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Deckers Outdoor Corp. (DECK)

Q3 2018 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good afternoon, ladies and gentlemen, and thank you for standing by. Welcome to the Deckers Brands' Third Quarter Fiscal 2018 Earnings Conference Call. At this time, all participants are in a listen-only mode.

Following the presentation, we will conduct a question-and-answer session. Instructions will be provided at that time for you to queue up for questions. [Operator Instructions] I would like to remind everyone that this conference call is being recorded.

I will now turn the call over to Steve Fasching, Vice President, Strategy and Investor Relations.

Steve Fasching
Vice President-Strategy & Investor Relations, Deckers Outdoor Corp.

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 would 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 statements of historical fact, are forward-looking statements and include statements regarding our anticipated financial performance, including but not limited to, our projected revenue, margins, expenses, earnings per share and operating profit improvement, as well as statements regarding our cost savings and restructuring plans, strategies for our products and brands, and our review of strategic alternatives.

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 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 to changes in its expectations, or as a result of the availability of new information.

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

David Powers

President, Chief Executive Officer & Director, Deckers Outdoor Corp.

Thanks, Steve, and good afternoon to everyone. Our third quarter performance meaningfully surpassed our expectations as our efforts to increase full price selling for our products and drive sustained profitable growth for our brands continued to gain traction. On top of great execution by our teams, an improved retail environment and more favorable weather compared with last year, also aided our results.

For our third quarter, sales were $810 million, compared to guidance of $735 million to $745 million. And earnings per share was $4.97 versus guidance of $3.65 to $3.75. While a portion of our outperformance was timing related, which Tom will review in a minute, our recent results are further validation that the improvements we've made and continue to make as a business are paying off.

Last year at this time, I discussed how we are working on leveraging our core competencies to strengthen our connection with consumers, target new audiences and become more strategically aligned with our key wholesale partners. These efforts included: preserving the UGG Classic's franchise with a focus on core brand positioning, reaching a younger consumer with existing and new distribution, growing the Men's business with an improved and focused product line, and creating compelling and segmented year-round offering.

This quarter is an indication that those efforts are paying off as we successfully executed on delivering seasonal, relevant product from UGG with standout items, such as innovative winter and waterproof boots, slippers, the Classic Mini and the new Men's styles; improving pricing in full-price selling through the rationalization of our wholesale distribution channel and better inventory management in the marketplace; driving significant sell-in and sell-through with new accounts such as Footaction domestically and ASOS internationally; enhancing our targeted marketing campaigns in order to attract the attention of new and younger consumers; and elevating our DTC consumer experience by offering a stronger presentation of lifestyle products from head to toe.

Overall, we are extremely pleased with our third quarter results, especially the performance of the UGG brand as sales grew 4% to $735 million, which was highlighted by strong full-price selling. This is a testament to the continued strength of the UGG brand globally and the importance of the brand to our retail partners.

Now, turning to performance by channel, starting with our wholesale and distributor business, channel inventory was much cleaner to start the third quarter than it was a year ago. This allowed our partners to capitalize on their full price inventory positions and capture demand as the appetite for UGG product grew throughout the quarter.

Sell-through further accelerated as we got deeper into the holiday selling season and weather turned exceptionally cold in many parts of the U.S.

These factors contributed to a stronger-than-expected reorder business as retailers placed additional orders to meet strong demand late in the quarter. Further aiding full-price selling was fewer wholesale closeout sales, which was accomplished by a strategic utilization of the UGG Closet, which brings in higher margins.

From a product perspective, we saw success with Classic Mini; ankle boots; slippers in Neumel, which are all geared towards the younger consumer and provide a great entry point into the brand; and cold weather and waterproof products, specifically the Adirondack and Butte.

Performance of our DTC channel was strong and we are very pleased to report a positive 1.7% comp versus guidance of a negative low-single-digits comp. The positive result was driven by stronger-than-expected e-commerce results and better trends in retail store comps. Our global e-commerce business delivered our largest volume quarter to-date, benefiting from strong online demand and a shift in consumer purchasing patterns.

Our brick-and-mortar business also outperformed expectations. While traffic remain challenged, comps were better than expected, conversion was up and units per transaction increased mid-single digits. Our stores remain a critical component of our consumer-facing omni-channel strategy, as they provide a physical touchpoint with the consumer, allowing them to interact with a broad assortment of the UGG product offering.

In our global DTC business, we experienced a meaningful increase in sell-through of the Classic Mini and the Neumel styles, drove continued consumer interest in segmentation by offering DTC exclusive products, which carried a higher average selling price and saw a notable growth with our non-UGG brands.

Shifting to our regional performance across all channels, in the U.S., we saw a number of improvements from last year, including better composition and quality of inventory ending the quarter, strong early full price sell-through, less overall promotional activity, and robust holiday sales fueled in part by cold weather late in the quarter.

On the international side, Germany continues to be a major growth driver as we capitalize on the growing popularity of numerous UGG Classic Mini styles. At the same time, we saw success in China due to increases in brand awareness and growing consumer demand following our first holiday season with our brand influencer, Angelababy. And with our recent conversion to direct distribution in Canada, we experienced much stronger sell-through for the UGG brand this holiday season with the Adirondack as a top performer.

