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Deckers Outdoor Corp. (DECK)

Q4 2017 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Dave Powers
President and Chief Executive Officer

BUSINESS HIGHLIGHTS

Opening Remarks

- Today, we are going to spend the first part of the call reviewing our fourth quarter and full year results
- After that, we will shift our focus forward to how we are driving improvements in profitability
  - This will include specifics on the savings plan that we announced last call, as well as our financial outlook for FY2018
- Before we discuss our results, I'd like to briefly comment on the process we announced at the end of April to review strategic alternatives
- That process is ongoing, and as you would expect, we are unable to comment until the board completes its review and improves the definitive course of action or otherwise, conclude the process

Q4 RESULTS

Sales and Non-GAAP EPS

- With that, let me turn to our results
- During Q4, we executed on our strategic goals and achieved sales and earnings that were ahead of our expectations
- For the quarter, our sales were above the range we provided due to better performance from UGG and HOKA, as well as better than forecasted DTC sales
- Non-GAAP EPS excluding restructuring cost and other charges was $0.11
- For the year, sales were $1.79B and non-GAAP EPS was $3.82
- For the quarter, we are pleased with the performance of the UGG brand and reception to the UGG spring and summer lines
- Sales of women shoes and sandals grew over 20% compared to last year as we made continued progress diversifying and deseasonalizing the UGG brand
- And as we indicated we would in our last earnings call, we reduced the amount of closeout products sold into the domestic wholesale channel

HOKA

- At the same time, we continued to drive growth at HOKA
- Sales for the quarter were up 33% pushing the brand over the key $100mm milestone for the year
- HOKA's new product introductions like the Arahi and Hupana helped fuel healthy unit and margin growth
- Looking ahead, we are excited about the domestic opportunity to expand distribution, as well as internationally where we are just beginning to scratch the surface of the brand's potential

DTC Comp

- Our DTC comp was flat for the quarter
- Once again, we experienced strong demand in our ecommerce channel offset by declines in our retail store sales
- For the year, our DTC comp increased 2.6% driven by strong performance from our ecommerce channel which benefited significantly from the launch of UGG Closet, as well as the close of our underperforming retail stores

Inventory Levels

- As we enter FY2018, we are in a much stronger position compared with a year ago
- The organizational review we completed has given us a clear path forward for improving profitability
- Inventory levels are healthier at our retailers and we have transitioned the marketplace to better product and with more quality distribution

Sales Headwind

- Nevertheless, we expect that the environment will continue to be difficult
- With the sales headwinds facing the majority of the retail industry, we are focused on improving profitability through the four strategic priorities I laid out a year ago

- As a reminder, they are, developing compelling product, focusing on digital, optimizing distribution and implementing cost savings

Brand Portfolio

- First, developing compelling product, across our brand portfolio, our teams have elevated their offering and consumers and the trade are responding positively
- HOKA is a perfect example which won 18 awards in the last year including Editor's Choice from Women's Health for Hupana
- With UGG, we've had success incorporating Treadlite and UGGpure further into the product line
- One example is the Royale Slide which was introduced this spring and quickly sold out
- For this fall, we continue to innovate and are excited about the launch of our waterproof classic with Vibram Arctic Grip and several high profile product collaborations, including our renounced collaboration with Phillip Lim

UGG Rewards Program

- Second, focusing on digital reach to consumers
- This past year, we had key wins with UGG Closet which drove significant growth in our ecommerce business and with the launch of our UGG Rewards program which now has nearly 0.5mm members
- We have great digital momentum especially in the U.S. where we estimate over a third of our total UGG sales are done online, including ugg.com and online sales with our wholesale partners

Optimizing Distribution

- Third, optimizing distribution
- The goal here is to transform our account base to align with the changes in consumer shopping behavior
- This year, we closed accounts that did not represent the best of the brand and we opened new accounts with quality wholesale partners who are committed to showcasing more of our offering and also have strong online businesses

Cost Savings Plan

- Finally, implementing a significant cost savings plan to streamline our organization and improve profitability
- This has been a major focus over the last 12 months and I'm excited to discuss that plan more in a moment

Thomas A. George
Chief Financial Officer

FINANCIAL HIGHLIGHTS

GAAP and Non-GAAP Financial Measures

- Today, I will take you through our fourth quarter and full year results and break out the restructuring and other charges recorded in the quarter

- Please note throughout this discussion where I refer to non-GAAP financial measures, I am referring to results before taking into account restructuring, impairment and other charges that our management believes are not core to our ongoing operating results
- 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's tab

Q4 RESULTS

Revenue and Gross Margin

- Now, to our results for Q4
- Revenue was $369.5mm which was ahead of our projections primarily due to better performance from UGG and HOKA and better DTC sales
- Gross margin was 43% compared to our non-GAAP result of 42.3% last year
- The y-over-y difference was driven by less domestic promotional activity and continued supply chain improvements, partially offset by foreign exchange headwinds
- Non-GAAP SG&A expense was $153.9mm compared to $154.5mm last year
- Non-GAAP EPS was $0.11 for the quarter vs. $0.11 last year

