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Deckers Outdoor Corp. (DECK)

Q2 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 Brand's Second 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'll now turn the conference over to Steve Fasching, Vice President of 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'll now turn it over to Dave.

David Powers

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

Thanks, Steve. Good afternoon, everyone, and thanks for joining us today. Before we discuss our second quarter fiscal 2018 financial and operating results, I'd like to briefly address the press release we issued this afternoon regarding the strategic review process. As you know, beginning in April, our Board of Directors conducted a comprehensive process to understand the level of interest in an acquisition of Deckers. We retain independent advisors to assist in our extensive review of ways to maximize shareholder value. This included looking at an outright sale of the company, as well as looking at other value drivers such as a sale of certain assets, capital structure optimization, and various ways to return capital to shareholders.

The Board considered and pursued all options. After a careful and thorough evaluation, the Board has concluded the process and has determined the best way to maximize shareholder value is to focus on aggressively driving the operating profit improvement plan combined with an increased share repurchase authorization to $400 million. The intention is to purchase a considerable amount by fiscal year end 2018. The Board remains open to considering and pursuing all strategic options to create value for shareholders but will no longer be actively pursuing a sale of the entire company at this time.

Our efficiency initiatives position us well to achieve the operating profit targets established for fiscal 2018 and beyond. We continue to focus on driving improvements in the business through streamlining our cost structure, improving our operating profit, and when combined with the share repurchase program, simultaneously returning capital to stockholders and positioning Deckers for accelerated EPS growth. We are very confident in our projected earnings growth.

With a strong balance sheet, cash position, projected cash flow, and relatively modest capital expenditures, the board feels it's the right time to announce the authorization of a significant share repurchase program. This will be funded through domestic cash flows and supplemented by modest incremental leverage. The board believe that the business can conservatively support a debt-to-EBITDA ratio of 1 time while also providing significant flexibility to support our growth initiatives and seasonal working capital needs. The share repurchase program will accelerate our EPS growth as we execute our $100 million operating profit improvement plan by the end of fiscal year 2020. We plan to repurchase shares in the open market and will opportunistically consider strategies to enhance our buyback.

Now turning to our results. I am very pleased to say we had another quarter of strong results. But before digging into the details, I think it is important to take a step back and talk about our transformation journey. Back in February we discussed the need to create a new path forward, one that would lead to significant improvement in our profit margins and build a solid foundation for sustainable growth. At that time, we discussed elements of a cost savings program that would drive growth savings in excess of $150 million. We also discussed our work with a top tier consultant, AlixPartners, with whom we began working in August 2016. They helped validate our findings as well as contribute additional profit-enhancing opportunities. The team has been hard at work, and we are well into implementing these initiatives.

On our fiscal year end call back in May we discussed how this more than $150 million in gross margin improvement and SG&A savings would translate into an incremental $100 million of operating profit by the end of our fiscal year 2020, and would generate operating margins of at least 13%.

In order to achieve this goal, we have made significant changes, and we are at the early stages of seeing the results of our efforts. This quarter is an example of the organization's commitment and ability to deliver on the items we have articulated, which include supply chain initiatives, implementation and process improvement efficiencies, indirect spend reductions and retail store closures. During the first six months of fiscal 2018, we have made meaningful headway in improving our operating structure and driving efficiencies throughout the organization.

To put our progress into perspective, during the first half of this fiscal year, gross margin is up approximately 130 basis points over the same period last year. Our non-GAAP operating expenses are down $12 million, and our operating income increased $35 million. While the entire management team is pleased with the initial results of our profit improvement plan, we are committed to becoming an even more efficient and nimble organization, increasing profitability and driving greater shareholder value over the long term.

As we continue to evolve our organization and executing our plan, we are identifying further opportunities to drive incremental profitability beyond 13%. Our second quarter results, which exceeded our expectations across the board, are proof positive that our plan is working. Revenues were $482 million, which was 10% better than our guidance and nearly flat to last year. Non-GAAP earnings per share was $1.54, up 25% from last year and ahead of our guidance range of $1 to $1.05. This strong performance was driven by several factors, and Tom will provide more details in a moment.