Turning to the Performance Lifestyle Group, I'm pleased to report the group grew a combined 37% in the quarter. Starting with HOKA ONE ONE, the brand continued its exceptional growth, increasing third quarter sales 66% to $32 million, and continued to exceed its growth targets as the team builds brand awareness and launches compelling new products. The improvement year-over-year was broad based with DTC sales up significantly, and wholesale, the brand's largest channel, continuing to grow meaningfully.

According to NPD, HOKA sell-through at U.S. retail easily outpaced the competition for the 12 months ended November 30, 2017, as the run specialty category was down 5%, while HOKA sales were up 47%.

Also, as further proof that the brand is resonating, HOKA's core styles at retail have expanded beyond the Clifton and the Bondi to now include the Arahi and Gaviota; two styles we launched in the last year and a new category for the brand, dynamic stability. These two additional core styles have driven increased shelf space and market share.

For Teva and Sanuk, I'm extremely impressed with how quickly the teams have driven significant gross margin and operating margin improvements in their respective businesses. They've done this by executing on a focused plan to drive SKU efficiency, optimize their distribution strategies and implementing operational changes to right size fixed overhead.

Teva grew sales by 33% in the quarter to $20 million. This growth was partially driven by an extended sandal selling season that drove more full price sales later into the year. The brand is also seeing significant success in closed-toe footwear with products including the Arrowood collection.

As for Sanuk, sales were flat to last year, which surpassed expectations, while the brand continues to rationalize international distribution and clean up the marketplace. Sanuk recently launched the Chiba Quest for both men and women, which is an extension to the Sidewalk Surfer franchise. The initial offering was exclusive to our DTC channel and will be available through our wholesale partners in our fourth quarter. The design and distribution plan for the Chiba Quest is focused around the core Sanuk consumer, and we are very encouraged with the initial feedback.

Our fiscal 2018 year-to-date results are proof that the team is successfully executing on our long term plan, and we continue to look for further opportunities to improve the business and drive healthy, profitable growth. With that in mind, we will continue to evolve our digital marketing capabilities, better engage our consumers and drive innovation in our products to bolster the importance of our brands in the marketplace.

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

Thomas A. George

Chief Financial Officer, Deckers Outdoor Corp.

Thanks, Dave, and good afternoon, everyone. Today, I will take you through our third quarter results in greater detail, break out the restructuring and other charges recorded in the quarter and provide an updated outlook for the fourth quarter and an update on fiscal 2018.

Please note, throughout this discussion where I refer to non-GAAP financial measures, I am referring to results before taking into account restructuring 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 Investors tab.

Now to our results for the third quarter. As Dave mentioned, sales came in much better than expected at $810 million, up 7% versus last year and above our guidance range. The drivers of the sales beat to guidance were approximately due to $30 million in net reorders with favorable weather conditions being a significant driver, $20 million was from the timing of wholesale orders originally scheduled for delivery early in our fourth quarter that our wholesale partners requested to be shipped sooner due to the strong third quarter sell-through, $10 million from better-than-expected DTC performance as the positive 1.7% comp compared favorably to our expectations of negative low-single digits, and $3 million from foreign exchange fluctuations.

Gross margin was 52.2%, also significantly better than expected and up 170 basis points versus last year. All brands saw gross margin gains due to a higher proportion of full price selling and the strategic management of the closeout channel coupled with continued supply chain improvements and FX contributing approximately 40 basis points year-over-year.

Non-GAAP SG&A was $220 million, up 9% to last year, but as a percentage of sales, it's under guidance by over 100 bps. The increase in SG&A dollars over last year was largely due to incentive compensation being accrued for this year versus a reversal last year, which contributed approximately $19 million of the increase, and variable expenses related to higher sales. These increases were partially offset by savings related to our retail store fleet and back-office restructuring efforts.

Non-GAAP diluted earnings per share was $4.97 compared to $4.11 last year and our guidance range of $3.65 to $3.75. The better-than-expected sales and gross margin drove approximately $0.70 of the EPS upside with additional contributions in the quarter of $0.28 from lower taxes, $0.15 from timing of early shipments, $0.08 from exchange-rate fluctuations, and $0.04 from the $25 million share repurchase. Non-GAAP adjustments were $10 million and were mainly related to our proxy contest, the board's consideration of strategic alternatives and other organizational charges.

Next, our balance sheet, at December 31, remained strong with cash and equivalents of $493 million compared to $296 million this time last year, inventory at $396 million, up 6% compared to last year, and short-term borrowings of $600,000 compared to $30 million last year. During the quarter, the company repurchased 361,000 shares of its common stock for a total of $25 million. As of December 31, 2017, the company had $375 million remaining under its $400 million share repurchase authorization, of which approximately $75 million is still expected to be utilized prior to the end of this fiscal year.

Now moving to our outlook, for the fourth quarter, based primarily on the shift of certain wholesale orders into the third quarter, we now expect sales to be in the range of $370 million to $375 million, non-GAAP EPS between $0.15 and $0.20, and effective tax rate of approximately 32% due to the anticipated repatriation of $250 million of international cash in the quarter.

