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Deckers Outdoor Corp. (DECK)

Q2 2020 Earnings Call

CORPORATE PARTICIPANTS

Erinn Kohler
Senior Director-Investor Relations & Corporate Planning, Deckers Outdoor Corp.

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

Steven J. Fasching
Chief Financial Officer, Deckers Outdoor Corp.

OTHER PARTICIPANTS

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

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

Sam Poser
Analyst, Susquehanna Financial Group LLLP

Ross Licero
Analyst, Telsey Advisory Group LLC

Paul Lejuez
Analyst, Citigroup Global Markets, Inc.

Tom Nikic
Analyst, Wells Fargo Securities LLC

Janine Stichter
Analyst, Jefferies LLC

Mitch Kummetz
Analyst, Pivotal Research Group

MANAGEMENT DISCUSSION SECTION

Operator: Good afternoon, and thank you for standing by. Welcome to the Deckers Brands Second Quarter Fiscal 2020 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'll now turn the call over to Erinn Kohler, Senior Director, Investor Relations and Corporate Planning. Please go ahead.

Erinn Kohler
Senior Director-Investor Relations & Corporate Planning, Deckers Outdoor Corp.

Hello, and thank you, everyone, for joining us today. On the call is Dave Powers, President and Chief Executive Officer; and Steve Fasching, 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, and earnings per share, as well as statements regarding our strategies for our products, and brands.

Forward-looking statements made on this call represent management's current expectations and are based on information available at the time such statements are made. Forward-looking statements involve numerous known and unknown risks, uncertainties and other factors that may cause our 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, and quarterly reports on Form 10-Q.

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.

Please note that throughout this discussion there may be references to certain non-GAAP financial measures for comparable prior-year results. These non-GAAP financial measures refer to results before taking into account non-recurring charges that are not believed to be core to our ongoing operating results. Our non-GAAP financial measures are not adjusted for constant currency. While we do not have any non-GAAP financial adjustments for the second quarter of fiscal 2020, a reconciliation between our reported GAAP and non-GAAP results for the prior year can be found in our earnings release that is posted on our website under the Investors tab.

With that, I'll now turn it over to Dave.

David Powers

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

Thanks, Erinn. Good afternoon, everyone, and thank you for joining us today. The Deckers team has delivered yet another strong quarter. For the second quarter of fiscal 2020, revenue increased by 8% versus last year to $542 million. Gross margins came in above 50%, and we delivered earnings per share of $2.71. These results are above the high end of our guidance range due to the outperformance in the HOKA ONE ONE brand as well as the strength seen through early shipments related to the UGG brand domestic business.

During the second quarter, we continued to drive momentum in our key initiatives, as HOKA continued to experience explosive growth, UGG men's boots increased by high teen percentages, UGG women's non-core expanded through the Fluff franchise and our online performance was strong. The Deckers team is focused on the execution of these key initiatives. And I believe our commitment to investing in marketing and innovation have been central to the strength of our results. Our results also highlight the organization's focus and discipline to drive healthy top line growth, while maintaining our top tier levels of profitability.

I'll now review the brand highlights from the quarter, starting with the Fashion Lifestyle group. The Fashion Lifestyle group consists of the UGG and Koolaburra brands. For UGG, global sales in the second quarter were up 2% versus the prior year to $405 million, driven by continued strength domestically with some offsets in our EMEA region. The health of our domestic business has been driven by a clean marketplace, thanks to our allocation and segmentation strategy as well as targeted investments in digital marketing and PR.

UGG brand interest in the US was up 11% in the quarter versus last year according to Google trends. In particular, we have seen another 20-plus-percent increase in customer acquisition within the key 18 to 34 year old demographic. This targeted demographic increase has been driven by the powerful organic PR earned by the UGG brand, which includes several high profile celebrities photographed wearing our product.

From a product perspective, the Fluff Yeah Slide shows no signs of slowing down. The hybrid sandal slipper has been a steady acquisition vehicle for new consumers online in addition to continued momentum in the wholesale channel. The UGG team has built a thoughtful plan for lifecycle management aimed at optimizing the Fluff franchise's differentiated points of distribution.

The women's non-core business is also experiencing early success with the newly launched Classic Femme, which is the fashion forward take on our iconic Classic boot. The UGG design team has done a fantastic job of delivering compelling new product with strong ties to our heritage styling. I believe the Classic Femme, combined with new products featured in the recent launch for our women's classics revolution campaign, go a long way in highlighting the depth of the UGG brand's differentiated product offering. Due to these new product introductions and segmented distribution strategy, our women's business is experiencing an increasing adoption from younger consumers.

On the men's side, I'm pleased with the early response to the Neumel Nation marketing campaign, our largest ever men's specific campaign, which drove a double-digit increase in the number of male consumers to UGG.com with over half of them being new to the brand. For the campaign, we partnered with actor and fashion influencer, Luka Sabbat, who well represents the UGG brand ethos of defying convention and changing culture. On the heels of Neumel Nation, UGG released its second limited edition collaboration with fashion designer Heron Preston. The collection features two heritage styles the Tasman Slipper and Classic Mini with updated features and benefits. Both the Neumel Nation marketing campaign and collaboration efforts are aimed to driving increased awareness and consideration from young male consumers, and I look forward to the results they will drive in our third quarter.

On the international front, we are in the early stages of a multi-year plan to reset the marketplace in our EMEA region. As a reminder, the marketplace reset in Europe is similar to the strategy that we successfully implemented in the domestic wholesale marketplace over the past few years. This strategy is intended to clean up inventory in the market place, consolidate the account base to focus on partners who best represent the UGG brand, and provide a more differentiated consumer experience. The end goal of this strategy aims to enhance the consumer experience with the UGG brand. We believe this strategy has been key to our domestic success and, as a result, we're working to drive successful implementation in the EMEA region. The revenue headwind of these actions, in addition to the impact of currency, is in total estimated to be approximately $25 million to $30 million for the remainder of fiscal year.