Now to discuss our lifestyle group's performance for the quarter. Beginning with Fashion Lifestyle, UGG revenue was $400 million which exceeded our expectations. While a significant portion of the higher-than-expected revenue was timing based and resulted from the earlier shipments of products, we are pleased that we exceeded our DTC plans and saw great success with men's and women's slippers, as well as sneakers.

Sell-through of slippers was strong in the second quarter and gives us great confidence in our strategy to create a year-round business and bring younger consumers into the brand. The Ascot, Tasman and Coquette all had a strong quarter and we expect this trend to continue.

On a product note, the second quarter also saw the introduction of the UGG Classic Waterproof in Azure and Mini silhouette. The Waterproof Classic is yet another example of our continued focus on driving innovation and product development, while addressing the functional needs expressed by our consumers.

For our key holiday season, we are planning a stronger mix of full price selling compared to last year, due to a stronger overall product lineup and cleaner inventory in the channel. We believe that the inventory at our wholesale partners is better positioned as compared to last year, both in terms of quantity and composition.

We had a strong sell-in of men's styles like the Neumel, Ascot and Hartley, several women's Classic II styles and also kids with the introduction of the Classic II for kids this fall. These are a few examples of how we are continuing to drive the UGG brand transformation in the marketplace. We are focused on building strong, longer lasting relationships with our existing consumers, while also attracting the attention of a new generation just being introduced to the brand. We have an incredible opportunity to leverage the power of the UGG brand and create a deeper relationship with our existing consumers, while at the same time attracting a new consumer with compelling product.

Shifting to our Performance Lifestyle group, HOKA had another great quarter with revenue of $41 million, up 34% over last year and above plan. The solid performance was driven by reorders from our global wholesale partners and strong DTC growth. This is a result of our focus on building brand awareness while maintaining authenticity with the core runner.

We are building on HOKA's momentum among serious runners by reaching new customers through word of mouth endorsement. For instance, HOKA recently sponsored the Iron Man World Championship in Kona and was the number one most worn shoe with over 18% of the participants wearing the brand, handily beating the second place shoe. HOKA is the fastest-growing shoe in Iron Man history as just three years ago its share was 6%.

HOKA's reputation for lightweight performance, quality and comfort is driving increased awareness and adoption to a wider range of consumers who are looking for new products that fit their needs. We are confident that this momentum will continue as spring/summer 2018 bookings were up 50% on September 30 versus the same time last year, driven by the Clifton, Bondi and Arahi styles. This includes significant international growth as we are just beginning to scratch the surface of the global market opportunity. We are particularly proud of the growth we have seen in HOKA's annual sales over the past four years, increasing from under $10 million to over $100 million.

This quarter, we saw significant margin improvements from our Teva and Sanuk brands. Teva revenues also came in better than anticipated at $21 million, up nearly 25% to last year, while gross margins were up nearly 440 basis points. Sanuk revenue was in line with expectations for the quarter and down compared to a year ago as we strategically closed certain international wholesale accounts and reduced closeouts nearly 50%. As a result of our work, Sanuk gross margins were up almost 1,000 basis points year-over-year.

The margin increases are a direct result of our execution to further enhance these brands' contribution through a focus on more full-price selling and cost containment. Looking ahead, we are optimistic with both brands' spring and summer 2018 product lineup with strong U.S. bookings for the season.

Now moving on to our performance by channel. DTC comps increased 3.7% in the quarter, which was slightly above guidance with both e-commerce and retail contributing to the beat with favorable performance in both domestic and international markets. We saw improvements in conversion rates at retail, stronger-than-expected performance by the UGG and HOKA brands, sell through of exclusive product in DTC, and product offerings within the tall boot category.

Global wholesale revenue was also better than expected with the timing of UGG global orders contributing to the majority of the beat, along with strong demand for HOKA, which resulted in net reorders for the quarter. Domestic wholesale revenue was down mid-single digits compared to last year, while international wholesale is up low-single digits driven by the strength we are seeing in Europe. As previously mentioned, closeouts were down significantly in the quarter, which helped drive a 230 basis point increase in whole sale gross margins.