For the full fiscal year, we are raising our guidance. This improved outlook includes flowing through $1.06 from the third quarter result driven by $0.70 of improved sales and gross margin performance, $0.28 of improved taxes, and $0.08 of improved foreign currency. This results in the following updated full-year guidance. Sales now expected to be in the range of $1.873 billion to $1.878 billion, gross margin of approximately 49%, SG&A as a percentage of sales of approximately 37%, operating margin of approximately 12%, non-GAAP EPS now in the range of $5.37 to $5.42, and effective tax rate of approximately 22.5%.

We would like to mention that although we are very pleased with how all brands performed in the third quarter, especially UGG in its most important selling season, we will look at the results objectively in planning the business for future holiday selling seasons. We benefited from the cold weather and an extra inventory turn due to the timing of the shipments early in the year, areas where we will remain cautious on in the future. But at the end of the day, we saw the true strength of our brands and how our product assortment is resonating with our consumer base.

Our GAAP tax rate for the quarter is 55.3%. The main driver was the enactment of tax reform during the quarter as the company is required to recognize the effective tax law changes in the period of enactment. The company recorded discrete tax adjustments related to tax reform for the remeasurement of the deferred taxes along with the deemed repatriated foreign earnings. With regard to our pro forma effective tax rate, as a result of the passage of the tax reform act, it is still early, and we continue to assess the long-term impact. But as a result of our fiscal year ending March 31, our current fiscal year in 2018 effective tax rate will benefit from the new rules and related reduction in the federal tax rate.

We now expect our effective pro forma tax rate to be approximately 22.5%, revised down from our previously guided figure of 26%. The 22.5% rate is due to the reduced U.S. federal tax rate and increased ratio of foreign to total company earnings. Beyond this year, we will benefit from a full year of the lower U.S. tax rate, but that will likely be offset by an increase in tax on international income as well as not expecting to receive the same benefit next year that we received this year from discrete items. Therefore at this stage, we are expecting our effective tax rate to remain at approximately 22.5%. The 22.5% includes a provision for federal tax of approximately half of foreign income. Accordingly, we will be able to repatriate our international cash free of federal taxes, although there will still be some state income taxes.

In terms of our cash position and capital allocation strategy, a significant portion of our cash balance is outside of the U.S. Due to the new tax rules, we plan on repatriating $250 million of international cash back on shore by the end of fiscal 2018. We expect that this, combined with our already strong balance sheet and enhanced cash flow generation capabilities due to the tax reform, will provide the company with significant liquidity in the near-term.

We are currently reevaluating our capital allocation strategy and are looking at further opportunities in addition to our current share repurchase program to put this cash to use in a way that we are able to profitably grow the business and drive shareholder value. We plan on providing more color on our plans on the next earnings call, but currently our main focus is on the $400 million share repurchase program we announced last October.

Before handing the call back to Dave, I'd like to say how encouraged I am by the tremendous strides that the company has made in executing the $100 million operating profit improvement plan, especially in light of our eventful calendar 2017. Our fiscal year-to-date results coupled with our updated guidance for the remainder of fiscal 2018 are proof that we're on the right track. We still have meaningfully progress to make on the plan, but I'm confident that we have the right people in the right positions to meet and exceed our long-term goals.

Now I'll turn it back to Dave for his closing remarks.

Steve Fasching

Vice President-Strategy & Investor Relations, Deckers Outdoor Corp.

Thanks, Tom. We closed out calendar 2017 on a high note across our entire brand portfolio, channels, and regions. For the of UGG brand it has been a very successful fall/winter selling season and as the trend continues into January, the strength of the brand and its compelling product offering is more evident now than ever.

Also, as we announced last year, the board of directors is now actively engaged in its search for two new members that will coincide with the retirement of two current members. In addition, management, the board, and the entire organization is firmly committed to achieving and exceeding our long-term targets of $2 billion in sales and at least a 13% operating margin by fiscal year-end 2020. Our third quarter results and updated fiscal year 2018 guidance further reaffirms our confidence in achieving the plan.

Before handing the call over for Q&A, I would like to say how proud I am of the progress the entire organization has made on our long-term plans. Our focus remains the same going into calendar 2018, generating healthy, profitable growth to drive shareholder value and returns on capital. On behalf of the Deckers' management team, I'd like to thank our employees for their dedication and for driving a very successful fall/winter season.

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

QUESTION AND ANSWER SECTION

Operator: At this time, we will be conducting a question-and-answer session. [Operator Instructions] Due to time constraints, please limit your inquiry to one question and one follow-up. One moment, please, while we poll for questions. Our first question comes from Camilo Lyon, Canaccord Genuity. Please proceed with your question.

Camilo Lyon
Analyst, Canaccord Genuity, Inc.

Q

Thanks. Good afternoon, guys. Great close to the holiday season.

Thomas A. George
Chief Financial Officer, Deckers Outdoor Corp.

A

Thanks, Camilo.

David Powers
President, Chief Executive Officer & Director, Deckers Outdoor Corp.

A

Thank you.

Camilo Lyon
Analyst, Canaccord Genuity, Inc.

Q

I wanted to – you gave really good detail on articulating the upside in UGG brand. I was hoping to get some clarity on how the outperformance of those different styles, whether it's the Classic, the Slim, the Mini, Neumel. How does that inform how you're going to – how your product innovation decisions will flow into next year given the success of these franchise names?

