to 300 basis points in gross margins last year, on markdowns. You had indicated you had 100 basis points of sheepskin that would benefit you this quarter, plus you had the benefit of mix. I'm just wondering what happened to the margins that you gave back last year on the markdowns.

Dave Powers - *Deckers Brands - President, CEO*

With regards to the past quarter, the results, the 50% margin?

Tom George - *Deckers Brands - CFO*

Scott, this is Tom, just to level-set things on the margin. For the quarter, we were at 50.5%; a year ago at 49.1%. Our input costs improved by 150 basis points, with about 100 of that being sheepskin and another 50 basis points related to supply-chain efficiencies. And then, there was some FX drag in the quarter, about 50 basis points, and then because of the higher concentration in DTC, we had about a 20 basis-point lift in the margin just by channel mix alone. So I don't know if that's the question you were getting to?

Scott Krasik - *Buckingham Research Group - Analyst*

That's helpful, but then again it doesn't explain -- you were writing checks last year to retailers. Were you writing the same amount of checks this year? Is that what you're indicating? So the 49.1% was the right base for you to start off of or did you write more checks, less checks?

Tom George - *Deckers Brands - CFO*

So Scott, I think what you're asking is because we provided some markdown money and marketing assistance last year, most of that was recorded in Q4. So while the map reduction went into effect in December, a lot of the margin that you're talking about actually happened in Q4. So the margin improvement that Tom just gave is really kind of the Q3 impact.

Scott Krasik - *Buckingham Research Group - Analyst*

Okay. And then, it looks like if you take out that $7 million of cost savings you're talking about in 4Q, you are still looking at almost 10% SG&A growth in the fourth quarter against a minus 5% topline. So I'm just wondering, what are you spending on that you need to grow SG&A that much in 4Q?

Tom George - *Deckers Brands - CFO*

Scott, some of that is related to retail stores. We're closing about 21 stores this year. A lot of those are going to close in the fourth quarter, so we had some additional stores in the third quarter. Some of it is some additional marketing around our e-commerce business, and another item is there is some increased incentive comp this year relative to year ago and that's really related to -- incentive comp related to lower levels of management relative to a year ago.

Steve Fasching - *Deckers Brands - VP Strategy & IR*

I think, Scott, the important thing to remember there is on the previous that Dave and Tom talked about, the $35 million that we previously announced, we said $25 million of that was related really to the retail-store closures. That really doesn't kick in until FY18, so the savings that we're talking about, while we've identified it, it's because we wanted to keep those stores open through the height of the season and then really close those stores in Q4. So we still have operating costs related to the running of those stores that will close in Q4. So you are seeing some of that lift; that goes away in FY2018.

Scott Krasik - *Buckingham Research Group - Analyst*

Okay. And then, so you alluded to more store closures, so maybe where do you see the store count by the end of FY18?

Dave Powers - *Deckers Brands - President, CEO*

We're still evaluating specifics on that, Scott. I would say that we're looking at a combination of closing owned stores from a global perspective, and then transferring stores in China from owned to partners. So we don't have all the final details on that, but we'll share that on the next call.

Scott Krasik - *Buckingham Research Group - Analyst*

And then, just last, I'm sure you've already seen your book form, at least the beginnings of it, so maybe help us understand. I know there's some new distribution. What is the order book starting to look like for next fall for UGG?

Dave Powers - *Deckers Brands - President, CEO*

It's too early for us to comment on that. The wholesale channels are still trying to figure out what happened in their business, so the order book conversations are live at the moment. It's too early to comment on it.

Tom George - *Deckers Brands - CFO*

And the other thing to remember there, Scott, is, remember, that's a big reason why we changed our fiscal year was so that we could give a better year-out guidance after we got a better read on the order book. So, we're still very early on that. There's still a lot to go in terms of understanding where we're at, and normally we give that on the next call and that's really why we changed our fiscal year.

Dave Powers - *Deckers Brands - President, CEO*

But the conversations have been healthy to date.