These results give me confidence that our transformation plan is working. We are taking the right steps to improve the business and these results are further proof. With the strong second quarter performance and greater confidence in the full year, we are increasing our annual guidance and Tom will provide further detail.

Now I'll turn the call over to Tom to provide more details about the quarter.

Thomas A. George

Chief Financial Officer, Deckers Outdoor Corp.

Thanks, Dave. And good afternoon, everyone. Today I will walk you through the details on our strong second quarter and first half fiscal 2018 results and provide an outlook for the third quarter and updated guidance for 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 were not adjusted for constant currency. A reconciliation between our reported GAAP results and the non-GAAP results can be found on our earnings release that is posted on our website under the Investors tab. Now to our results.

For the second quarter, as Dave mentioned, revenue was $482 million, nearly flat to last year. However, this was significantly above our guidance of down 10%. The beat was driven by earlier than planned shipments, UGG, DTC out performance, HOKA, domestic wholesale reorders, and a DTC comp of about 3.7%. Breaking down the revenue upside, $29 million was due to timing as product originally expected to ship in the third quarter shifted into the second, $7 million from better-than-expected UGG, DTC performance, $6 million was from favorable foreign currency rates verses our expectation largely in European currencies, and $3 million was from higher demand for the HOKA brand as we continue to experience exceptional growth in the U.S. wholesale channel.

Gross margins were up 220 basis points over last year and were also much better than our expectations. The main drivers are the year-over-year increase were lower closeout shipments executing on our supply chain initiatives and a higher mix of DTC revenue. Non-GAAP SG&A dollars expand was $157 million, down 2.6% from last year's $161 million. As a percent of revenue, SG&A expenses were 32.6% in the quarter versus 33.2% last year.

Non-GAAP earnings per share came in at $1.54 compared to last year's $1.23, and our guidance range of $1.00 to $1.05. The combination of better-than-expected revenue, gross margin and operating leverage drove the beat. Breaking this down, approximately $0.22 was related to the shift in revenue, $0.15 from more favorable foreign currency exchange rates, and $0.11 of improved operational performance due to supply chain initiatives that drove gross margin improvements, stronger results from our DTC channel, higher demand for our HOKA brand, along with fewer closeouts. Non-GAAP adjustments in the quarter were $0.05 million and were related to the strategic alternatives' review process and other organizational changes.

Our first half of fiscal 2018 results included revenues were $692 million, up $32 million to last year. Gross margin was 45.6%, an increase of nearly 130 basis points over last year. Non-GAAP SG&A dollars were $302 million, a decline of $12 million from last year. And non-GAAP earnings per share were $0.27 versus a loss of $0.55 last year.

Our balance sheet at September 30 remains strong, with cash and equivalents of $231 million, up from $110 million at September 30 of last year. Inventory was down 4% to $556 million from $578 million at the same time last year, and short-term borrowings of $133 million, down from $278 million last year. Over the past 12 months, our margin enhancement initiatives, along with the management of our balance sheet, has resulted in free cash flow generation of over $280 million.

Now moving on to our outlook. For the third quarter of fiscal 2018, we expect revenue to be in the range of $735 million to $745 million, and non-GAAP earnings per share in the range of $3.65 to $3.75. There are a couple of key items to note for our third quarter guidance. Revenue is down from last year, primarily due to the timing of orders from the third quarter into the second. And last year we did not fully pay out performance based compensation. And in the quarter, this headwind accounts for about $10 million in operating expenses, which equates to approximately $0.25 on an after tax earnings per share basis.

For fiscal 2018, we are increasing guidance. Revenues are now expected to be in the range of up 1% to up 2%, gross margins of approximately 47.5%, SG&A as a percent of revenue of approximately 37%, operating margin of 10.5% and non-GAAP earnings per share now in the range of $4.15 to $4.30. The effective tax rate for the year is assumed to be 26%. We are also updating our brand and channel level guidance. Brand revenues are anticipated to be UGG down low-single digits, HOKA up approximately 40%, Teva up mid-single digits, and Sanuk flat to down low-single digits. Full year guidance assumes the following. DTC comp down low-single digits to up low-single digits, domestic wholesale revenue down mid- to low-single digits, and international wholesale revenue growth now up high-single digits to up low-double digits.