David Powers
President, Chief Executive Officer & Director, Deckers Outdoor Corp.

A

Yes, good question. We're really excited with the results, particularly of the Mini and the Neumel. I mean, obviously those are core franchise styles that we can really build off of, but they also speak to the fact that we're bringing in new consumers into the brand. The Mini from our research indicates a younger consumer is purchasing into the brand. That style took off in the quarter and continues to be strong. And then the Neumel, which we have specifically targeted our lead style to reach a younger male consumer, continues to perform extremely well.

So from an innovation standpoint, we've done a lot of work, particularly in our Classics franchise and in our weather product this year. Going forward, we're going to continue to utilize that innovation to create more styles that cross that boundary of fashion and function on the women's side, making sure that the style looks good, but it performs and can be worn all day in any weather conditions, continuing to innovate around comfort and material usage head to toe in our lifestyle product as well, and then really spending more time on evolving the fashionability of our franchise styles going into fall 2018 and beyond.

Camilo Lyon
Analyst, Canaccord Genuity, Inc.

Q

Great. My follow-up to that is you spoke about the inventory and how there were reorders in the quarter, not surprising given how you cleaned up the channel going into the season. Could you help us characterize the channel inventory exiting the quarter and how that fits, particularly in light of the reorder inventory in what seems to have been a very cold persistent pattern of weather in the Northeast? How do you feel about the inventory today as it relates to the inputs that have been in place?

David Powers
President, Chief Executive Officer & Director, Deckers Outdoor Corp.

A

Yeah, we feel really good about it. We spent a great deal of care going into Q3 to making sure that the channel was clean. The teams did an amazing job of working closely with our key accounts to manage the right level of inventory, not flood the market, and keep turns healthy. We think we got another turn from the weather this season, which helped a lot.

And then the strong winter starting around the Christmas timeframe and flowing in through January has allowed a lot of our key accounts to continue to sell through their inventory and provide a few more reorder opportunities.

So generally speaking, we're very pleased with the makeup of the wholesale channel and the quality of the inventory that's out there, higher-priced, less closeouts, and ending the season in a good makeup composition for a spring setup and going into next fall's order book.

Camilo Lyon
Analyst, Canaccord Genuity, Inc.

Q

Perfect. My last question is just on SG&A dollars. I think at the outset of the year, there was a possibility for SG&A dollars to be down year-over-year this year. Looks like they'll finish up a touch. Can you just help us understand the opportunities and the pathway you see going forward to reducing your overall expense base?

David Powers
President, Chief Executive Officer & Director, Deckers Outdoor Corp.

A

Yeah. We're still on that pathway. We still have targets in sight for revenue and operating margin improvements as part of our profitability improvement plan for FY 2020. There are some puts and takes obviously through this quarter and year that I'll let Tom tackle.

Thomas A. George
Chief Financial Officer, Deckers Outdoor Corp.

A

Camilo, some of it – the increase, some of it's related to foreign exchange. Foreign exchange was a benefit to the top line and the margin but also had some more operating expenses internationally.

And there's also an increase in performance compensation this year relative to a year ago, especially in the quarter. Whereas a year ago there was actually a reversal of performance comp, and this year there's a provision.

And there's also some additional marketing that we've spent in Q3, which definitely paid off and we're expecting to spend a little bit more marketing in Q4 as well.

But to Dave's point, we feel really good on what we've accomplished on the cost savings plan. We've got a lot of good visibility of additional cost savings for SG&A. And probably to add one more point, we've got – benefited in the quarter and for the year about 120 basis points of gross margin improvement and roughly $23 million related to our cost savings initiatives in the supply chain.

David Powers
President, Chief Executive Officer & Director, Deckers Outdoor Corp.
A

Yeah. I think that's a key thing to keep in mind is the supply chain improvements are hitting the bottom line faster than we expected and will continue to drive against that opportunity. And so that benefit paid off as well as the reduced closeouts in the channel and more full-price selling helped the margin. And if you see the year-end operating gross margin, much better than expected. So a little bit higher on SG&A, but the bottom line profitability is still solid.

Thomas A. George
Chief Financial Officer, Deckers Outdoor Corp.
A

And better than what we...

David Powers
President, Chief Executive Officer & Director, Deckers Outdoor Corp.
A

Better than expected, yeah.

Thomas A. George
Chief Financial Officer, Deckers Outdoor Corp.
A

Right.

David Powers
President, Chief Executive Officer & Director, Deckers Outdoor Corp.
A

Yeah.

Camilo Lyon
Analyst, Canaccord Genuity, Inc.
Q

Yeah. Got it. Great job, guys. Thanks a lot. Good luck.

David Powers
President, Chief Executive Officer & Director, Deckers Outdoor Corp.
A

Thanks, Camilo.

Thomas A. George
Chief Financial Officer, Deckers Outdoor Corp.
A

Thanks.

Operator: Our next question is from Randy Konik, Jefferies. Please proceed with your question.

Randal J. Konik
Analyst, Jefferies LLC
Q

How are you?

David Powers
President, Chief Executive Officer & Director, Deckers Outdoor Corp.
A

Hey, Randy.