Overall, I'm encouraged by the progress UGG is making with a variety of consumer segments, and look forward to continued strides in our holiday quarter as we launched our largest ever holiday campaign. The holiday campaign will celebrate the gift of UGG with a Los Angeles based A-list music family. Look out for that launch over the coming weeks.

Turning to Koolaburra. Global sales in the second quarter increased 41% versus the prior year to $26 million. Koolaburra growth was aligned with the brand strategy of gaining market share in the domestic wholesale family value channel. We're excited to be launching Koolaburra with a few new partners this season in conjunction with the increased demand experienced with our existing partners. The brand is also testing some category extensions this fall, which includes the launch of licensed home product with Kohl's. Having said that, our near-term focus for the brand remains on building compelling footwear targeted for the family value channel.

At the close of the second quarter, I feel both UGG and Koolaburra are well positioned to capture holiday demand through segmented and differentiated product in their respective channels of distribution.

Shifting to the Performance Lifestyle group, which is comprised of HOKA ONE ONE, Teva and Sanuk. HOKA continues to exceed expectations. For the second quarter, HOKA global sales increased by 50% to $78 million. Similar to the first quarter, the HOKA brand's growth is well balanced with strength domestically, internationally, and across both wholesale and direct-to-consumer channels.

From a product perspective, the HOKA brand experienced success in both its core franchises as well as with new product introduction. On the franchise front, Clifton and Bondi continued to experience significant growth year-over-year. In the meantime, HOKA is also finding success with new styles such as the Carbon X and Rincon, which are bringing new consumers to the brand. The HOKA evolution is best evidenced by recently becoming the number two brand in terms of run specialty market share for the month of August according to NPD.

The Rincon was released in July with a target to acquire high school and college aged athletes. This innovative new silhouette was designed with the lightweight cushion expected in a typical HOKA shoe but a more accessible price point. The coordinated Rincon marketing campaign was highly successful in the quarter with 50% of online consumers being new to the brand, and nearly 40% of those consumers represented in the 18 to 34 year-old demographic.

In terms of new product launches, for the spring 2019 season, I'm happy to announce that every single new product HOKA launched won an award. These accolades range from the Rincon winning Editor's Choice by Runner's World, to the Carbon X winning Gear of the Year from Outside magazine. This recognition is a direct result of developing innovative high-performance product, and combining it with the right marketing and distribution. Congrats to everyone involved in these impressive achievements. This is yet another indication of strength of our product and innovation engine at Deckers.

Shifting to Teva. Global sales in the second quarter increased by 7% to $23 million. The Universal and Hurricane franchises continued to drive brand momentum, so much so that Teva was able to regain the title of number one in market share within the sports sandal category for the spring 2019 season according to NPD.

The brand had an impressive spring season both in terms of revenue performance and brand heat. Teva was featured in The New York Times as well as an article in Vogue that gave Teva the honor of being called "The Shoe of Summer." Congrats to the Teva team on a great spring season.

Looking to fall, we are encouraged to see the Ember franchise and corresponding marketing campaign had continued to be an acquisition vehicle for the brand, driving a nearly 50% increase in search interest according to Google trends.

For Sanuk, global sales in the second quarter were $11 million. Most of the decline versus last year is attributable to the weakness in the Yoga Sling franchise. As noted during our Q1 earnings call, we've made the strategic decision to exit the warehouse channel to focus on healthier full price channels. We expect sales volumes will continue to decline for the balance of FY 2020, but remain focused on exploring healthier avenues for brand distribution as we work to reposition it in the marketplace.

All of Deckers brands and marketing teams are making great strides on building compelling product with targeted and diverse consumers in mind in conjunction with a strategic global marketing plan that enables increased investments. Our brand strong PR in addition to focused digital marketing efforts are what drove first half performance. And I look forward to additional progress on that front.

Moving to channel performance in the second quarter, global wholesale increased by 9% versus the prior year, driven primarily by domestic expansion in UGG, HOKA, and Koolaburra as well as international expansion of HOKA and Teva. Gains in HOKA and Teva internationally have mostly been driven by the strength of our Asia Pacific region. In aggregate, international wholesale was slightly down versus the prior year due to the UGG reset in EMEA as well as negative pressure from foreign currency exchange rates.

From a direct-to-consumer perspective, comparable sales increased 7% versus the prior year with total DTC sales up 5% versus the second quarter last year. E-commerce continues to drive gains in the DTC channel, which has been led by the strength of UGG and HOKA. The HOKA brand's gains in DTC are shifting the channel mix dynamics for the brand, which is leading to an improved gross margin profile. While largely a selling quarter, our second quarter performance was solid, but the Deckers team remains focused on delivering our largest third quarter ever. I'm confident that with the recent momentum of the business, we are well positioned for the back half of the year.

I'll now hand the call over to Steve to provide more details on our second quarter financial performance as well as outlook for the third quarter and our full fiscal year. Steve?

Steven J. Fasching

Chief Financial Officer, Deckers Outdoor Corp.

Thanks, Dave, and good afternoon, everyone. As Dave just mentioned, we have tremendous momentum in the business and have delivered a record second quarter. This quarter is yet another example of the progress we have made in growing our brands, while at the same time delivering improved levels of profitability. And now, I'll walk you through some of the elements of the quarter.

Revenue was $542 million, up 8% versus last year, and above the high end of our guidance range of $515 million to $525 million. Of the better-than-expected performance, approximately $10 million was driven by the HOKA brand, with exceptional results both in wholesale and direct-to-consumer channels, with the balance of the beat driven by earlier domestic wholesale shipments for the UGG brand.