Scott Krasik - *Buckingham Research Group - Analyst*

Okay. Thank you.

Operator

Erinn Murphy, Piper Jaffray.

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

Great. Thanks. Good afternoon. Just wanted to focus on that $90 million of incremental cost-savings opportunity. I guess, when did you guys start looking at this as a layer of opportunity? Is this something that has just come up in the last few months since the season's been more difficult or has it been something that you guys have been evaluating? I guess I'm trying to understand how much rigor is around this.

And then, if you could just bucket out the piece around reduced marketing versus the headcount reduction and some of the other initiatives you've talked about.

Dave Powers - *Deckers Brands - President, CEO*

Thanks, Erinn. So as I announced on the last couple calls, one of the main priorities for me when I took on this new role back in June was to get a look at our operating structure and look for efficiencies.

So over the past six months, we've been working with a firm that I mentioned on the phone, as well as internal work, to get after what I would say is opportunities to increase the long-term profitability of the Company. So, this work has been ongoing since I took on the new role over the last six months. We finalized some of the details of that through the end of Q3 and we're ready at this point to announce the specifics on that, as you heard on the call.

Tom George - *Deckers Brands - CFO*

So we have a good -- a real solid road map, Erinn, and in the May call, the fourth quarter call of May, we'll be able to provide more details, as well as more around the cadence of the savings.

(multiple speakers). But I would say regardless of the result of the quarter, we've been on track for this for quite some time and we're super focused on it, as well as looking for growth opportunities to offset the opportunities down the road.

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

Got it. Okay. And just maybe approaching Scott, first question he asked as it related to the third quarter. When you went into the quarter, you put out a number of scenarios on the guidance, assuming at the low end of the range the environment was just as bad as last year; at the high end, obviously weather in that case could have cooperated better. We didn't get the weather benefit; the season started late, as you alluded to, but were there other items that you just completely missed in the forecast? Were you assuming just a more robust reorder cadence? I'm just trying to understand at least on the topline miss what were some of the things you hadn't put into that original forecast. It seems somewhat conservative on the low end, initially.

Tom George - *Deckers Brands - CFO*

So what happened really is we said in some of those guidance projections on the last call and subsequent conversations that the lower guidance really depended on reorders. And so if we didn't get the reorders, we would have -- I'm sorry -- the higher end of the guidance depended on reorders; the lower end of the guidance depended on -- it looked like a no reorder or low reorder situation.

What we didn't account for is the carryover inventories a lot of our wholesalers had in their inventories from closeouts that we did last Q4, and so what we believe is the amount of business that was done overall in our wholesalers was strong and healthy, but the mix of carryover versus new inventory in the quarter was higher than we anticipated.

Tom George - *Deckers Brands - CFO*

Just on that, because I think it's an important question to understand kind of what happened in Q3, as you kind of indicated the warm start in October and November, I think, really scared wholesalers in terms of commitments or taking orders that they had.

The other thing, as Dave mentioned, is really the composition of inventory that a lot of our -- a few of our top wholesalers bought last year and carried over into Q3, and so kind of the two related, the cautious nature of the wholesalers, combined with the warm start, really didn't encourage them to be aggressive with their buys. And as we all know, they are very concerned about inventory management.

So, when the weather did turn kind of early December, that's when things really started to sell, but it was too late to get wholesalers to commit to more reorders so late in the season. They didn't want to take that risk of the additional inventory.

And so that's where we really saw kind of the difference from what we had guided to. And it also leads into how we're thinking about next year and we look at this year. So when you look at the reduction in the guidance that we're giving in Q4, recognizing what happened, we don't want to build a channel with more closeout inventory. So, strategically, we're taking down that number, which we feel better sets us up for sell-in next year at a better sell-in price.

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

Got it. That's helpful. Thank you, guys.

Operator

Jonathan Komp, Robert W. Baird.