Finally, on our sheepskin pricing update, we continue to see stable prices in the sheepskin market. We expect our sheepskin cost for fiscal 2019 will be similar to this year and to not materially affect our gross margin. This does not constitute our gross margin guidance for next year as our sheepskin cost's only one component of our gross margins.

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

David Powers

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

Thank you, Tom. Reflecting on our progress so far this year, I'd like to reiterate my confidence in a few things: our profit improvement plan to drive operating margin to better than 10.5% this fiscal year, our ability to achieve an operating margin of at least 13% by the end of fiscal 2020 which would put Deckers in the top quartile of our industry, our ability to implement a capital allocation framework that will drive an increased ROIC, and a plan to create a capital structure that will drive increased shareholder value and return meaningful capital to shareholders to a robust share repurchase program.

We have the right management team in place that intimately know the drivers of the business and we are supported by an outstanding organization that is driving structural improvements in the business in the face of dynamic marketplace headwinds. I am now more confident than ever that we will achieve our fiscal 2020 operating margin target. As always, I would like to thank our employees for their hard work and dedication, as well as our shareholders for their continued support.

Before turning over to Q&A, I would like to briefly address our upcoming Annual Meeting on December 14. We have been speaking with, and will continue to speak directly with, many of Deckers shareholders to hear firsthand what they think about the future direction and leadership of the company. Deckers has a diverse and experienced Board of Directors that is actively engaged in our transformation process and is helping to deliver continued operational improvement. Our board works closely with management and has been, and will continue to be, a significant agent of change to improve Deckers' performance and drive shareholder value.

Now as we get into Q&A, I'd like to remind all participants that the purpose of today's call is to discuss our earnings results and the outcome of our strategic review so we ask that you please keep your questions focused on these topics. We thank you for your cooperation in that regard. Operator?

QUESTION AND ANSWER SECTION

Operator: Thank you. We will now be conducting a question-and-answer session. [Operator Instructions] Our first question comes from the line of Randy Konik from Jefferies. Please proceed with your question.

Randal J. Konik
Analyst, Jefferies LLC

Q

Yeah. Thanks a lot. Can you hear me?

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

A

Yes we can.

Randal J. Konik
Analyst, Jefferies LLC

Q

Can you hear me?

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

A

Hey, Randy.

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

A

Yeah. Can you hear us?

Randal J. Konik
Analyst, Jefferies LLC

Q

Oh. Okay. Sorry. Hey, guys. How are you?

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

A

Okay.

Randal J. Konik
Analyst, Jefferies LLC

Q

Yeah, I can.

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

A

Great. Thanks.

Randal J. Konik
Analyst, Jefferies LLC

Q

So, I guess, question for Dave. So you showed nice progress in the quarter even ex the timing shifts. So, I guess, what I want to talk about is how do you think about distribution both domestically and abroad as we get towards the – as we lay out the 2020 plan? How do you think about making progress around the key accounts and working more closely there on the domestic side? And then give us some update on how you're approaching international development further? That's my first question.

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

A

Yeah. Great question, Randy. So, as you know, we've been working pretty aggressively in North America over the last 12, 18 months to reduce the amount of distribution we have in this marketplace and elevate it with key partners. And we've made great progress to that event or to that goal. The last year coming into Q3 we have roughly 350 fewer points of distribution in North America, and that's net of the new stores that we are now selling in through Macy's. So we'll continue to skinny down that distribution list strategically in the right way in North America and continue to work with the top partners in a more strategic way which we, again, we started about 12 months ago, meeting with them on a regular basis, free lining product, having robust segmentation strategy conversations with them, and collaborating on how we can better elevate the presentation in-store and online to our consumers.

So we'll continue that in North America. I think the important thing to know in North America also is that part of the long-term strategy is we are focused on strategically growing and maintaining the core classic business, but at the same time aggressively growing in new areas of opportunity, which is men's spring and summer across all categories and then in lifestyle.