Overall, gross margins were up 20 basis points over last year to 50.4%. This result was an improvement over our implied guidance with the main drivers of the variance to expectation coming from savings from the utilization of less expensive freight options, an improvement from higher gross margin rates on close-out sales, and a favorable mix with the HOKA brand increasing its penetration to the total company, beyond what we had anticipated including incremental growth in e-commerce. These partially offset by channel mix as wholesale grew faster than DTC.

In terms of SG&A expense, our dollar spend was up 8.9% to $175.9 million compared to last year's GAAP spend of $161.5 million and up 9.1% compared to last year's non-GAAP spend of $161.2 million. The spend was aligned with how we guided the quarter. This increase versus last year was driven primarily by incremental marketing investments that have been put in place to drive awareness around the HOKA brand, UGG men's product, as well as the extended UGG women's offerings.

This all resulted in earnings per share of $2.71 compared to last year's GAAP earnings per share of $2.48, last year's non-GAAP earnings per share of $2.38, and the high end of our guidance range of $2.15 to $2.25. The $0.46 beat to the high end of our guidance came from $0.15 of increased HOKA performance, $0.15 of favorable gross margins including savings in freight and a higher margin rate achieved on close-out sales, $0.10 from earlier domestic wholesale shipments from the UGG brand, $0.03 from reduced share count related to the repurchase of shares in the second quarter, and $0.03 from a lower tax rate for the second quarter due to timing of discrete tax entries partially offset by the reduced interest income.

During the quarter, we repurchased approximately 1.1 million shares of the company's common stock at an average price of $145.31 for a total of $155 million. As of September 30, 2019, $160 million remains available under our share repurchase authorization.

Our balance sheet at September 30 remained strong as cash and equivalents were $178 million, down 2% from $182 million at September 30 of last year, which includes repurchasing $155 million worth of shares during the second quarter. Inventory was up 8.5% to $559 million from $515 million at the same time last year, and we had $14 million in short-term borrowings under our credit line as compared to $71 million last year.

Before moving on to our updated guidance, I'd like to reiterate the performance achieved in the first half of fiscal 2020 as compared to the first half of last year. Our portfolio of brands delivered $819 million in revenue, representing a 9% increase versus prior year, driven by a disciplined approach to driving our key initiatives. Strong gross margins of 49.2% were achieved, an increase of 46 basis points.

And even with the strategic reinvestment, we experienced SG&A leverage with operating expense decreasing as a percentage of revenue, all this leading to a 27% increase in operating income for the first half of the year and a nearly 50% increase in earnings per share versus the first half of last year.

Now, moving on to our outlook. For the third quarter of fiscal 2020, we expect revenue to be in the range of $885 million to $900 million, which anticipates growth in the range of 1% to 3%. This is on top of the strong increase that we experienced in the third quarter of last year. To provide some additional color on the brand elements, we expect UGG to be roughly flat as the domestic strength will be largely offset by international pressures, strong growth with both the HOKA and Koolaburra brands, a year-over-year decline in the Teva EMEA business, which will be offset with growth in Q4 due to the timing of the distributor orders and lower sales in Sanuk, with this resulting in earnings per share to be in the range of $6.30 to $6.40.

Within our third quarter guidance, we expect global wholesale reorders for the UGG brand to equal cancellations, and we are expecting an increase of promotional activity as compared to the prior two years.

Next, for fiscal year 2020, we are updating our financial guidance. We are increasing sales from our prior range of $2.1 billion to $2.125 billion to now be in the range of $2.115 billion to $2.14 billion, an increase of $15 million. This increase in guidance reflects the strength and the momentum that we continue to see in the HOKA brand with the raise related to the second quarter performance as well as the lift on the balance of the year for the brand. Our expectations for the HOKA have continued to climb well beyond our original outlook for the year. But it is important to keep in mind that, with this increase, our near-term ability to chase further incremental revenue for HOKA is limited due to timing of inbound inventory.

As we have pivoted into the peak selling season for the UGG brand, our full-year outlook for UGG remains consistent with our original guidance for fiscal 2020, at flat-to-low single-digit revenue growth. As previously mentioned, our outlook assumes a higher level of promotional activity as compared to last year and remains unchanged for the back half of the year.

To summarize our updated outlook for the full year at a brands level is as follows: UGG revenue expectations remain flat to up low-single digits; HOKA is now expected to be up in the mid-to-high 40% range; Teva is still expected to be approximately flat, inclusive of the EMEA distributor channel shift; Sanuk is expected to be down in the 30% range; and Koolaburra in still expected to grow in the mid-50% range.

Turning to the remainder of the P&L, gross margins are expected to be approximately 50.8%, SG&A as a percent of sales are anticipated to be slightly lower than 36%, operating margin are now expected to be approximately 15%, and we are raising our expected earnings per share to be in the range of $8.90 to $9.05 on a newly updated share count of approximately 28.7 million shares with a full-year tax rate of 20.5%.

The roughly $0.45 raise in earnings per share is being driven by increases of $0.20 from higher HOKA brand sales, including the second quarter beat and raised expectations for the back half of the year, $0.20 related to the second quarter share repurchase, and $0.15 from favorable second quarter gross margins. These partially offset by $0.10 of additional expense added in the second half as we continue to shift our expense profile from fixed to variable spend allowing us to reinvest in our key initiatives and support our increased full-year revenue outlook.

Our guidance for the third quarter and fiscal year 2020 excludes any potential non-GAAP charges as well as the effect of any future share repurchase. Additionally, we believe that we have been able to mitigate any material impact from tariffs in the current fiscal year 2020. On that topic, we are continuing to assess the impact of tariff policy decisions going forward. As there still are a lot of factors to work through, we are not yet providing an estimate on the impact beyond fiscal year 2020. We are evaluating options that can potentially offset these increased costs, including considerations of pricing power within our brands as well as continuing conversations with our suppliers who are willing to work with us.