Jonathan Komp - *Robert W. Baird & Company, Inc. - Analyst*

Thank you. Dave, I want to ask -- I think you had mentioned, I want to clarify first, but I think you mentioned the men's business was up something like 36% year over year. And I'm wondering if you could just give even directional color on what you saw across the other pieces of the business.

Dave Powers - *Deckers Brands - President, CEO*

So, first of all, the men's business we're very pleased with. In our key account, it was up 34% overall. We had strong results in our DTC channel, driven by really the most -- biggest highlight in that category is our new male style, which is gaining real traction with a younger consumer. We're really excited about that opportunity to bring in younger and male consumer into the brand.

We also had strength in the slipper categories across men's and women's. And then in women's in general, the Classic II was very strong for us in our DTC channels, which we think is the best indication of the business. Struggled a little bit in the fashion styles, but really the overall Classics franchise did well and was a driver of our DTC business. As Steve alluded to, unfortunately in wholesale we just didn't get the reorders because of the pickup in sales happened too late for them to reorder that product.

Jonathan Komp - *Robert W. Baird & Company, Inc. - Analyst*

Got it. And that partly gets to my second question. I just wanted to kind of dig in and maybe see what gives you comfort that some of the new product and marketing initiatives on the women's side specifically are resonating, understanding that obviously a lot of noise going on in the wholesale marketplace. But any other feedback or consumer work you've done that would support that some of the new direction is working?

Dave Powers - *Deckers Brands - President, CEO*

I believe a lot of the changes we've made in our digital marketing infrastructure and our ability to connect to the consumer is paying off. Our site traffic on our own e-commerce site was up 35% for the quarter. Site visits from social was up over 300% in the quarter.

So to me, those are strong indications of the marketing and the product that we're bringing into the market is exciting our consumer. It's driving interest in the brand quite dramatically, and, again, we saw that increase in our DTC business. So what we just didn't see, again, at the end of December was the reorders that would indicate that in the wholesale business, but all internal channels that we've seen and the KPIs that we track indicate that those are paying off.

Tom George - *Deckers Brands - CFO*

I think also, just to add a little bit, John, we saw success with Classic II in December, so when we looked at our e-commerce performance where we were actually selling side by side, we sold two to one Classic II to one. So some of the other positive signs are as we made that transition from I to II, in our own direct channels and, to a certain extent in some of our wholesalers we saw strong selling of Classic II, so good customer acceptance. People still bought I in the outlets, but they were buying II, and when put side by side in our own direct-to-consumer channel, buying significantly better than I.

Dave Powers - *Deckers Brands - President, CEO*

And I would say that that's true globally as well. We had great growth in our China business, in our DTC business there, as well as our new market, Germany, that we're building that business. And DTC generally across the globe indicated that the consumers are reacting to that marketing and that product, and the Classic II was definitely a strong winner for the season.

Jonathan Komp - *Robert W. Baird & Company, Inc. - Analyst*

Got it. And maybe just the last one for me, bigger picture on the margin side. It sounds like you are at least starting to think about kind of how some of the cost savings roll in 2018, 2019, and maybe into 2020, and this year you are going to be below a 10% EBITDA margin on an adjusted basis for the first time. Any thoughts or updated perspective on, as you look out to, say, a 2019 or 2020 type EBIT margin, where you should be thinking for this business?

Dave Powers - *Deckers Brands - President, CEO*

First of all, I would say that 9% is not good enough, obviously, for us and we're not happy with that and we're doing everything we can to improve that above the 10%, 11% levels that we've had in recent years.

So the cost savings, as I said, are going to be a key player in that. Driving growth back into the business will be a key player in that, including the margin improvement. But as we've said in the past, getting to a mid-teens number is still on the radar for us. It's going to take us a little bit longer than we anticipated to get there, but we have some activities in place and these cost savings are going to help us accelerate that path over the next 18 to 24 months. And we'll give more guidance and detail on that on the next call.

Jonathan Komp - *Robert W. Baird & Company, Inc. - Analyst*

Okay. Thanks.

Operator

Camilo Lyon, Canaccord Genuity.