From an international standpoint, Europe continues to be a strength of ours. We're opening up new distribution there. We opened up ASOS this past spring to give us a better digital presence in that marketplace, and that's been very successful. They're buying a broad range of product and we're continuing to look for more strategic partners, particularly in Germany, where we see a lot of upside still.

And then in Asia Pacific, the key opportunity there that we've talked about over the time period is in our China partners, third party partner retail. We had some very strong large partners over there who are seeing success with our business right now and are continued to be excited about opening more doors and partnering with us across all categories to expand our distribution or reach in that marketplace.

And of course this is all in line with our overall intent to drive more product through our DTC channels, particularly our e-commerce cannel, and we're ramping up our digital analytics and our digital marketing through social influencers to continue to drive that challenge at the same time.

Randal J. Konik
Analyst, Jefferies LLC

Q

That's very helpful. And then, I guess, [ph] seems I'll get a little (27:02) more follow-up here.

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

Q

Sure.

Randal J. Konik
Analyst, Jefferies LLC

Q

The way you kind of framed out operating margin, it sounded like increased confidence around obtaining that 13% – at least 13% goal in fiscal 2020. It almost sounds like it's almost more of a starting point. So has there been some things that have come up in your transformation process that you've identified where you said this could be additional opportunity for us over the next three to five years as we kind of go for it? Just trying to get a sense of bringing that increased confidence to that long-term operating margin guidance and the drivers.

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

Q

Yeah. I think what I was alluding to there is since we started down this journey of the profit improvement plan over a year and a half ago, we realized that we were able to identify some cost savings pretty much across the board from an SG&A perspective, but also a significant amount, about a third of the $150 million in cost of goods sold. So having that level of visibility across the business now gives us more visibility into the puts and takes and the opportunities going forward. I'm not at liberty to say exactly right now where we think there is additional opportunity or how much there is, but suffice to say that the entire organization is focused on improving the profitability of the company. We think that the traction in the business we're seeing already the margin flow through in the last quarter, the way we're cleaning up distribution, we're reducing close outs coupled with the SG&A improvements and the COGS improvements leads us to believe that there's potentially more opportunity ahead of us.

Operator: Our next question comes from the line of Mitch Kummetz from Pivotal Research. Please proceed with your question.

Mitch Kummetz
Analyst, Pivotal Research Group LLC

Q

Yeah. Thanks for taking my questions. I guess I got a couple for Tom. Tom, maybe just on the guidance, when you look at the cadence of the back half Q3 versus Q4, I think if you adjust your Q3 outlook for the $0.22 on the shift, you're still looking for kind of down earnings there and then sort of default kind of Q4 guidance for a pretty big year-over-year uptick in the earnings. Can you just help us out a little bit? I mean, I feel like that's consistent with kind of how you've laid this out for the last couple of years, but is there anything else we really need to be thinking about in terms of kind of that quarterly flow?

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

A

No. I think, Mitch, you've got it laid out really well. Relative to the prior year, as well as relative to our old guidance, the biggest driver is that timing, that $29 million of sales and $0.22 per share that moved into the second quarter versus the third quarter. Another thing to point out is at these levels of profitability, there's the opportunity for increased incentive comp, as well as there's some increased marketing. We're going to focus more marketing into this quarter relative to some of the other quarters. And as a result of that, you do have some higher operating expenses that put some pressure on the earnings per share as well.

Mitch Kummetz
Analyst, Pivotal Research Group LLC
Q

Okay. And then on the revenue guide, you've obviously raised the revenue guide. I think last time you provided some guard rails kind of around weather and macro, things like that. Has anything changed? I mean, obviously the overall revenue guidance has gone up, but in terms of kind of underlying assumption again around kind of weather and macro, has anything changed on that front from where you were, I think, as of the last quarter?

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

I think in terms of weather, pretty much the same assumption as before. What we have done though for the – especially the December quarter, is given that the current marketplace out there, we wanted to take a more cautious view on the promotional environment. So we've taken down our gross margin in the December quarter a little bit. We still expect it to be at the low end of the guidance, at least flat to the prior year and a little bit higher at the high end, but that's probably the only thing there. Steve, you want to...