Randal J. Konik
Analyst, Jefferies LLC

Q

A quick question. I just wanted to kind of ask about – you talked the – one of the strategies you've been kind of going through is this idea of getting smarter with the wholesale channel of distribution, kind of working even harder with the accounts that kind of really matter and kind of reducing the accounts that are less important.

Where are we in that process? And on Amazon's holiday release, one of your boots was mentioned as a top seller. So just wanted to get some perspective on how you're thinking about where the wholesale channel strategies have come from? And where do you think they're going? And how does Amazon kind of fit within that kind of construct going forward?

David Powers
President, Chief Executive Officer & Director, Deckers Outdoor Corp.

A

Yeah. Great question. I have to give our wholesale teams a lot of credit for the way they've transitioned the market over the last year. We had some pretty significant account rationalization coming out of Q3 last year. We had to close some sizable accounts and do some marketplace shifts to elevate and protect the brand, reach new consumers, make sure that we're as efficient as possible, and then a lot of segmentation work with reclassifying the marketplace between core, premium, and pinnacle product distribution.

So you're seeing the results of that this quarter, better segmentation, better consumer reach, all accounts for the most part pleased with the quarter. There were some areas where there was some uncertainty when we opened up Macy's and went into Amazon in a more robust way, but those panned out well and really feeling good about the work that's done.

I'd say we're mostly there. I think you'll see the segmentation have a bigger impact starting this fall, as the product development teams catch up to the segmentation plans, and we start creating a specific product for each of those channels, better segmenting them, better storytelling around specific customers and key accounts.

Amazon, this season went well. We did have solid performance with them. A little bit of pricing issues here and there, but nothing significant, and I'm pleased with how the accounts managed through that. And we were able to get some sizable volume on some key styles through Amazon that will benefit the bottom line and reach new consumers.

Randal J. Konik
Analyst, Jefferies LLC

Q

That's helpful. And I guess my last question, just looking at your website, I guess there's this elevated marketing presence around the collective. So it just seems like there's been an elevated lifestyle orientation to the marketing, both individuals and so forth.

Are you seeing good engagement to that? And is it helping kind of diversify even further when you see the product traction coming through in the business? Kind of give us some perspective on where the marketing has comes from, where it's going, and how that's helped kind of further kind of get people to buy these other types of lifestyle-type products, et cetera.

David Powers
President, Chief Executive Officer & Director, Deckers Outdoor Corp.
A

Yeah. Great question. Over the last year, we felt it was important under Andrea's leadership in the UGG team to really signify a step change in the positioning and the direction of the brand. And so some of that marketing out there is a little bit polarizing. We've had mixed reviews on some of it, to be honest, for more traditional accounts. But what is resonating is the effect that it's having on a younger consumer, and we've made significant progress over the last year with the amount of 18 to 24-year-olds buying into the brand. We made up a lot of lost ground that we had over the last couple years, and I think you're seeing that in the sales recorded in some of the new accounts.

And it's definitely helping bring new styles to the consumer and showcasing UGG as more than just a boot and an item that's relevant in different fashion circles, that's relevant from a lifestyle head-to-toe perspective, and really showing the energy of the brand. We're going to continue to evolve that. We have some exciting things in the pipeline going into this spring and this fall. And so as we continue to expand the reach for the brand through segmentation and product innovation, that campaign will continue to be important. So I'm really looking forward to what the teams will do to evolve that going forward.

Randal J. Konik
Analyst, Jefferies LLC
Q

Very helpful. Thanks, guys.

David Powers
President, Chief Executive Officer & Director, Deckers Outdoor Corp.
A

Thanks.

Thomas A. George
Chief Financial Officer, Deckers Outdoor Corp.
A

Thanks.

Operator: Our next question is from Jonathan Komp, Robert W. Baird & Co. Please proceed with your question.

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

Yeah. Hi, thank you. I want to follow up with a question on the wholesale business. And you touched on this a little bit already regarding the state of the inventories in the channel, but more related to the psychology of the retail partners that you have. And following two pretty tough years for the wholesale business with the cleaner inventories and some of the product and brand momentum, how you're thinking about their willingness to commit to stronger orders for the fall season ahead?

David Powers
President, Chief Executive Officer & Director, Deckers Outdoor Corp.
A

Yeah, I think that's the million-dollar question on the table for us and many people in the industry. Coming out of one of the strongest holiday periods in a while, we certainly benefited from macro-environmental trends in addition to the strength of the brand, but weather was an impact. And so we think that the weather impact was roughly about $30 million in reorders for the UGG brand. The good news is that the accounts filled through well as you said. They're positioned in clean inventories, less close outs, less markdown inventory in the channel.

So we feel good about the setup for next year. The variable there is how are these key accounts in the marketplace going to view their open-to-buy as to whether this holiday was kind of a one-time event or a sustainable benchmark that they can build off of. So we'll take it with a conservatively optimistic view. Obviously we're pushing for growth and we're going to continue to drive that in the right channels and styles, but we're mindful of maintaining the positioning of the UGG brand and not flooding the marketplace with supply again.

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

Q

And I guess just to follow up on that, I want to ask. I know a number of years ago there were two consecutive years of pretty mild winters followed by a cold spell and the following year after the cold winter you saw pretty a sharp bounce back in the wholesale business. And I'm just curious structurally if there's anything in your mind. Obviously, it's a different environment, but structurally is it all that different from back then, or just curious to get your thoughts there.