As a reminder, we have stated that less than 20% of our current global production is created in China and shipped to the United States. During this period, we also provided an update on our sheepskin pricing. We continue to see stable prices in the sheepskin market and we expect no change in the sheepskin cost for fiscal 2021. This does not constitute our gross margin guidance for next year as our sheepskin costs are only one component of our gross margins.

With our strong first half results behind us, we remain confident in delivering the expectations outlined for the balance of the fiscal year. Our full year guidance implies second half revenue growth of 2% to 4% versus last year. This is on top of the 5% growth achieved in the second half of fiscal 2019.

To summarize our full-year guidance, we are now projecting top line growth in the range of 5% to 6% with the intention of delivering a 15% operating margin. To achieve this, the Deckers organization is focused on executing our strategies in the upcoming peak holiday season. And while there is work ahead of us, I would like to thank the team for their continued dedication and energy put into our brands everyday.

With that, I'll now turn it back to Dave for his closing remarks.

David Powers

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

Thank you, Steve. As I look back on the first half of this year, I'm encouraged by the progress we've made on our key initiatives. This includes investing in marketing to drive brand heat and awareness in HOKA, UGG men's and UGG women's non-core, building our technology tools and talent base to advance analytical capabilities and drive efficiencies in how we connect with consumers both existing and acquired, and using innovation to develop incremental opportunities that can add value to our brand portfolio.

I would like to thank all of the Deckers employees across the globe for their continued devotion to delivering strong results through the execution of our strategies.

But before I turn the call over to Q&A, as you may have seen in our earnings press release earlier this afternoon, Mike Devine has been appointed to the role of Chairman of the board. Mike has been on the board for the past eight years and assumes the role from John Gibbons. I look forward to working with Mike in this capacity.

John will remain on the board, and I'd like to thank him for his leadership as Chairman. The past few years have been transformational for Deckers and John has been a great partner in this journey. John's insight and expertise has been instrumental on our progress, and I'm extremely grateful for his contributions to the Deckers organization. And as always, I would like to thank all of our stakeholders for their continued support. I'm excited about the opportunities in front of us and the direction our organization is headed.

With that, we'll now open the call to Q&A. Operator?

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] The first question today comes from Jonathan Komp of Baird. Please go ahead.

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

Q

Yeah. Hi. Thank you. I want to maybe start with the UGG brand and curious to hear a little bit more color, what you're seeing in the marketplace. I know you called out some earlier deliveries, I'm curious maybe what drove that. And then, as you look to the third quarter, just given how favorable conditions were last year, any updated thoughts on what you expect over the next few months as you cycle some of that favorability?

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

A

Yeah. Jon, this is Dave. The early deliveries were just opportunistic. One of our accounts or couple of our accounts were open to receiving some inventory a little bit earlier, so we took advantage of that, but the setup for the quarter looks good. As you know, we've been working particularly in North America to really clean up the channel, going into the season coming out of a strong last year. The inventory is very clean, the accounts were set up, we've had a little bit of warm start in the season, but the sell-through is still good at wholesale. And I think we are poised with the diversification efforts in the segmentation and allocation plans for a good quarter.

Obviously, as you heard, there is some softness still in the European market, a lot of that is by design with the segmentation and allocation strategy and the market reset, coming out of the UK there, but still some macro headwinds with Brexit going on and the malaise of UK consumer, but all in all, I think the way that we have been focusing on younger consumer, diversifying the product offering, managing the marketplace very tightly, working with our key wholesale partners and going to the back half of the year with increased marketing investments, we feel we're in a solid position.

Steven J. Fasching
Chief Financial Officer, Deckers Outdoor Corp.

A

Yeah, just – this is Steve, Jon. Just to add on that, as we look at the UGG domestic wholesale, business is good; channel for us is relatively clean, which is why our customers want product and we have an ability to ship on products, so we'll take advantage of that. As Dave said, international will be down as we reset Europe, but other than that, all the signs are good at this point and the product is resonating.

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

A

Yeah. We are hearing of some softness in the channel at a macro level. Obviously, there is some news out there about soft-line softness and some of the wholesale partners managing tightly with their inventory, but as far as our brand set up particularly with UGG, Koolaburra and HOKA, we're still seeing healthy demand and good positioning.

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

Q

Yeah. That's encouraging to hear. Maybe one on HOKA then, just given that when I look over even on a trailing 12-month basis, I think you've added about $100 million of revenue to the brand, which is quite impressive. I'm just wondering as you look kind of breaking through to the next phase of growth, any updated thoughts on the team and the infrastructure and kind of the level of investment in place to support the growth maybe longer term as some of the inventory constraints become less so?

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

A

Yeah, I think one of the beauties of Deckers and our platform that we've been working on over the last few years to really improve our capabilities across the board is to be able to support the growth and the hyper growth of the HOKA brand. And obviously, with a margin profile of that brand, the efficiencies we've created across the organization, we're well-positioned to continue to invest not only just in the marketing dollars, but innovation design, sourcing of that brand and for the distribution globally. So, it's exceeding our expectations. We're in a little bit of chase mode on inventory, but we're in a good shape to be able to capture the demand at this point. We're planning for a continued strong growth in that brand, and so we are – you'll see as we guide at the beginning, going into FY 2021, continued investment to be able to continue the growth of that brand.

And it's really a global opportunity. As you know, North America wholesale in DC is very strong for that brand, but we're seeing tremendous growth still in Europe, Japan and we haven't really started going after China yet. So, very pleased, very excited with the acceptance and the demand coming from the consumer. The innovation pipeline is still strong and the designs that will be coming out over the next 6 to 12 months, we feel, will continue that momentum and we're going to continue to invest in it.

Steven J. Fasching
Chief Financial Officer, Deckers Outdoor Corp.

A

Yeah, and great international opportunity.

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

A

Yeah.