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

Yeah. Maybe – and just a little bit of caution with, you mentioned, weather. With the warm start to October, what we factored in is a little bit caution with a warm start to the quarter.

Operator: Our next question comes from the line of Camilo Lyon with Canaccord Genuity. Please proceed with your question.

Camilo Lyon
Analyst, Canaccord Genuity, Inc.
Q

Thanks, guys. Good to see the progress you're making. I've got a couple questions. I guess just I'm feeling off of the last comment you made there, Steve. The warmer start to October I think is now probably like the more or less the third or so warm start to the fall season. But I think what's been different, correct me if I'm wrong here, is that there hasn't been a level of panic that we've been accustomed to seeing by the retailers.

Maybe you could talk a little bit to that and maybe talk about the conversations you're having with those retail partners today as we approach November. What do you think is the panic date that that really starts to set in? And how does that translate into, I guess, the pace of promotionality? You just mentioned a little bit more promotionality expected for Q4 of December. Was that really starting to ramp now, and is there an impact there to how they're viewing the later quarter receipts?

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

Yeah, so this is Dave. I can answer that. First of all, I think I would start with – as you know, Camilo, we spent a lot of time over the last year cleaning up the channel. And if you remember last year around this time, we had the challenge of the Classic I transition, and then close out carry over from the previous Q4 that retailers were holding into Q3 of fall 2016.

That is behind us, and so we feel very good about the setup for this quarter. Suffice to say the inventory in the channel is cleaner and healthier from both the composition and a quantity perspective. So you have a situation where you're going into the quarter where the retailers feel good about their inventory level, the channel is not stuffed, and I think overall they're feeling confident in the brand, albeit there's a slow start across the business to everybody because of the weather, but the inventory levels are much better in line. We don't have the level of closeouts planned into the quarter.

That being said, there is always that risk of – and I wouldn't call it panic, but obviously going on promotion in certain areas so we planned a conservative amount of that into our business. But it won't be to the level that we saw last year.

Camilo Lyon
Analyst, Canaccord Genuity, Inc.

Q

Is it fair to say that in that cleaning up of that channel you've gotten retail partners that are a little bit more patient with the promotional trigger and more supportive of the brand in totality? It seems like there's been a [indiscernible] (34:23) promotion.

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

A

Yeah. I think that's safe to say. Yeah. As you remember last year we had a couple people going off price. Those days are behind us. I think we have the right distribution with the right partners who understand the value in full price sales and what it does to their business. And it's in their best interest to maintain the full price through the season where we can.

Camilo Lyon
Analyst, Canaccord Genuity, Inc.

Q

Got it. And then just my next question, my follow-up question is store closures. Can you just update us on your thinking around store closures, the quantity and the timing, and how do you think about the recapture of those sales of those closures?

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

A

Yeah. So retail is obviously a healthy conversation across the industry and it's an important one for us. It's important in our long-range operating improvement plan. As you know, we've put long range targets out there for approximately 125 stores by the end of FY 2020. Long term that's still our target. I think what is important to know that to get to that ultimate ideal store level, there's a lot of considerations that you have to take a look at that are in the best interest of the shareholders. So lease expirations, lease negotiations, location and type of store that we have in the mix.

So between now and that time, we're going through the process of evaluating the best timing. And I think it's important to know that you could spend a lot of money to quickly get out of a large number of stores, but that's highly dilutive to the profitability of the company in the short term. Exiting stores in this environment, particularly when you have a small amount of store locations globally such as we do with a strong balance sheet, you have very little negotiating power. So what you'll start to see is more reduction in store counts starting mostly in FY 2019. That's when a lot of our lease expirations come up for review. And then we'll continue to manage that through to the end of FY 2020 and get to our ideal target.

At the same time we are still taking efforts to enhance the performance of our fleet. We've made quite a few steps to improve operating expenses within the stores, but also the HQ support network of those stores, elevating our experience, leveraging our omni-channel capabilities, bringing more exclusive product to our DTC channel, and just elevating overall service and engagement. So we're managing both the top line and the experience, as well as managing to the bottom line.