David Powers
President, Chief Executive Officer & Director, Deckers Outdoor Corp.

A

Yeah, I think that from a macro level perspective, the accounts are much more conservative on inventories and ending quarters clean and driving profitability. And so you're definitely seeing that. We've seen that over the last couple years really. I think for the most part, from what I can tell or we can tell, the accounts feel good about how they've ended this season and want to maintain the momentum going into next year. People are looking for a return to growth, a return to improved profitability. I think you're starting to see store traffic stabilize a little bit, but certainly the shift to online is going to continue, and I think people are just going to continue to manage their inventory selectively with the right brands and the right product and minimize the amount of hangover product so they can continue to have a healthy business.

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

Q

And last one, just following up once more. As you get more visibility to the state of the order book, would you be any more or less willing to take on speculative inventory just given what you see today as everything that you just outlined along with the clean state of the channel? Just curious how you're thinking about your willingness to take on inventory risk.

David Powers
President, Chief Executive Officer & Director, Deckers Outdoor Corp.

A

Yeah, I think we – the last couple years, we've spent a lot of time on inventory management. We still have work to do. Our inventory is a little bit elevated right now and that's a key priority for the management team going forward. But we make sure that through our buying process we identify key styles that we think there may be reorder upside in. Neumel, certainly the HOKA brand is one of those that has tremendous upside, some of the innovative fashion for the season – sorry, the classic iterations for the season. So we'll selectively do that, and I think it's served us well this year, but we don't want to get ahead of ourselves and we're continuing to want to drive the growth but still end the season clean.

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

Q

Okay. Thank you.

David Powers
President, Chief Executive Officer & Director, Deckers Outdoor Corp.
A

Yeah, thanks.

Operator: Our next question comes from Jim Duffy, Stifel. Please proceed with your question.

James Vincent Duffy
Analyst, Stifel, Nicolaus & Co., Inc.
Q

Thank you. Hello, everyone. Nice work executing ...

David Powers
President, Chief Executive Officer & Director, Deckers Outdoor Corp.
A

Hey, Jim.

James Vincent Duffy
Analyst, Stifel, Nicolaus & Co., Inc.
Q

...across many fronts.

David Powers
President, Chief Executive Officer & Director, Deckers Outdoor Corp.
A

Thank you, Jim.

James Vincent Duffy
Analyst, Stifel, Nicolaus & Co., Inc.
Q

Tom, thank you for the help on the tax reform benefit lurking around the corner to 2019. With the reiterated commitment to the 13% plus EBIT margin, it seems the intent is to flow that through to the earnings and shareholders rather than see it as an opportunity to reinvest. Is that accurate?

Thomas A. George
Chief Financial Officer, Deckers Outdoor Corp.
A

Well, I think a lot has happened with tax reform and it's impacted us very favorably. Although we had some one-time charges this quarter related to revaluing our deferred tax assets as well as putting a provision against all our earlier foreign earnings, the real positive there is we've got a lot more liquidity we can consider going forward. So we're evaluating our capital structure at this point in time and evaluating the added liquidity and our ability to invest in the business, but our top priority is increased shareholder value. And the immediate priority is finish that $100 million share repurchase by the end of the year and get focused on the remainder of the $400 million authorization.

David Powers
President, Chief Executive Officer & Director, Deckers Outdoor Corp.
A

Yeah. I think just to add onto that. We're definitely committed to shareholder returns and increasing shareholder value. The buyback is important. We stay committed to that. And I think the good news is with this cash position going forward, it gives us more alternatives to increase shareholder value but also to invest in growth in the brands. We have some incredible brands that still have upside, lot of opportunity globally in the marketplace, and that's going to require some investment. But know that we're still committed to what we said last year with regards to targets for FY 2020, returning shareholder value.

James Vincent Duffy
Analyst, Stifel, Nicolaus & Co., Inc.

Q

Okay. Thanks. And, Dave, you mentioned still some work to do on the inventory. I was surprised to see it up year-to-year with the upside, and pull forward of sales. Can you speak in little more detail about where you sit with inventory, and some of the opportunities to speed inventory turns?

David Powers
President, Chief Executive Officer & Director, Deckers Outdoor Corp.

A

Yeah, I'll let Steve, walk you through some of the details on that.

Steve Fasching
Vice President-Strategy & Investor Relations, Deckers Outdoor Corp.

A

Yeah, Jim. So inventory is up. And it goes a little bit to, I think, John's question before about elevated inventory. As we said almost two years ago, in certain cases we're willing to carry a little bit of elevated inventory of carryover style to take advantage of opportunities in the season. I think this is a season where that was demonstrated and executed. In terms of the inventory levels that we're looking at right now, the reason we're up year-over-year primarily is driven by bringing UGG's spring summer inventory in earlier this year. So in Q3 as opposed to Q4.

We also have higher inventory around the HOKA brand. So with the continued explosive growth of the HOKA brand and driving sales forward, we're bringing more inventory in related to HOKA. As you may have seen today, we had the new fly collection introduction with HOKA. So some of that inventory is related to new product introduction. And then some of the other inventories around UGG kind of as we said, a willingness to carry a little bit of elevated inventory. As Dave said, we recognize there's some work to be done internally. We're already beginning to address that. But overall, it worked well for us in this quarter.