Restructuring and Other Charge

- In Q4, we recorded $35.9mm in restructuring and other charges related to retail closures, impairments and organization changes
- Of the $35.9mm, $9.9mm were non-cash charges

DTC Sales

- Now to the year, revenue was $1.79B compared with $1.88B last year
- The decrease was driven by $106.8mm decrease in wholesale and distributor sales partially offset by $21.8mm increase in DTC sales
- Gross margin was 46.7% compared to our non-GAAP result of 45.4% last year
- The 130 basis point increase in gross margin was due to improved input cost and continued optimization of our supply chain partially offset by foreign exchange headwinds

Non-GAAP SG&A

- Non-GAAP SG&A was $669.6mm compared to $656.2mm last year
- Non-GAAP EPS was $3.82 compared to $4.50 last year
- The y-over-y decline was driven by lower sales and higher SG&A, partially offset by a 130 basis point increase in gross margin
- The non-GAAP effective tax rate was 23% and better than expected for the year, but slightly higher than last year's non-GAAP rate of 22%
- During the year, we incurred charges totaling $167.5mm related primarily to restructuring and impairments of which $134.2mm were non-cash charges

Backlog

- At March 31, 2017, our backlog was up 6.6% compared to the same date last year
- Directionally, UGG U.S. backlog was up low-single digits and UGG international was up double digits
- As a reminder, our March 31 backlog only includes orders from wholesalers and distributors for delivery in April through December
    - This backlog figure represents about a third of our total revenue and does not include our company DTC sales
- All of fourth quarter or any future orders we may book such as at-once orders or closeouts

Dave Powers

President and Chief Executive Officer

Q4 HIGHLIGHTS

Opening Remarks

- As I said when I assumed the CEO role 12 months ago, FY2017 will be a transitional period for the company
- With the year now behind us, we are moving forward with a sound plan in place to improve profitability and lay the foundation for future growth

SG&A and Cost of Goods

- Last call, we announced $150mm cumulative savings plan before reinvestment that consisted of a combination of SG&A and cost of goods improvements
- We said that these savings will be implemented over the course of the next two years with the full benefit being realized in FY2020
    - We also said that we'd provide more guidance on how the savings would flow through once we completed the year and finished our pre-book
- With that process now complete, we are pleased to share that $150mm of announced cumulative savings will drive $100mm improvement in operating profit for the FY2020
- With these savings, along with modest low single digit revenue growth, we believe we can achieve an operating margin of 13% in FY2020

Savings

- To provide some more perspective on where the savings will come from
- COGS improvements will be achieved by reducing product development cycle, optimizing material yields, consolidating our factory-base and continuing to move production outside of China
- SG&A savings will come from, further retail store consolidations, process improvement efficiencies and reduced indirect spend
- The process to implement savings is already underway
- For FY2018, we expect net SG&A to be approximately $10mm lower
    - However, this understates how quickly we are addressing our cost structure
- On a like-for-like basis, SG&A would be nearly $30mm lower excluding the reinstatement of performance-based compensation

Global Retail Fleet

- In regards to our global retail fleet, as we look out over the next two years, we are planning to reduce our global company-owned brick-and-mortar footprint by 30 to 40 stores which includes both closures and the transfer of existing company stores to partners
- By FY2020, we are targeting to have an optimized company-owned fleet of approximately 125 stores globally

Thomas A. George
Chief Financial Officer

Q4 HIGHLIGHTS

Performance

- For FY2018, we expect revenues will be in the range of flat to down 2%, compared to 2017 levels
- Included in down 2% sales guidance are the following assumptions
- Slightly improved promotional environment with less closeout product in the channel
- Similar weather conditions to last year, DTC comp up low-single digits, domestic wholesale sales down mid-single digits driven by U.S. wholesale account rationalization

International Wholesale

- International wholesale sales up mid-single digits
- In-season reorders netting cancellations and fewer retail stores which represents loss revenue of approximately $15mm
- The flat sales scenario assumes the following improvements
- In-season reorders exceeding cancellations, slightly higher international wholesale business, and a colder start to the fall/winter selling season
- By brand, we expect UGG revenue to be in the range of down 3% to down 1%, HOKA to grow approximately 20% to 25%, Teva up 1% to 5%, Sanuk down 10% to down 5% and Koolaburra to be approximately $13mm to $16mm

Gross Margin

- With respect to gross margins, we expect full year gross margin to be approximately 47.5%, SG&A as a percentage of sales is projected to be approximately 37%
- For the full year, non-GAAP EPS is expected to be in the range of $3.95 to $4.15 on a share count of 32.7mm and an effective tax rate of 27%

CapEx

- As a reminder, this excludes any charges that may occur from additional store closures and other restructuring charges
- CapExs for the FY is expected to be $45mm and we expect to generate FCF of approximately $150mm