Camilo Lyon - *Canaccord Genuity - Analyst*

Thanks, guys. Going back to how you're thinking about your wholesale strategy going forward, I'm curious to know how do you think about pricing and ensuring price integrity around your key brands, particularly UGG, as it relates to your wholesale partners. How do you force price integrity as you are having these discussions with your wholesale partners?

Dave Powers - *Deckers Brands - President, CEO*

I think the key there, Camilo, is really around controlling the amount of inventory in the marketplace, and so having too much inventory in unproductive styles or just across the board leads to discounting in price. So the first thing we're doing, and that's indicative of the decision we made in Q4 to not flood the channel with closeouts, we're going to start being cleaner. We're going to be more selective in who we sell to, we're going to be more selective in how we allocate Classics products going forward, and we're going to continue to drive a more healthy full-price business over time.

Camilo Lyon - *Canaccord Genuity - Analyst*

Does that mean that you need to be -- that you need to shrink the ultimate market-size opportunity for the brand? Is that what we're kind of moving into here?

Dave Powers - *Deckers Brands - President, CEO*

Not necessarily (multiple speakers). We're still focused on driving growth, but we want it to be healthy, more profitable growth in the right channels. We're optimizing every turn and every sale.

Camilo Lyon - *Canaccord Genuity - Analyst*

And then, you definitely levered or you took advantage of the UGG Closet opportunity. That seemed to have benefited the e-commerce channel nicely throughout the quarter. Can you tell how the thought process has evolved around your markdowns and your promotional strategy in season?

Dave Powers - *Deckers Brands - President, CEO*

First of all, the good news in that -- even though we had good results in our UGG Closets, the full-price sales on our e-commerce site were healthier than last year and so we're making improvements there.

What I really like about the Closet is a couple things. One, it's a much more profitable outlet for that closeout or off-price inventory versus selling that into off-price retailers at a much reduced margin. At the same time, we bring new consumers into the franchise, and as we do that, we gather their information so we can continue to cultivate that relationship and increase our sales over time. So for us, it's a very healthy way to take care of off-price inventory. We don't want it to be a main driver of our UGG site, obviously. But we see it as a healthy way to do it.

The other way to think about this also is if you are selling closeouts in Q4, I would rather sell them direct to the consumer and have them in the hands of the consumer than sell them to a closeout channel and have them in the hands of a wholesaler who is going to hold onto that for Q3 and Q4 of next year.

Camilo Lyon - *Canaccord Genuity - Analyst*

Okay. Thanks. And then, just finally, you mentioned Q4. This is the second year where the fourth-quarter initial expectations were far higher than what the reality ended up being. In retrospect, where have you been more aggressive and where do you think you should really start to focus to hone in on what the true fourth quarter can deliver?

Dave Powers - *Deckers Brands - President, CEO*

As far as we're being aggressive, we're still aggressive with all the brands in this quarter. I think what you're seeing, obviously, is a little bit as a result of the wholesale slowdown, generally speaking, but also self-inflicted because we're holding back on closeout quantity in that quarter.

Going forward, we still see great opportunity across the UGG brands in men's and women's and spring and summer product, which you are going to see some great launches in the next few weeks of styles that we think are more indicative of the opportunity there. HOKA will continue to be a major driver. The expectation for that brand in Q4 is continuing to increase and there is definite upside in this quarter. We'll continue to see it out of the HOKA brand. And I'm really optimistic still about Teva and Sanuk and their improved product pipeline and the innovation and marketing they are bringing to market.

So we're bullish on all brands for Q4 going forward. Again, what we're seeing right now in the guidance for Q4 is partially self-inflicted to make sure we have a cleaner marketplace overall.

Camilo Lyon - *Canaccord Genuity - Analyst*

Is there a way to quantify what that self-inflicted detriment to the revenue line is?