And then we have some new dynamics with new business in terms of spring/summer and HOKA, but also looking at ways to optimize it moving forward.

James Vincent Duffy
Analyst, Stifel, Nicolaus & Co., Inc.

Q

Great. Thank you for the help.

Steve Fasching
Vice President-Strategy & Investor Relations, Deckers Outdoor Corp.

A

Sure.

David Powers
President, Chief Executive Officer & Director, Deckers Outdoor Corp.

A

Thanks, Jim.

Operator: Our next question comes from Rafe Jadrosich, Bank of America Merrill Lynch. Please proceed with your question.

Rafe Jason Jadrosich
Analyst, Bank of America Merrill Lynch
Q

Hi. Good afternoon. Thanks for taking my question. As you look at the gross margin upside this year and just the stronger performance overall, are there any changes to the components between gross margin, SG&A leverage to achieve that 13% operating margin by 2020?

David Powers
President, Chief Executive Officer & Director, Deckers Outdoor Corp.
A

Not dramatically, no.

Thomas A. George
Chief Financial Officer, Deckers Outdoor Corp.
A

...we've talked about before. I mean, going forward, one thing to consider on the gross margins we'll have some more supply chain improvements. I don't think you can plan additional FX as you look forward. But another thing to keep in mind as we grow the other brands, they don't really have as big a direct-to-consumer element. So the gross margins as we grow the other brands. Those gross margins and those brands aren't as strong, but they have great operating margins going forward.

So there's really no change in terms of gross margin versus operating expense savings and how we drive that 13%. Nothing has come to our attention to really change that outlook.

David Powers
President, Chief Executive Officer & Director, Deckers Outdoor Corp.
A

No, and I think for us against our original roadmap, some of the timing might be different. We're seeing faster improvements on the gross margin from our supply chain initiatives. Obviously we're improving operating margin faster than expected, so we're still evaluating the right timing for some of these puts and takes, but essentially still structurally the same.

Rafe Jason Jadrosich
Analyst, Bank of America Merrill Lynch
Q

Okay. That's helpful. And then when you finish this year, can you tell us where you'll be in terms of the store closings and how that'll progress in 2019? And then can you discuss what you're seeing in terms of sales transfer as you're closing stores?

David Powers
President, Chief Executive Officer & Director, Deckers Outdoor Corp.
A

Yeah. We haven't shared the store count, but we're still on track to what we put out there as the 2020 target of 125 stores. We have some popup stores that we did this season that performed really well, and we'll continue to utilize that strategy as we go forward.

But still staying on track to the store closure plan. And really just to reiterate what we've said is, we're going to optimize profitability and cash flow to close those stores through lease negotiations and natural lease expirations versus big cash payouts. So we're still on track to do that. The teams have done a great job improving profitability in the retail channel and leveraging the assets and improving SG&A, and so we'll continue to stay on that track.

Rafe Jason Jadrosich
Analyst, Bank of America Merrill Lynch
Q

Okay. Great. Thank you.

David Powers
President, Chief Executive Officer & Director, Deckers Outdoor Corp.
A

Okay.

Operator: Our next question comes from Corinna Van Der Ghinst, Citi Research. Please proceed with your question.

Corinna Van Der Ghinst
Analyst, Citigroup Global Markets, Inc.
Q

Thank you. Hi, good afternoon.

David Powers
President, Chief Executive Officer & Director, Deckers Outdoor Corp.
A

Hello.

Corinna Van Der Ghinst
Analyst, Citigroup Global Markets, Inc.
Q

Hi. Aside from cold weather, I was wondering if you could just talk about why the direct-to-consumer business was so much stronger than your plan? Why do you think your consumer started to shift more of her purchases online this quarter? And kind of how do you see the cost trending going forward into Q4 and next fiscal year?

David Powers
President, Chief Executive Officer & Director, Deckers Outdoor Corp.
A

Yeah, I think a couple things. I think some of the exclusive product that we had in our DTC channel paid off in having a reason to go to our e-commerce site or to our stores.

I think the digital marketing teams have done a tremendous job of reaching our consumers in a more qualified and targeted way, driving them to our sites.

And I'm particularly pleased with the e-commerce results, despite the fact that we did open Amazon, and we had Macy's as a key partner selling online as well. So again, speaks to the strength of the brand and the work that the digital marketing teams are doing.

And then in our stores, I think we heard quite a few comments over the quarter, and I would agree, that the stores looked better than ever, because of the lifestyle component in the stores. So more compelling head-to-toe storytelling, better presentation, helped with conversion, helped with ASPs and UPTs. And so we'll continue to build on that momentum.

I feel good about those channels going forward. There's still a traffic headwind out there and people shifting online, but our omni-channel capabilities are helping greatly. And we opened an East Coast 3PL this quarter, which improved our delivery time to consumers quite dramatically. That was an investment that we made but that paid off in better customer service and better sales.

Thomas A. George
Chief Financial Officer, Deckers Outdoor Corp.

A

As far as the comp assumptions in the fourth quarter, our DTC comp is expected to be up low single-digits, and that's compared to flat a year ago, and that brings the total year up mid single-digits relative to low single-digits last year.