Non-GAAP Diluted EPS

- For Q1, we expect revenue to be up low-single digits compared with the same period a year ago

- And we expect the non-GAAP diluted loss per share of approximately $1.70 to $1.65 compared to a diluted loss per share of $1.80 last year
- With respect to the 6.6% increase in our backlog at March 31, and how that ties to our full year outlook for revenue to be flat to down
- There are a few factors to keep in mind

Backlog

- First, backlog is simply recorded at a point in time and can't be compared with accuracy from year-to-year
- For example, this year the main driver of our backlog growth was due to changes we have made with our EMEA wholesale partners in the way that they pre-book
- Traditionally, our EMEA wholesale partners have booked later than the U.S.
  - This year, we really pushed them to place orders earlier so that we can better manage our inventory and get commitments upfront

Inventory

- Second, between reorders in December and our fourth quarter business, there's still a meaningful amount of wholesale sales that we currently don't have orders for
- While inventory in the channel is cleaner than it was a year ago, based on how the past two holiday seasons have played out combined with the ongoing traffic challenges across brick and mortar retail, we believe that it's prudent to be conservative when it comes to our assumptions until we have more visibility into the consumer demand

Direct-to-Consumer Business

- And third, our full year forecast obviously includes our direct-to-consumer business which is not captured in backlog and represented roughly 35% of our FY2017 sales
- And as I said, it is important to remember that we are facing a headwind in FY2018 from the stores we closed in FY2017 which, in total, account for approximately $15mm

Dave Powers
President and Chief Executive Officer

CLOSING REMARKS

- We are confident in our ability to execute our plan to improve profitability
- We have made significant progress in the last year, and I want to thank our employees for their hard work, tireless dedication and willingness to embrace change to get us to this point
- I look forward to continuing to successfully execute our strategy as we drive towards the 13% operating margin
- As a reminder, we will be not commenting on our strategic alternatives process

QUESTION AND ANSWER SECTION

Jonathan R. Komp
Robert W. Baird & Co., Inc.

Q

A couple of questions on the longer term outlook. First, maybe just asking on the 2020 view of reaching $2B of sales with next year projected flat to down slightly, obviously implies a better growth the following two years. So I just wanted to maybe parse out what you're seeing in terms of initiatives to help restart the top line growth rate after this coming year?

Dave Powers
President and Chief Executive Officer

A

Yeah, sure. This is Dave. So, what I would say, the focus for us around driving growth and getting to that $2B mark is really around the HOKA and UGG brands. For UGG, we're really focused on driving growth through the men's business, spring and summer businesses in women's. And then really from a channel perspective, it's ecommerce globally. Europe's been driven by opportunity that exists still in Germany and then in China. And in addition to that, in the HOKA brand, we see significant opportunity for growth in that brand, [ph] just are (20:54) surpassing the $100mm mark. We're going to reallocate some resources to drive growth in that brand, investing in marketing to drive awareness and investing in capabilities in our international markets to activate the opportunity there as well.

Jonathan R. Komp
Robert W. Baird & Co., Inc.

Q

Okay. And any thoughts on – I think, it's implied kind of a mid-single digit top line growth after this year. Any thoughts on how quickly you could – it sounds like the cost savings side is really developing and materializing pretty quickly. But any thoughts on how quickly the revenue could get to those levels?

Dave Powers
President and Chief Executive Officer

A

Yeah. Well, I think, we're conservative at this point based off the challenges in the marketplace that we see in the short term. So, we're applying that and definitely for FY2018 and spilling to FY2019 and 2020. We're focused on driving growth higher than that but at this point, from the outlook for today, again, some of the headwinds of store closures, we think that's the right number.

Jonathan R. Komp
Robert W. Baird & Co., Inc.

Q

Okay. Great. And then maybe one more just on the longer term targets, the difference in the growth vs. the net margin improvement, could you just maybe walk through kind of what the difference is there or what you're investing in or what the offsets vs. the gross savings might be?

Thomas A. George
Chief Financial Officer

A

Yeah, we still see gross margin expansion with all of our supply chain initiatives we've been talking about, and the factory – movements in the factory as well as the other initiatives we've talked about. But we see a lot of leverage on the SG&A line. We feel really good where we stand from a cost-savings initiative, on the SG&A side. In fact, we've got enough levers in place and enough visibility on the operating expense side including, we're talking about further reduction in our retail store fleet. And when you consider all that together, we feel even if we get flat revenue growth through 2020, we've got enough levers in place that we could still drive $100mm of operating profit improvement and an operating margin at least 13%.

Camilo Lyon
Canaccord Genuity, Inc.

Q

So, Tom, on just your last comment there. So, the $100mm in the profitability improvement and the 13% EBIT margin you're expecting is assumed in the flat sales growth number, flat number? So, any [indiscernible] (23:32) that increase?

Thomas A. George
Chief Financial Officer

A

The long-term targets we talked about, we feel we've got the right opportunities in place to grow the top line as well and we'll have to do some reinvesting to do that and we'll generate $100mm of operating profit and a 13% operating margin.