Steve Fasching - *Deckers Brands - VP Strategy & IR*

(multiple speakers). We talked about it and Tom talked about it in his section. There is a component of a reduction to Sanuk. The rest of that is really that change in thinking in terms of the closeout strategy --

Tom George - *Deckers Brands - CFO*

For the UGG domestic wholesaler.

Steve Fasching - *Deckers Brands - VP Strategy & IR*

For the UGG domestic wholesaler. And we're also taking a cautious view at this point in time of the direct-to-consumer business in the March quarter.

Operator

Corinna Van Der Ghinst, Citi.

Corinna Van Der Ghinst - *Citigroup - Analyst*

Thank you. Just a follow-up on the guidance reduction. You guys mentioned that the business really improved into December, and then the Q4 sales were guided down another 5% to 6% and you guys obviously called up some of the drivers behind that. But also, is the deceleration based on an actual slowdown in your business at wholesale into January, or can you tell us a little bit of what the cadence has looked like so far this quarter to date?

Dave Powers - *Deckers Brands - President, CEO*

There's been a little bit of slowdown. I think the industry is seeing a little bit of a hangover after the strong December. January, just kind of general market from what we can tell, has definitely slowed down and so that's part of the projection into Q4. We're seeing a little bit of that as well in our DTC channels, but the majority of the takedown for us is holding back on closeout volume.

Corinna Van Der Ghinst - *Citigroup - Analyst*

Okay. Great. And then, I believe you said that reduced marketing is part of that $90 million in additional savings that you guys announced today. If I'm not mistaken, didn't you guys highlight the need for increased global marketing around the UGG brand in order to reignite that younger consumer and grow your global brand awareness? Is this going to hurt your future sales plans?

Dave Powers - *Deckers Brands - President, CEO*

Good question. I think it's important to clarify that because we do believe that a strong marketing attack plan globally is the right thing for our brands.

What we're really doing with marketing is reallocating spend and making sure that we're increasing our return on spend in marketing. So, for example, we have five brands that are distributed globally. We've taken a deep look at how those marketing dollars are spent by brand, by channel, by region and we will be doing some reallocation of spend to really drive the business where we see the biggest upside, which is the UGG and the HOKA brand primarily in North America and China.

Corinna Van Der Ghinst - *Citigroup - Analyst*

Okay. Great. And then if I could just sneak one last question in, maybe you could talk a little bit more about the progress that you guys have made so far with your Amazon strategy, where you want that relationship to go longer term, the merchandising, and just in terms of segmentation with your other channels that you are growing.

Dave Powers - *Deckers Brands - President, CEO*

So we are in the early days of that. We're now on their site selling directly for the first time, and so far, so good.

It's one that we are monitoring closely. We have resources put on that account specifically and are working, I would say, very closely with them in a partnership. We believe and I certainly believe that the consumer is going to continue to migrate to the Amazon platform, and so in order for us to, again, control our distribution, we think it's important to be on there, to be visible to that consumer in a positive way.

But that requires work on our end to clean up the marketplace and so we're going through the exercises, as we talked about last time, of cleaning up distribution in North America, and that includes online third-party sellers, so we can do more healthy business in a more premium positive way on the Amazon platform. But I think we'd be foolish to think that Amazon is not going to be a major player in the future. The younger consumer is migrating there quickly, and we think it's important for us to show up with all of our brands in a positive way on that platform and leverage that opportunity to reach more consumers.

Corinna Van Der Ghinst - *Citigroup - Analyst*

And just in terms of the segmentation and how you are going to keep your key retail accounts happy -- I'm sorry, wholesale accounts happy?

Dave Powers - *Deckers Brands - President, CEO*

So that's all contemplated within our segmentation strategy across product, across men's, women's, and kids in the UGG brand, and the good/better/best and premium distribution strategy is contemplated within that.

So, we can't share all the details on that yet, but trust to say that there will be segmentation around our key retailers at the top end of the distribution chain, with more premium product, more special product, and then core accounts will have limited offering as we go through the full distribution.

Corinna Van Der Ghinst - *Citigroup - Analyst*

Okay. Great. And so just to clarify, Amazon will be good/better?