Steven J. Fasching
Chief Financial Officer, Deckers Outdoor Corp.

A

Continuing to see kind of that brand resonate on an international front and a lot more opportunity on that international front.

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

Q

Great. And maybe just last one, if I could, maybe bigger picture for the organization, Steve or Dave, you're planning this to be the third year of mid-single digit top line growth. And you've reset the operating margin back to 15% here, just any broader thoughts on how you view kind of the growth trajectory going forward for the company and any sort of kind of an algorithm even at the high level to think about as a sustainable level?

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

A

Yeah, we've worked hard to get to this point. And I give the teams a lot of credit for their discipline, while at the same time really building strong healthy brands across our global marketplace. And for us, there is no looking back. We're continuing down this path. We think that we have some very meaningful and important brands for the consumer and our wholesale partners. And we believe that we can continue this level of growth in mid-single digits, and then 15% operating margin for the foreseeable future for sure.

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

Q

Okay. Appreciate all the color. Thank you.

Steven J. Fasching
Chief Financial Officer, Deckers Outdoor Corp.

A

Thanks, Jon.

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

A

Thanks.

Operator: The next question today comes from Jim Duffy with Stifel. Please go ahead.

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

Q

Thanks. Good afternoon.

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

A

Hey, Jim.

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

Q

A couple of questions from me. First, I wanted to ask about the purposeful turn in the European business. Dave, can you give us some milepost to look for, for your progress with that? I know you've been through this before in the US market, when do you expect to come out the other side with the European business?

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

A

Yeah, as we said before, it's a multi-year strategy and we do have proof-of-concept with this strategy in North America, which took us two to three years to really get to the real strength of where we are now, so I would expect the same in Europe. This is really the first time that we have been pulling back on inventory with the allocation strategy and reducing the amount of off-price sales. Part of what you're seeing in the takedown of the projection this year is the decision to not chase off-price sales. We're more focused on creating a healthy long-term position for the UGG brand versus chasing a revenue number, and I think that's the right thing to do.

The teams have been working very hard on the allocation strategy there and making sure that each account has differentiated point of view and going after the right consumer with the appropriate product. My sense is, we will come out at the end of this year in a much better inventory position and cleaner marketplace, and then we can really start the reset going into FY 2021 for fall 2020.

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

Q

Great. And Dave, I wanted to ask about the HOKA brand, you've had some good success with non-performance running styles, the hiking boot, the Hupana shoes, can you talk a little bit about opportunities that you see beyond just the performance running category for the HOKA brand?

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

A

Yeah, the first thing I would say is all of the product is performance-based and they're all built for running as our core in running and hiking obviously is our core target. That being said, lot of our styles are being adopted by a non-runner consumer both on the fashion side as you see some of the HOKA brand, and kind of the top fashion boutiques across the globe, which is very exciting.

But I think more importantly, the average consumer from an athletic standpoint, people are wearing HOKA, starting to run again or from a casual lifestyle perspective, but the performance attributes of that ultra-lightweight, cushioned performance and that ride resonates with the casual consumer as well. And so, I think you're starting to see a lot more consumers adopt it, because they just love how it feels and, hopefully, some of those consumers are also getting back into running again at the same time.

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

Q

Great. Thank you.

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

A

Yeah.

Operator: The next question today comes from Sam Poser with Susquehanna. Pleased go ahead.

Sam Poser
Analyst, Susquehanna Financial Group LLLP
Q

Good afternoon. Thanks for taking my question.

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

Sure.

Sam Poser
Analyst, Susquehanna Financial Group LLLP
Q

Could you give us the breakdown of where this expected incremental promotional activity is supposed to come from, because I believe in Europe, you were promotional last year, so can you just walk through that expectation I guess both in Q3 and Q4?

Steven J. Fasching
Chief Financial Officer, Deckers Outdoor Corp.
A

Yeah, Sam, so this is Steve. So, we're expecting in our guidance, right, increased level of promotional over last year. We think that will be wholesale with some of the retailers that we're working with, so that's what we've embedded. We'll see how it plays out, right, the biggest part of our season is still ahead of us. We'll see how the consumer shows up. Early signs are good sell-through, clear inventory. So, it's a kind of a wait-and-see, and we'll see kind of what happens. But where it's mostly factored is, is kind of in wholesale with a little bit that you'll see in our DTC business.

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

Yeah. And as you said, Sam, we're not expecting to play into that, the need to be able to – the need to do that in the European business. But we do have the ability to do that, if necessary, in North America wholesale. And I think, as we discussed on last call, if there is upside to the season, it's probably more in the margin side than in the sales side.

Sam Poser
Analyst, Susquehanna Financial Group LLLP
Q

And could you give us some idea of what you expect the gross margin to be in the third quarter?

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

Yeah.

Steven J. Fasching
Chief Financial Officer, Deckers Outdoor Corp.
A

Yeah, so we're kind of implied in our guidance, it's roughly down about 90 basis points from last year.

Sam Poser
Analyst, Susquehanna Financial Group LLLP
Q

Got you. And then, also, are there expenses, I know you're switching this variable model, but are there expenses looking ahead that you sort of expect to fall away next year, given some of the work you're doing in international markets that some of that probably cost some money to do, maybe you closed more stores and so on and so forth, can you give us some idea there sort of just looking ahead?

Steven J. Fasching
Chief Financial Officer, Deckers Outdoor Corp. A

Yeah, we haven't given anything out on 2021, it's something clearly that we'll look at, I wouldn't right now factor in kind of anything from a significant expense reduction. A lot of the work that we're doing is kind of with the infrastructure that we have, so, once we get back to growth, we'll need infrastructure to support that growth. So, there we'll be able to kind of use our existing infrastructure to lever growth as we return to growth on the international.