What I wanted to reinforce was the fact, we have enough SG&A savings levers in place that – if we're not getting traction in the marketplace, we'll slow down the reinvestment and we'll still get $100mm of operating profit improvement and still at least a 13% operating margin growth.

A

Yeah. So, Camilo, just to be clear on that. So Dave talked about 2020 with low-single digit growth revenue targets. That's what we're talking about, the $2B. To Tom's point, we can still achieve the targeted 13% even if we don't get that low-single digit revenue growth. That there's enough variability in the expenses that we can cut back to still achieve that 13% operating profit target.

Thomas A. George
Chief Financial Officer

A

Correct.

Camilo Lyon
Canaccord Genuity, Inc.

Q

Got it. Got it. Understood. Thanks for the clarity. So now, I did want to ask on the cadence of the expense savings. It sounds like, so you're going to see about $10mm this year. How do we think about that, that incremental expense savings, the realization in FY2019 as you get to 2020?

A

Yeah. So as you think about the $100mm profit improvement, basically one of the headwinds, as Dave mentioned that we're facing in 2018 is an assumption of a performance based compensation pay-out. So that's netting some of that down in 2018. Once you get to 2019, the way we have it modeled in, roughly as you get a more like-for-like, so the savings or profit improvement that you'll see will be greater because you won't now have that headwind of the performance-based compensation. So similar types of improvements for 2019 and then into 2020. And that's what gets you your $100mm.

Camilo Lyon
Canaccord Genuity, Inc.

Q

Got it. Great. And then my final question, Dave, if you could just give some thoughts on how you think about – or how you have thought about your wholesale rationalization domestically. And [indiscernible] (25:51) this past season in which there was a lot of – some of your – there were a few wholesale partners which pulled the promotional trigger sooner than they should and disrupted the pricing in the market. How did you address that? And what should that look like as we get into fall?

Dave Powers
President and Chief Executive Officer

A

Yeah. Good question. So, we've made pretty significant progress on transforming the North American marketplace. And that's the combination of a few things. One is cleaning up the number of accounts that we have in the North America business. We talked about that over time. So, we've closed quite a few accounts, roughly about 400 accounts in the UGG branch. Some of those sizable and we have addressed some of the challenges we had last year with [ph] map (26:38) violations and discounting.

And as you know, we incubated some new opportunities last fall as well with Macy's and then also Amazon. So, we've cleaned up some of the smaller disruptive accounts. We've strengthened the relationship with our top key accounts. And we've opened new accounts that we think represents the brand in a positive way. And also allow us to do more ecommerce business across the board in those channels.

So, still work to go. But we still feel very confident in the progress we've made. And the repositioning of the brand. The other thing to keep in mind is we will be going into this quarter, the fall quarter in a better place from an inventory perspective, less closeout inventory in the channel and the headwind of the Classic I hangover is behind us.

Camilo Lyon
Canaccord Genuity, Inc.

Q

And just on that final point, do you expect more account closures or where you stand now is where you're comfortable at? And did the onboarding of Macy's in a bigger way and Amazon whether that's direct offset to the accounts that you've closed or did you come out at a deficit or surplus?

Dave Powers
President and Chief Executive Officer

A

Yeah, so, we will continue to evaluate the fleet. We have new management in place in North America sales and a strategic account focus there. But over time, we will be closing more smaller accounts, I think that's the right thing to do for the brand and just how we control the marketplace and presentation of the brand. And overall, we will be slightly down. So, while we are opening new accounts, offsetting some of those closures and some of the conservative nature of our key accounts nets us in a situation that's slightly down from North America wholesale.

Omar Saad
Evercore Group LLC

Q

I appreciate all the information. I wanted to see if we could dive in a little bit deeper on the solid performance of UGG in the quarter. Maybe to get a better understanding, it was determined by new styles, channels, the weather? Any insight there would be helpful I think as we're trying to understand the evolution of that brand and how it's [indiscernible] (29:00)

Dave Powers
President and Chief Executive Officer

A

For Q4? Yeah, so, what we're seeing in UGG…

Omar Saad
Evercore Group LLC

Q

[Indiscernible] (29:03).

Dave Powers
President and Chief Executive Officer

A

Yeah. Okay. As you know, we've been focused on diversifying the UGG brand and building our spring and summer business for quite some time. And we actually have had a pretty successful quarter in two categories, sneakers and in sandals. So, we had a few sneakers that were performing very strong for us, sold through at a high rate and drove the increase of 20%.

And then sandals, across the board, but the introduction of the Royale Slide into our DTC channel was a best-seller as well. So starting to get traction in these new categories and I think it's driven by the fact that it's distinct ownable product that has the DNA of the brand and have uniqueness in the marketplace. And also, we're having more belief from our partners of showcasing that product in the timeframe as well. I don't know, Thomas, you want add anything on the total?