David Powers
President, Chief Executive Officer & Director, Deckers Outdoor Corp.

A

Yeah.

Corinna Van Der Ghinst
Analyst, Citigroup Global Markets, Inc.

Q

Okay. Great. That's really helpful. And then just a quick follow-up on your comments around your supply chain initiative. Can you provide a little bit more color on kind of some of the specific projects that were completed this fiscal year? What you're looking to accomplish over the next year? And kind of what inning you feel like you guys are in right now in terms of those projects?

David Powers
President, Chief Executive Officer & Director, Deckers Outdoor Corp.

A

Yeah, so we're making great progress in there. A lot of it has come down to material sourcing. We've done great work over the last couple years on sheepskin pricing and utilization of those materials.

But the teams across the board from the product design and development and go-to-market teams and the supply chain have worked on shortening our product development cycle on key styles, improving SKU efficiency, and just making sure that we are spending the time in the right areas, so that the factories can provide better pricing on some of our key franchise styles that are going to help the bottom line overall.

Continuing to move production outside of China into Vietnam, we've made great progress there. And then continuing the consolidation of our factory base.

So I think that there's still opportunity there, and the teams are working against that, and we've identified that within the FY 2020 plans. But it's good to see that that work across the board from a focus of the teams all the way from design to the sourcing teams is paying off sooner than expected.

Corinna Van Der Ghinst
Analyst, Citigroup Global Markets, Inc.

Q

Okay. Thank you.

Operator: Our next question comes from Bob Drbul, Guggenheim Investments. Please proceed with your question.

Robert Drbul
Analyst, Guggenheim Securities LLC

Q

Hi, guys. Good afternoon.

David Powers
President, Chief Executive Officer & Director, Deckers Outdoor Corp.

A

Hi, Bob.

Robert Drbul
Analyst, Guggenheim Securities LLC

Q

Just a couple questions. The first one is, can you give us an update on the Koolaburra brand at Kohl's and can you discuss the opportunity to sell the UGG brand at Kohl's and where that relationship stands today?

David Powers
President, Chief Executive Officer & Director, Deckers Outdoor Corp.

A

Yeah, so this is the second year of Koolaburra in the marketplace. We initially launched with Kohl's last year. And the performance of that brand in Kohl's and other key accounts that we sold to this year were great. So very pleased with how that brand has performed. The accounts like it because it's higher-priced than some of the private label or lower-priced cold-weather boots have performed in their channel. So it gives them higher-price, good and healthy margins, which helps with obviously their ASPs in their channel as well.

As far as the opportunities for that going forward, we're going to build on that momentum, we're going to expand to some key accounts going into FY 2018. We have improved margins from the scale that we're getting through those accounts. And so we still see Koolaburra, while small, but can have an impact on growth for the company over the next couple of years, and we're continuing to drive that fast because it's resonating well with the consumer and important in those key accounts.

With regards to UGG. If you remember, when we launched Koolaburra we said we are launching it so that we can better segment UGG in the marketplace. There are absolutely no plans to bring UGG down to Kohl's or that level of the market, the family channel, or the mid-tier department stores. We're utilizing Koolaburra as a way to continue to elevate UGG in the marketplace, but fill in some of that distribution gap with the Koolaburra brand which we think has opportunity going forward.

Robert Drbul
Analyst, Guggenheim Securities LLC

Q

Great. And on that one of the categories you called out was the slipper business. Is that specifically to a younger customer, the 18 to 24-year old customer that you feel like you're making progress with? Or is that sort of a broader success that you're experiencing today?

David Powers
President, Chief Executive Officer & Director, Deckers Outdoor Corp.

A

I think it's a broader success, but the sharp point is the younger consumer. And what I love about it is you are starting to see – there's a slipper moment happening, and I think UGG is leading it, and I think we're going to take full advantage of it both in men's and women's. Our Tasman style is doing extremely well, that's a heritage style that's been in the line for some time, and you're starting to see that be adopted by the younger male and female consumer.

And a lot of the fashion iterations the team has done on slippers are working very well and getting noticed by younger consumers. So the core slipper business is strong, and the new slipper business that we are creating through fashion iterations and more of an indoor, outdoor mentality are performing well and creating energy for the category.

Robert Drbul
Analyst, Guggenheim Securities LLC

Q

Great. Thank you very much, guys.

Operator: Ladies and gentlemen, we have reached the end of the question-and-answer session and I would like to turn the call back to Dave Powers for closing remarks.

David Powers
President, Chief Executive Officer & Director, Deckers Outdoor Corp.

Thanks. We are extremely pleased with our performance in the third quarter, and this once again demonstrates we are on the right path. The team's ability to exceed our targets over the last year is proof that we are aggressively pursuing and implementing improvement opportunities and driving long-term value to our shareholders.

I'm especially impressed with the tenacity and focus of the team despite the numerous distractions the company faced over the last year. This demonstrates the strength of the Deckers organization. Our board of directors, the management team and employees are committed to realizing our long-range vision. I'm proud of all of our accomplishments to this point, but know there is still work ahead. I want to thank all of our stakeholders for their support and continued dedication to improving our organization as we continue on this journey.

Operator: This concludes today's conference. You may disconnect your lines at this time. Thank you for your participation.