So, from that standpoint, again, we haven't given guidance on next year, but I wouldn't expect a significant fall-off. I think to the earlier question about how we look at our P&L profile, looking at a 15% operating margin, we're going to spend appropriately as we have now seen a lot of our gross margin efforts come through.

And then, the shift to variable that we're talking about is really about how we invest more in marketing to drive the initiatives to build brand awareness around the things that we're doing. So, building awareness with HOKA, building awareness with men, with UGG, building awareness with spring summer, women's and UGG as well. So, and when we look at that, still a lot of opportunity.

Sam Poser
Analyst, Susquehanna Financial Group LLLP Q

Thank you. I've two last questions. One, what tax rate do you expect for the third quarter? And lastly, could you give us the direct or the wholesale sales by brand, so we don't have to wait for the Q, so it's easier to model everything going forward please? Thank you.

Steven J. Fasching
Chief Financial Officer, Deckers Outdoor Corp. A

So, the tax rate for Q3, we haven't given that, but there is going to be some fluctuations between Q3 and Q4, but roughly we are kind of modeling that like 21% interest rate for Q3.

And then I think your second question was just the – sorry, it was the wholesale breakout UGG in Q2.

Sam Poser
Analyst, Susquehanna Financial Group LLLP Q

No, for the wholesale for the DTC breakup by brand for the second quarter that comes out in the Q, but it really would help us model everything if you would give us one or other and we can back in to other one.

Steven J. Fasching
Chief Financial Officer, Deckers Outdoor Corp. A

Yeah, I can take that out, so the – you want it in total wholesale?

Sam Poser
Analyst, Susquehanna Financial Group LLLP Q

No, like UGG wholesale was this, Teva wholesale was this, Sanuk wholesale was this, HOKA and so on.

Steven J. Fasching
Chief Financial Officer, Deckers Outdoor Corp.

A

Okay. Sure, got you. So, of the $542 million, $332 million was UGG brand wholesale, roughly $51 million was HOKA brand wholesale, Teva was $17 million, Sanuk was $8 million and Koolaburra was around $25 million.

Sam Poser
Analyst, Susquehanna Financial Group LLLP

Q

Thank you very much. Continue the success.

Steven J. Fasching
Chief Financial Officer, Deckers Outdoor Corp.

A

All right. Thanks.

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

A

Thanks, Sam.

Operator: The next question today comes from Ross Licero with Telsey Advisory Group. Please go ahead.

Ross Licero
Analyst, Telsey Advisory Group LLC

Q

Hi, guys. Thanks for taking my questions, and congratulations on the quarter. Just had a question we've been hearing a lot about stability in the market rate now, can you talk about what you're doing for that how you're messaging it to the customer?

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

A

Yeah. It's a great question. And I think if you've seen some of the – if you've been to our website, Deckers website, I'll start there, couple of years ago, we put out some sustainability goals. We call them our 7 by 2027. That have guided a lot of the activities around sustainability for Deckers, but also each of our brands. And over the last three to six months, each of the brands is doing individual work to improve the way they operate across the planet both in product and then in just kind of operational areas as well.

I can't get into all those specifics that are happening right now, but there is work being done, and we are going to see some more conversations happening in the marketplace with each of our brands, around efforts they are making, but it is probably best at a brand level versus the Deckers level to focus into that because there is unique approaches to this space, based on the brand positioning and the relevancy in that marketplace and for the consumer. But I'm excited to say that is something that Deckers, as an organization, is taking seriously. We are standing behind it with our global 7 by 2027 goals and within each of the brand and the work that they are doing. And I think you'll see some continued evolution in the product that we're bringing to market on the short term.

Ross Licero
Analyst, Telsey Advisory Group LLC

Q

Okay. Great. Thanks. And on the men's side, you said the men's boots were up double-digits, but did you – can we get a little more color on men's overall?

Steven J. Fasching
Chief Financial Officer, Deckers Outdoor Corp.

A

Men's overall UGG for Q2?

Ross Licero
Analyst, Telsey Advisory Group LLC

Q

Yes.

Steven J. Fasching
Chief Financial Officer, Deckers Outdoor Corp.

A

Yeah. So, other than – just men's is growing faster than the average overall, so men's is up more than the average.

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

A

Yeah.

Ross Licero
Analyst, Telsey Advisory Group LLC

Q

Okay. Great. Thanks a lot.

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

A

Yeah. It's really focused on Q3, if you've seen our Neumel, we are calling it Neumel Nation marketing campaign, their efforts in the script, very great, very positive response to that campaign. As we said, that's driving interest at the brand and traffic, but the product is really a Q3 product, so you should see the bigger impact of that business happening over the next couple of months focused on the Neumel and winter boots.

Ross Licero
Analyst, Telsey Advisory Group LLC

Q

Okay. Thanks.

Operator: The next question today comes from Paul Lejuez of Citi Research. Please go ahead.

Paul Lejuez
Analyst, Citigroup Global Markets, Inc.

Q

Hey. Thanks, guys. Can you maybe talk about gross margin trend by channel? What channels were the driver of the improvement this quarter, when you're looking at each channel relative to itself? Also curious, if you've seen a lot of fluctuations or inconsistency, with the inconsistent weather out there. And I guess I'm kind of curious how you'd look at what percent of your assortment that would you consider weather-dependent this year versus what percentage it was last year? Thanks, guys.

Steven J. Fasching
Chief Financial Officer, Deckers Outdoor Corp.

A

Yeah. Let me walk you a little bit maybe just through the margin walk rather than kind of breaking that. So, a year ago, we were at 50.2%; this year, we're at 50.4%, so a 20 basis points improvement. About 50 basis points of improvement through margin expansion, so that's just achieving better margin on product as we continue to work on those efforts. We had, as I mentioned, part of a driver of the increase in our margin was really kind of better full price selling, so less promotion, better margins on our close-out. That was about 80 basis points. And then we had a takeaway relief from FX about 70 basis points, the channel mix because we had more wholesale growth that was about 20 basis takeaway, and then kind of miscellaneous other stuff roughly 20 basis points, so that's kind of the walk on the year-on-year.