Thomas A. George
Chief Financial Officer

A

Our UGG business internationally was stronger than expected. Our direct to consumer business was stronger than expected, really led by our domestic ecommerce business did very well. And then, this is not UGG but the HOKA business was above expectations for that quarter.

Scott D. Krasik
The Buckingham Research Group, Inc.

Q

A bunch of questions. I'll try to make them fast. For the year, what were classics as a percentage of total UGG sales and then what were specialty classics as a percentage of total UGG sales?

Thomas A. George
Chief Financial Officer

A

In terms of women, classics are still about – they ended up still about 25% of the women's…

Dave Powers
President and Chief Executive Officer

A

Core classic.

Thomas A. George
Chief Financial Officer

A

core classics were 25% specialty classics still ended up about 25% of the women's business. So consistent with what we [indiscernible] (30:57).

Dave Powers
President and Chief Executive Officer

A

We think that's a good steady rate going forward. [ph] If we balance (31:01) out that business in core classic to 25%, we think is a healthy rate going forward.

Scott D. Krasik
The Buckingham Research Group, Inc.

Q

Now, that's good. And then just as you look at the backlog as of right now. Is that sort of how the backlog is booked as well or are there any outliers within the backlog?

Dave Powers
President and Chief Executive Officer

A

No. Pretty consistent. Yeah. I think the clean-up both from a classics perspective in the marketplace and the account rationalization, the focus on innovation and styles like the waterproof classic, the weather product and some of the specialty classics, really netted us out in a very similar shape to the fall which I think, is the right thing to do.

Scott D. Krasik
The Buckingham Research Group, Inc.

Q

Good. Okay. And then what's your DTC comp assumed for the full year and is there any quarter where you expect it to be an outlier?

Thomas A. George
Chief Financial Officer

A

We expect the DTC comp to be up low-single digits.

Scott D. Krasik
The Buckingham Research Group, Inc.

Q

Okay.

Thomas A. George
Chief Financial Officer

A

For the quarter [indiscernible] (31:59).

Dave Powers
President and Chief Executive Officer

A

Yeah. For Q1…

Thomas A. George
Chief Financial Officer

A

For Q1, up low-single digits. Yeah, right?

Dave Powers
President and Chief Executive Officer

A

Which is equivalent to what we delivered for the year. So our full year DTC comps were low-single digit positive.

Scott D. Krasik
The Buckingham Research Group, Inc.

Q

Okay. Now, that's helpful. And then just sort of when you look at the 2020 plan. What percentage of your UGG sales do you expect to come from wholesale and what percentage do you expect to come from DTC?

Dave Powers
President and Chief Executive Officer

A

Yeah. We haven't given that level of visibility yet. DTC will be driven by growth in ecommerce and we're really heavily investing in continuing to bolster that business globally. We'll have some store offsets against that, but ecommerce will be a driver. And on an international level, will be driven, as I said, from really Germany and the Europe market and then, upside in China. But we haven't given out the mix yet of full wholesale. But it should be, definitely more, a little more in DTC.

Thomas A. George
Chief Financial Officer

A

But it will be held back a little bit as we reduce our store count.

Dave Powers
President and Chief Executive Officer

A

Yeah. Right. So yeah.

Scott D. Krasik
The Buckingham Research Group, Inc.

Q

Yeah. Okay. And then, just – I'm sorry.

Dave Powers
President and Chief Executive Officer

A

But ecommerce – I was just going to say ecommerce will grow faster.

Thomas A. George
Chief Financial Officer

A

Correct.

Scott D. Krasik
The Buckingham Research Group, Inc.

Q

Okay. Thanks. And just lastly, I mean you guys should generate a ton of cash based on this plan. I'm just wondering how and when you elect to deploy the cash and thank you very much.

Thomas A. George
Chief Financial Officer

A

Good question. That is part of the board's current strategic evaluation. So, we really, really can't comment on that right now.

Randal J. Konik
Jefferies LLC

Q

So, Dave, I just want to follow-up on the wholesale rationalization. You gave us perspective on – I think, you said closed 400 accounts. Is there any more granularity you can give us on how many – because you said there's more to come, just any more granularity on how much more will come? And then is it safe to assume that given where the backlog trends are and given the account closures that have occurred already. It's almost seems as if the – you've reached finally a nice or at least inflection stabilization in the core account base, is that fair? Or is that on the way, how do you think about that? That's my first question. Thanks.

Dave Powers
President and Chief Executive Officer

A

Yeah, I'll answer your second one first. I think that we have landed on a nice stabilization of core accounts that are driving the majority of the volume. So, we use the term we want to win with the champions, the channel champions. And we think that with our current key accounts and some of the new ones we've incubated, we believe these are the players that are going to be around for a while. They have strong ecommerce businesses that we can continue to develop and they're going to represent the brand in a positive way. And that includes some of newer accounts we're incubating such as Footaction and SIX:02 in North America.