Dave Powers - *Deckers Brands - President, CEO*

I think we're still evaluating that. They're certainly not premier, but -- or premium, but that's something that the teams are working through right now to make sure we have the right balance, depending on what we do with the rest of the distribution chain.

Corinna Van Der Ghinst - *Citigroup - Analyst*

Great. Thank you so much.

Operator

Omar Saad, Evercore ISI.

Omar Saad - *Evercore ISI - Analyst*

Dave, I wanted to see if I could get you to talk a little bit more about DTC, the total retail business. The comps looked to inflect there against a -- looked to be a little bit of a tougher compare. I know e-commerce was a big driver, but I think 30% of the business now kind of on an LTM run rate, something like that. How are you thinking about that business over the next year? How big can it be, both e-commerce (multiple speakers). It feels like your execution there is improving. Help us think through how you think about that channel.

Dave Powers - *Deckers Brands - President, CEO*

We still see DTC as a very important channel and I'm pleased with the results we saw in Q3. It tells me that the teams are doing the right things from an operational standpoint, that our digital marketing efforts are paying off, and that we're servicing that consumer in a quality way.

Over time, you are going to see a little bit of a shift in strategy there. Still early to share some of that, but trust to say we want to do more business over time through our online channel and use our stores to drive excitement and interest into the brand as a key touchpoint and experiential component of our DTC strategy. But I think you'll ultimately see e-commerce become a bigger component of our DTC business over time.

And then, our full-price store is a more strategic from an experiential standpoint and we have a healthy outlet business to help with the off-price market in that opportunity as well, because our outlet business and stores are still very profitable for us around the globe as well.

So if you think about the full-price stores as kind of top-tier flagship from a positioning standpoint, outlets driving a lot of positive profitability and volume, and really gearing up through an omnichannel focus in our capability to drive more consumers to our e-commerce business globally. And then, augmenting that where we can with third-party distributors and wholesale, so our partner program in China, which has proven to be very successful so far, and looking at other opportunities of that around the globe.

Omar Saad - *Evercore ISI - Analyst*

Great. And then, how do I -- I thought you guys are doing some interesting things around loyalty. There's some engagement-based loyalty stuff you are doing, not just the traditional points you build up to get discounts or whatever. Maybe talk through a little bit how you're thinking about that, and using the customer data, and also how you are engaging in trying to engender that loyalty with what you are doing, I think the social media aspect as well.

Dave Powers - *Deckers Brands - President, CEO*

I'm really pleased with the launch of our UGG loyalty program. We have over 400,000 customers that have signed up in the last quarter since the launch, which is very positive.

What we know about the UGG consumer and younger consumers in general is they value experiences more than things, in some cases. So we're trying to make it more than just a points-based discount program. We're trying to reward our consumers as ambassadors of the brand and recognizing them for their social behavior and creating more opportunities to win experiences from the UGG brand and offering them special product over time.

So, this isn't just a, hey, shop more, you get more discounts on the brand. This is really engage with the brand in a more positive, experiential way and become ambassadors of the brand at the same time. And so, the early indications of this have been very positive and I believe it's helping drive traffic across all of our social channels and our direct channels as well, as well as improving visibility and excitement that will also help our top retail partners.

Omar Saad - *Evercore ISI - Analyst*

Got it. That's very helpful. Thanks, Dave. Good luck.

Operator

Mitch Kummetz, B. Riley.

Mitch Kummetz - *B. Riley & Co. - Analyst*

Thanks. I got a few; I think we can go through this fairly quickly, though. Tom, I think you said you were taking a conservative approach to DTC in Q4. Can you tell us what your comp assumption is there?

Tom George - *Deckers Brands - CFO*

What we're looking at there, Mitch, is a negative low single-digit comp assumption for DTC.

Mitch Kummetz - *B. Riley & Co. - Analyst*

Okay. And then on the UGG inventory, how much Classic I inventory are you guys currently sitting on? Is there any way to quantify that?