Paul Lejuez
Analyst, Citigroup Global Markets, Inc.

Q

All right. Was the full-price selling benefit in both channels? Were you trying to both channels there?

Steven J. Fasching
Chief Financial Officer, Deckers Outdoor Corp.

A

A lot of it came – yes, I mean you could – where we were doing close-outs, so where we have reduced selling online with better as well as some of our traditional close-outs through wholesale.

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

A

Yeah. And with regards to the weather question, for the UGG brand, generally speaking, the whole brand is somewhat weather-dependent with the exception of probably slippers, but what we've been doing over the last few years is to reduce our dependency on cold weather related products. So, for example, we've reduced the reliance on core classics. We brought a lot more fashion boots into the assortment across men's and women's. I think some of the diversified product that you've seen toward the younger consumer is of less weather-dependent, diversifying into men's is less reliant on the core classic business.

So, we're used to be kind of one-trick pony, which is at the core classics across all the channels. The diversification effort, the fashionability of the brand, the diversification across new consumers has given us more fashion relevance and less weather dependency across the board. And I think that served well last year, and it's already stronger this year, and it's something that's going to continue to evolve. So it's less – certainly, we are still depending on the weather, just like everybody else is, but I think we are much more fashion relevant to the consumer now that is looking for product from us just beyond kind of cold-weather product.

Paul Lejuez
Analyst, Citigroup Global Markets, Inc.

Q

Have you actually seen more consistency in business, even though the weather has been inconsistent as a result of those strategies?

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

A

I would say so.

Steven J. Fasching
Chief Financial Officer, Deckers Outdoor Corp.

A

I would say we've seen improvements in other kind of less weather depending categories, absolutely.

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

A

Yeah, for sure.

Paul Lejuez
Analyst, Citigroup Global Markets, Inc.

Q

Got you. Thank you, guys. Good luck.

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

A

Thanks.

Operator: The next question today comes from Tom Nikic with Wells Fargo. Please go ahead.

Tom Nikic
Analyst, Wells Fargo Securities LLC

Q

Hey. Good afternoon. Thanks for taking my question. Quick one on the gross margins. I think you said Q3 should be down 90ish basis points, which would mean at Q4 would be down quite a bit, basically double that amount in basis point. Is that just a function of the hard multi-year compares? Is it tariffs? Just any sort of color around that would be helpful.

Steven J. Fasching
Chief Financial Officer, Deckers Outdoor Corp.

A

Sure. So, you're right, Tom. You've kind of got the numbers right, that is how we're looking at the back half of the year. It's a combination of the things that you mentioned. The big point would be the comparison that we have to last year, right? So, we are assuming a higher promotional back half than what we saw last year. As you recall, last year was a pretty exceptional year, especially – sorry, exceptional back half of the year. We saw sell-through at full price incredibly strong, so not what we normally see, which is kind of why we're taking a slightly more conservative approach as we look at the back half of this year. But that will be the biggest component of the take-back. We'll see how the season plays out, but we do have higher promotional environment factored in into the back half. And then, there is always a component of FX in there, and then you'll have some impact potentially with the tariff piece. So, that's kind of how we are looking at it. We'll see how it plays out in terms of what the margin is, but you're right. And the biggest component of that will be our assumption around a more promotional environment than what we saw last year in the back half.

Tom Nikic
Analyst, Wells Fargo Securities LLC

Q

That's helpful. Thanks. And just a longer-term picture about HOKA. I think, obviously, it's one of the more interesting long-term growth stories in the footwear space. Based on your guidance this year, it's going get to something in the $300 million to $350 million range. Is there any sort of multi-year target you can give, some sort of potential revenue base for the brand that you can see in the next couple of years?

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

Yeah. This is Dave. I mean, really no, we are not prepared to give that kind of guidance right now. I will say that we do think this has significant upside and the strength of the brand that you're seeing now, we see that continuing going into FY 2021 and beyond. Our sights are set above, over the next two or three years, $500 million and beyond.

Tom Nikic
Analyst, Wells Fargo Securities LLC
Q

Got it. And just a quick another one on HOKA, I know you're still early stages international there. Can you give us some sort of sense as to what the domestic versus international split is for the HOKA brand?

Steven J. Fasching
Chief Financial Officer, Deckers Outdoor Corp.
A

Yeah, it's still about two-thirds domestic, one-third international.

Tom Nikic
Analyst, Wells Fargo Securities LLC
Q

Got it. All right. Thanks very much.

Steven J. Fasching
Chief Financial Officer, Deckers Outdoor Corp.
A

Okay.

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

Thank you.

Operator: The next question comes from Janine Stichter of Jefferies. Please go ahead.

Janine Stichter
Analyst, Jefferies LLC
Q

Hi. Good afternoon. Thanks for taking my question. Just one more on the gross margin. I think you called out less expensive freight as a driver as well, just trying to understand what's going on there. I think last year it was a driver of gross margin, you had said you didn't expect it to continue. And then I think you'd called out planning to use more expensive freight in the second quarter this year, so is there anything structural going on there with how you're looking at freight, and how should we think about that continuing?

Steven J. Fasching
Chief Financial Officer, Deckers Outdoor Corp.
A

Yeah. I think the way we are looking at freight, historically, up to last year, we used more air-freight. I think we've gotten better at bringing product in, so that's helped alleviate some of that need to bring in air-freight. We have used a little bit more this year than we did last year, as we're bringing inventory in, where we see spikes in demand largely like HOKA. So, I think we are – and demonstrated by our margin improvement, we are better at how we're bringing product in. We've been working with our factories, doing better job level loading them, that's helping us bring inventory in. It's also helping us schedule it a little bit better. It is also showing up as we bring inventory in a little bit earlier as well.