Beyond that, we'll continue to look at cleaning up the distribution. We want to elevate the presence of our brand year round. We want to showcase the full breadth to the brand. We don't need more distribution for core classics, we have that covered. And the customer knows where to find that So, I think you'll see another couple hundred, few hundred over the next few years of [indiscernible] (35:32) up in North America but we haven't given the real detail and mapped that out exactly yet.

Randal J. Konik
Jefferies LLC

Q

Got it. And then can I ask about the international? Obviously, it seems like the opportunity there's been – looks like there's some fits and starts there. So just have you – can you give us some perspective on how you think about potential sizing of the international opportunity? What things you need to take on to get that geographic part of the market to accelerate? And beyond, I think you said Germany and UK, what are the – I think China you said, what other areas are interesting and what areas are just not appealing and why?

Dave Powers
President and Chief Executive Officer

A

Yeah. So we've been working hard over the last year, couple of years, but really in the last year to kind of reset the game plan for Europe and also in China. We have new leadership in our European business for the UGG brand that came on in the last six months. We have spent a lot of time cultivating the new markets there of Germany and looking for new opportunities beyond existing accounts and beyond classic business. And I feel like we're in a pretty good place in Europe. The brand continues to be strong, the order book looks good for the fall season and I think that people are realizing there's more opportunity for the UGG brand.

So, good leadership in place, good account segmentation strategy in place, product is right for the market, and also the strategic partnerships with the key people over there are in place. So, I think we're in a good position for Europe.

On the Asia Pacific side, the game is really all about China. And so, we have obviously proved success with the brand with our owned store model and ecommerce model. The partner program is off to a strong start. And we realized that through the conversations with our partner, and the opportunity in the brand in that market, there's bigger upside for growth over time. So we're going to invest in the brand in that market, we've shifted some marketing dollars for this year heading into fall 2017. We are in the process of aligning with a key celebrity in that market to really drive brand heat and brand awareness. And with the continued partnership with our wholesale partners opening doors for the UGG brand, we see that as a significant opportunity.

Randal J. Konik
Jefferies LLC

Q

And then can I just ask one last one here. On the good work you're doing around cleaning up the distribution on the U.S. market, now that's going to create more UGG scarcity value? And then give you more ability to kind of [ph] police (38:16) pricing, et cetera. So how should we be thinking about kind of AUR trend and pricing architecture in the UGG-based business, sort of UGG business over the next couple of years? Because it seems like, there's an opportunity to kind of get more firmer pricing, less markdowns, less closeouts not just on a seasonal basis, but on a more [ph] scenable (38:39) structural basis that should give this business model more kind of long-term higher structural margin. So I just want to get your thoughts on that and then I'm done. Thanks.

Dave Powers
President and Chief Executive Officer

A

Yeah. I think you're thinking about it the right way. We are invested in the long-term health of the UGG brand, we think a little bit of scarcity across some of the core classics business over time is the right thing to do. And we're focused on improving ASPs and a tighter control on inventory in the marketplace. So you'll see this fall that we're going to have less closeouts in the market, that's the plan. More full price business and tighter control of the inventory through the process. So you've really summed up the goal long-term.

Jim Duffy
Stifel, Nicolaus & Co., Inc.

Q

A couple of questions for me. First, thanks for the detail identifying the components of the savings opportunity in both the cost of goods and SG&A buckets. Tom, which of those do you expect to come earlier in the window and which do you see materializing later in that window through FY2020?

Thomas A. George
Chief Financial Officer

A

Both start coming not only in 2018 but 2019 and 2020. So they'll occur in all three years. We see the SG&A opportunities is very large and significant, not only this year but also in 2019 and 2020.

Jim Duffy
Stifel, Nicolaus & Co., Inc.

Q

Okay.

Dave Powers
President and Chief Executive Officer

A

And I think, Jim, we're starting to see the impacts already of the COG savings. And then the SG&A savings will be heavily driven by retail store closures over the next two years. So, it's just a matter of timing of when we can get those stores closed.

Thomas A. George
Chief Financial Officer

A

As well as the other indirect expense savings we see and the other organizational process improvement efficiencies we see.

Dave Powers
President and Chief Executive Officer

A

Yeah.

Jim Duffy
Stifel, Nicolaus & Co., Inc.

Q

Okay. And then in terms of the evaluation of the retail fleet. Is it just a matter of an NPV calculation or IRR calculation about getting out of those leases?

Dave Powers
President and Chief Executive Officer

A

Well, the assessment really comes down to, A, is it a strategic location? Does it serve the brand long-term? And then you couple that with the financial performance, current financial performance. And then based on outlook for that location, what kind of returns are we getting on there. We have our threshold of 20% returns on profit for four-wall. But then when you look at that over time, we think that we need to have a more balanced fleet between full priced and outlet stores globally, full priced to serve the consumer and the brand diversification efforts. And then the outlet stores in the market to make sure we keep a clean marketplace and drive profit.

Jim Duffy
Stifel, Nicolaus & Co., Inc.