Tom George - *Deckers Brands - CFO*

I'd say to talk about inventory in general, the elevated inventory levels really are a function of Classics in general, mostly the Classic II, not the Classic I. That's good news because historically when we've had elevated Classic inventories, we've been able to eventually move that without any significant markdowns, so there's going to be a lot of focus going forward and a lot of new processes and systems in place to be able to manage the inventories down. And we have the opportunity now. It's still early enough in the season to adjust the buys going forward as well.

Dave Powers - *Deckers Brands - President, CEO*

And to add to that, Mitch, I would say that the Classic I inventory in the channel is, I would say, close to very clean in that we have some to fuel our outlet business for the next maybe six months, but if you go on the e-commerce site right now, the only Classic I product on there is the Classic Talls. We have more inventory in the Tall, but we think it's a healthy amount of Classic I. Now that we've gone through this transition of the Classic II, we're in good shape to drive a more full-priced base business going forward and really leverage the Classic II success.

Mitch Kummetz - *B. Riley & Co. - Analyst*

Okay. And then, how are you guys approaching some of these rogue retailers on a go-forward basis? Obviously, we had The Walking Company just had a lot of stuff on sale through the holiday season. Are you guys looking to cut these guys out or what is your sort of approach to that?

Dave Powers - *Deckers Brands - President, CEO*

We're evaluating all that. As we spoke on the last call, we take it very seriously and we're doing what we can to make sure we drive a full-price business. We own that through the amount of distribution we have in the marketplace and the amount of inventory we have in the channel. And, again, going back to a cleaner, healthier inventory situation and really closely monitoring working with these accounts is what we're going to do.

But, as I said, just optimizing our distribution for the short and long term and making sure that the partners that we're selling to are representing the best of the brand, that's priority number one.

Mitch Kummetz - *B. Riley & Co. - Analyst*

Got it. And then lastly, how are you thinking about planned promotions going forward for the UGG brand? If I recall correctly, I think you made a comment at [Sandi] that you had a pretty robust calendar of planned promotions for holiday. I know if it's Classic II, it's non-core styles or otherwise non-core products? Are you going to kind of maintain the same approach or do you think you have to look at that more closely as it kind of relates to price integrity of the brand?

Dave Powers - *Deckers Brands - President, CEO*

I'm proud of the fact that we kept the integrity of the Classic II launch high through the first quarter, of Q3. I said on the last call and subsequent conversations that we would not discount the new Classic II product, and we haven't done that. We have no plans to do that.

I think going forward, discounting and sale is going to continue to be important to the consumer, so it's something that we have to recognize and be more strategic about. But I see us doing that through more seasonal interpretations of the classics in fashion, but our goal really is to continue to protect that full-price classics business and offer value to the consumer through some of the seasonal product.

Mitch Kummetz - *B. Riley & Co. - Analyst*

Got it. Okay, great. Thanks, guys. Good luck.

Operator

There are no further questions at this time. I'll turn the call back over to management for any closing remarks.

Dave Powers - *Deckers Brands - President, CEO*

Thanks, everybody. Before we conclude the call today, I would like to once again reiterate our commitment to increasing profitability and delivering greater shareholder value.

I believe we're on the right track with major initiatives that we have in place now to achieve these primary goals. Once again, those major initiatives that we're focused on are improving product integrity and distribution in the marketplace, attacking our overall cost structure, and right-sizing the organization. It's going to take a little bit of time to implement all the initiatives we're working on, but we are starting to see some of the benefits of our actions in the coming fiscal year.

Finally, I wanted to thank all of our employees for their hard work during the quarter. This is a very dynamic time and I'm excited about the progress we are making with all of our brands. As we enter a new chapter for the organization, I would also like to thank our shareholders for their continued support as we drive for increased value for all of our stakeholders. Thank you.

Operator

Thank you, gentlemen. This does conclude our teleconference for today. You may disconnect your lines at this time and we thank you for your time and participation today.