So, I think through a lot of the efforts and the margin improvements that we're achieving, we're kind of seeing that pay off. So, we'll always use some air-freight. We didn't use quite as much as what we had anticipated in our guidance in Q2. We did use some, but not nearly to the extent that we thought we would. And it's something that we'll continue to look at. So, kind of to your question, things have changed and improved. I think we're doing a slightly better job, but there will always be cases where you're going to have to use some of it, especially when you have kind of hot product and a brand that's in demand like HOKA.

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

But the general cost of freight overall is not coming down.

Steven J. Fasching
Chief Financial Officer, Deckers Outdoor Corp. A

Coming down, yeah.

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

Yeah.

Janine Stichter
Analyst, Jefferies LLC Q

That's helpful. Thank you. And then, just one question on the Fluff franchise. It sounds like that's still growing nicely more than a year in now. Can you just talk about where that growth is coming from? Is it new accounts? Is it deeper penetration in the accounts they're already in? And, how are you seeing the customer you acquire from that franchise? Is she buying other boots or how are you seeing her migrate outside of the Fluff and the Fuzz?

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

Yeah, it's a great question, and it's something that we're really excited about on a number of fronts. First is, we are attracting a younger consumer and a large portion of that younger consumer is first time purchases to our website. So, it's serving as a vehicle for acquisition, as well as driving the business for us in the short and long-term. So, we're going to continue the diversification efforts, still using key partners in those used accounts to reach that consumer, but it really is across the board, where it's performing at least in North America. That style isn't resonating as well in places like China and outside of the UK just yet. But the demand for that product going into the back half of the year and into next year is very strong, and we think this is a franchise that we can build on through continued diversification efforts and design and marketing distribution efforts, for quite some time.

Janine Stichter
Analyst, Jefferies LLC Q

Great. Thank you very much.

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

Thank you.

Operator: The last question today comes from Mitch Kummetz of Pivotal Research. Please go ahead.

Mitch Kummetz
Analyst, Pivotal Research Group

Q

Hi. Thanks for taking my questions. Steve, I was hoping you could reconcile a couple of pieces of the guidance for me. I think you said, for Q3, UGG's flat but I think you said that US would be up. And then I know you also said that UGG reorders will equal cancellations. I know last year that was a net positive including the US. So, I'm trying to understand how – if the reorder and cancellation side of it's worse, but domestic UGG is still up, is the difference that you expect DTC to grow a lot or that the order book going into Q3 is a lot stronger than a year ago, I'm just trying to understand how you get there.

Steven J. Fasching
Chief Financial Officer, Deckers Outdoor Corp.

A

Yeah, the piece I think that you might be missing is the UGG international wholesale is down, and that's driven by the reset that we're talking about in Europe as well as the currency impact on our international business.

Mitch Kummetz
Analyst, Pivotal Research Group

Q

No, I get the international. I mean specific to the US, because you expect US to be up, but I would think that in the US, the reorder cancellation piece you're expecting at UGG worse than a year ago, so it seems like the difference would then be DTC or the order book, and I don't know if that's the case.

Steven J. Fasching
Chief Financial Officer, Deckers Outdoor Corp.

A

Yeah, we are up. It's a small number.

Mitch Kummetz
Analyst, Pivotal Research Group

Q

Okay.

Steven J. Fasching
Chief Financial Officer, Deckers Outdoor Corp.

A

Yeah.

Mitch Kummetz
Analyst, Pivotal Research Group

Q

Okay. And then also for Q3, you're saying gross margin now down 90 bps. I know you're expecting more promotions this year than last. Can you say how much of the down 90 bps is specific to the promotions? I mean is it like down 100 bps or down 200 bps in the promotions and then the others puts and takes elsewhere that gets you to 90 bps? I'm just trying to understand how much you're...

Steven J. Fasching
Chief Financial Officer, Deckers Outdoor Corp.

A

Yeah.

Mitch Kummetz
Analyst, Pivotal Research Group
Q

Yeah, so...

Steven J. Fasching
Chief Financial Officer, Deckers Outdoor Corp.
A

That's it; you nailed it. So, yes, the promotion is down more than the total, because we have some positive offsets.

Mitch Kummetz
Analyst, Pivotal Research Group
Q

Okay. And then I guess maybe just one last one, since I'm last in the queue, when you're given the numbers to Sam, I kind of played this into my model, and it looks like UGG DTC was down roughly 5% in the quarter. Is that just all about the reduction in the store comp? Is there any way you can speak to kind of the comp performance of UGG DTC? Was that up in the quarter?

Steven J. Fasching
Chief Financial Officer, Deckers Outdoor Corp.
A

So, DTC on the $542 million was, call at $99 million, right? A year ago, we did just under $94 million, so the total DTC was up, now that will be all brands.

Mitch Kummetz
Analyst, Pivotal Research Group
Q

And lot of that was HOKA, right? I mean HOKA, e-commerce was up huge, right? I think HOKA DTC looks like just, by the numbers you gave us, was up like 100%. I'm just trying to understand what the UGG DTC did in the quarter, if you can get that specific, maybe not.

Steven J. Fasching
Chief Financial Officer, Deckers Outdoor Corp.
A

Yeah, you'll see it on the Q, when it comes out, but the UGG DTC was down and that's going to be – the down will be some fewer retails as well as our more challenging retail.

Mitch Kummetz
Analyst, Pivotal Research Group
Q

Okay. All right, all right. Thanks for your help. Good luck.

Steven J. Fasching
Chief Financial Officer, Deckers Outdoor Corp.
A

Okay.

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

Thanks, Mitch.

Operator: This does conclude our question-and-answer session as well as the conference. Thank you for attending today's presentation. You may now disconnect your lines.