Q

Okay. Great. And then I know implementation of product segmentation strategies go hand in hand with your agenda to be more strategic on distribution. In this FY, will we see evidence in the marketplace of those product segmentation strategies or is that delayed into the next FY?

Dave Powers
President and Chief Executive Officer

A

Yeah, no, good question because that's really important for the brand long-term. You're going to see initial results of segmentation. The challenge with that is we are retrofitting, so to speak, the product line for fall 2017, but when you get to spring 2018 and really fall 2018, you will see a much more robust segmentation strategy with product designed specifically for channel and tier.

Joseph Wyatt
Morgan Stanley & Co. LLC

Q

Just a few questions here. Can you talk about the sort of the cadence of store closures we might see over the course of the year? And then secondly on the cost focus between gross margin and SG&A, is it possible for you to sort of rank the importance of each of the elements that you listed? Thanks.

Thomas A. George
Chief Financial Officer

A

In terms of the cadence, we're still evaluating that. What typically goes into play is if you can't get them done sooner in the year then you go ahead and take advantage of peak and get a big return on the store. And you typically have them closed by the end of the FY end. In terms of what may be closed this year vs. next year, to be determined. It is going to be a function of, in some cases, what kind of cash payment we need to make to get out of the store. But for this year, for FY end 2018, the assumption we're making is that they're going to be closed towards the end of the year. So, therefore there's really not a big impact on revenues for the year.

Dave Powers
President and Chief Executive Officer

A

Correct. Including transfers to our partner [indiscernible] (43:38).

Joseph Wyatt
Morgan Stanley & Co. LLC

Q

All right, thanks. And my second question. So, I guess, if you rank like the importance of the buckets of COG savings?

Thomas A. George
Chief Financial Officer

A

As far as the components driving the cost savings?

Joseph Wyatt
Morgan Stanley & Co. LLC

Q

Yes.

Thomas A. George
Chief Financial Officer

A

Let's see. The biggest thing there is consolidating the factory base, moving production outside of China, the material yield, some of the other sourcing negotiations and things that we're doing.

Dave Powers
President and Chief Executive Officer

A

And then ongoing over time. The go-to market process and development process. So, SKU rationalization, SKU optimization, and then just improving our product development and cycle times, we'll have a payback on that too.

Rafe Jason Jadrosich
Bank of America Merrill Lynch

Q

In terms of the $50mm of reinvestment, where will that be focused?

Dave Powers
President and Chief Executive Officer

A

Yeah. So, there's a few areas. First and foremost, the reinvestment will be focused on our growth drivers. So, in the UGG brand, again, around the areas of men's in spring and summer. And then creating awareness in the HOKA brand. So, that's a marketing reinvestment in the HOKA brand. In addition to that, as Steve mentioned, putting back the performance-based comp into the mix. And then you have a level of sales-related variable expenses to the growth over time as well, those three buckets.

Rafe Jason Jadrosich
Bank of America Merrill Lynch

Q

Thank you. And then just can you – I might have missed this, how many stores did you finish the year with?

Dave Powers
President and Chief Executive Officer

A

160?

Thomas A. George
Chief Financial Officer

A

160.

Dave Powers
President and Chief Executive Officer

A

160. And then we said by 2020, we think 125 globally owned stores is the right number for the size of the business and our ability to showcase the brand.

Robert Drbul
Guggenheim Securities LLC

Q

I guess, the first question is, on the backlog numbers that you talked about, does that include the account closures that you had or did you exclude it y-over-y?

Dave Powers
President and Chief Executive Officer

A

It's total. So, it includes the account closures that we've had. Correct.

Robert Drbul
Guggenheim Securities LLC

Q

Okay. Okay. And then can you talk a little bit on update on the men's business, how it's performing, the outlook, as well as what you've learned with the Koolaburra with Kohl's.

Dave Powers
President and Chief Executive Officer

A

Yeah. So men's is – we're really excited about the momentum we have in men's. We started off last fall with continued momentum in our male style. And that outlook for that product going into fall 2017 is very strong. In fact, the male has become the number one style in the men's business which is a first for us. It's usually a slipper. So it's indicative of the fact that we're getting a new customer into the brand, the younger consumer in the brand and diversified distribution for the men's products. So, we're very excited about the progress in men's across the board, particularly in that new male franchise that we think we can continue to leverage.

Koolaburra, again, a small business but started off well this past year with our introduction and launch primarily at Kohl's. We're going to continue that business to grow in a handful of accounts. We're not looking to sell this at a broad distribution. It's independent. It's [ph] really around (47:28) a key account focus and with a lean team. And we think this year we can double the business from last year and continue to incubate that business over time.

Robert Drbul
Guggenheim Securities LLC

Q

And if I could just follow up on the 400 accounts, is there a dollar number of sales that was attributed to those accounts or how much did that influence the backlog that isn't in your backlog this year that you guys did do business with last year?

Dave Powers
President and Chief Executive Officer

A

Yeah. Generally speaking, large number of doors, small amount of business, except for maybe a handful of a little bit more sizeable ones.

Thomas A. George
Chief Financial Officer

A

Right.

Corinna Gayle Van der Ghinst
Citigroup Global Markets, Inc. (Broker)

Q

Just some quick follow-up questions from me. On the reinvestment that you guys are planning, is that incorporating any additional marketing expense or can you talk a little bit about what you guys are focusing the marketing on and also the percent of sales vs. last year maybe?

Dave Powers
President and Chief Executive Officer

A

Yeah. As a percentage of sales over time, we see it roughly about the same, maybe a little bit of an increase. But what we've done over the last year, through all this restructuring work is we've scrubbed the marketing spend globally and we're reallocating to three main areas: one is digital, globally across all brands; one is in UGG, particularly in the areas of spring and summer in men's and China. So, incremental spend is focused on there, reallocated there. And then really on driving awareness in the HOKA brand.

And so from a percentage increase over last year by brand, HOKA is going to have the most significant increase in marketing spend to drive awareness. So we can start to see more success in the run specialty channel and beyond. And also in Europe where we have a pretty strong business that needs more awareness help in the country of Germany and the UK. And then incubating China as well. So obviously, that brand has momentum, when the customer hears about it and when they try it, they're hooked. But we just need to focus on growing awareness to optimize the size of that brand.

Corinna Gayle Van der Ghinst
Citigroup Global Markets, Inc. (Broker)

Q

Okay. That's helpful. And then just a follow-up on Macy's. I think you guys had said you're expanding to around 100 doors. Is that number going up more than you guys had previously planned? Can you talk a little bit about the expansion that you guys are doing there? Are you going to do more shop-in-shops than you've done in the first season? And then just kind of what those square footage expansions will look like?

Dave Powers
President and Chief Executive Officer

A

Yeah. So we started last fall with the initial launch in Macy's Herald Square which was very successful. And in fact, they gave us more space for the month of November and December. And we also did a 35-store test with a broad demographic of store locations. We've now parlayed that into continuing to support the Herald Square and shop-in-shops that established. And then we're going to 200 doors, I believe we started that for spring and that will continue into fall. And right now, we're comfortable with that amount. We want to optimize the business in those stores and make sure we have a robust presentation across all genders and all seasons. And that's going well so far, so we're optimistic about the opportunity going forward into this fall, both in stores and online.

Corinna Gayle Van der Ghinst
Citigroup Global Markets, Inc. (Broker)

Q

Okay. Great. And then just one final follow-up on just your inventory management plans going forward. You guys [ph] seem to run at (51:11) DSW last fall and you've utilized the UGG Closet function a bit more. Can you talk about how that strategy is being planned for this fall vs. last year and how you're kind of thinking about that longer term as well?

Dave Powers
President and Chief Executive Officer

A

Yeah. So a couple of things. One is, we spoke on the last call about selling less closeouts into the channel this past Q4. So we achieved that goal in North America. So there's less closeouts in the channel to begin with. We did utilize UGG Closet to help flush them with inventory which, from my perspective, is a very healthy way to do because you are getting higher margin per style, you're getting the customer data as you make that sale. And then you are selling the inventory directly to the consumer vs. to an account who may hold on to that and then sell it later in fall which will disrupt your full-price business.

So that's going to continue going forward. We'll utilize UGG Closet for that as a way to optimize the margin of excess inventory. Generally speaking, we are focused on having fewer closeouts across the board over time. And then we will continue to utilize key accounts for some of the closeout business such as DSW and Nordstrom Rack, et cetera.

Q

First one, I guess from me is, as you close stores, how are you thinking about balancing the recapture between your own ecommerce website to those units and 3P replenishment type website, the Amazon, [ph] Smondo (53:00), et cetera. As the units shift especially on the 50% of business that's classic and specialty classics?

Dave Powers
President and Chief Executive Officer

A

Yeah. So, it's hard to capture 100% of that business, obviously. And so we're planning on capturing a small percentage of that business from the store volume. The other challenge that we have to face when we do close those store is those stores are driving business to our online channel through our infinite UGG program and click-and-collect. So, we're not going to capture 100% of those store closure business. That's why we estimated the $15mm headwind this year. We will see a little bit of pickup but it's certainly not to the rate where we can capture that business going forward.

Dave Powers
President and Chief Executive Officer

CLOSING REMARKS

- With the FY2017 now closed and FY2018 beginning, I would like to reiterate our focus on improving profitability and strengthening our brands for future growth
- As we look forward, the entire company is intensely focused on achieving our 13% operating margin target for 2020
- We'll do this by driving growth in our UGG and HOKA brands, optimizing profitability in our Teva and Sanuk brands, and executing on the cost savings and gross margin improvements over the immediate term
    - While the marketplace may continue to have its challenges, we're confident in our ability to control our cost structure in line with the changes in our business patterns while continuing to optimize our sales channels globally
- In closing, I would like to thank all of our stakeholders for their support and employees for their continued focus and passion for the business.