Operator: Our next question comes from the line of Jay Sole with Morgan Stanley. Please proceed with your question.

Jay Sole
Analyst, Morgan Stanley & Co. LLC

Q

Great. Thank you. Dave, I just wanted to follow up on the strategic review and just make sure I understood what the message is. It sounded like there's no effort being made at this time for an outright sale of the company, but does that exclude the possibility of selling a brand or taking some other strategic action with part of the company?

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

A

Yeah. At this point, we're focused on the plan going forward. I think what's important to know is that the strategic process did not end in an ultimate sale of the entire company, and the board and management feel like the best plan going forward is to double down on the plan that we have in front of us. We think that will return the most shareholder value over the next few years. And then enhancing that with the share buyback proves to be the better way to bring shareholder value, both in the short-term and long-term to our shareholders. So the process evaluated all options ultimately did not end in a sale of the entire company, but we're always open minded and we'll continue to work to see how we can always evaluate those opportunities with the shareholder interest in mind throughout the process.

Jay Sole
Analyst, Morgan Stanley & Co. LLC

Q

Okay. Got it. And then if I can follow-up on the last question about the stores, can you just talk about the interplay between stores and obviously e-commerce sales to the UGG brand and what the interplay is between having a store and what that does through the e-commerce sales in the area and how you think about the store base in relation to what you think you can do online directly with the UGG brand?

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

A

Yeah. As you know, we spend a lot of time over the last few years really enhancing our ability to service the consumer, both in our stores and online. And those lines have blurred, obviously, throughout the industry, and I think to our advantage. We're able to manage the engagement of the consumer and the sale to the consumer through stores and/or e-commerce. We have the capabilities of click and collect so you can purchase online and pickup in store. We're now offering ship from store which is a better way of managing our inventory. Through Infinite UGG you can purchase in-store and that gets delivered from online. And the teams – it's a shared group of teams that are managing the business across both retail and e-commerce.

They're optimizing inventory flow and offering to the consumer. And every time we open a store, we do see a pickup in the e-commerce business in the range of roughly 15% to 50% in some cases in that demographic area. But we're managing that as we look at the long-term fleet and what the right stores are in the right locations. But generally speaking, we do see an impact of the e-commerce business from those stores. So as we close doors over time, we don't expect all that revenue to go directly online or all of it to our wholesale partners. We will pick up some but the good news is we have the customer information that we can continue to cultívate, and we'll continue to drive more to our loyalty programs so we can keep them in the fold and to continue to engage with them despite the store closures.

Operator: Our next question comes from the line of Scott Krasik from Buckingham Research. Please proceed with your question.

Scott D. Krasik
Analyst, The Buckingham Research Group, Inc. Q

Yeah. Hey, guys. How are you?

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

Good, Scott.

Scott D. Krasik
Analyst, The Buckingham Research Group, Inc. Q

So just a couple more clarifications on the announcement today. So for the share buyback, you said you are planning to be as aggressive as possible, buying stock back through the end of this fiscal year but nothing is considered in the press release?

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

[indsicernible] (40:47) That's correct.

Scott D. Krasik
Analyst, The Buckingham Research Group, Inc. Q

Or nothing is considered in the guidance? Sorry.

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

Correct.

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

Yeah. Scott, this is Steve. Just so we clarify on that, yeah. So we have made the announcement around the share repurchase. We did put out kind of some time line in terms of the amount that we would intend to purchase by the year end. But we wanted to be clear on the EPS that that does not contemplate a share repurchase. We're trying to show a like-for-like so that the actual raise that you're seeing in the guidance is not related to a share repurchase, it's actually the flow through of the business improvement. So depending on what the share repurchase is, that will accelerate our earnings per share growth.

Scott D. Krasik
Analyst, The Buckingham Research Group, Inc. Q

Okay. And then just in terms of the comment about the debt, so is that an ongoing target? Like as you generate cash and EBITDA goes up then you'll continue to buy back stock to maintain that 1 times leverage?

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

A

No. It's not an ongoing target. I think the comment about that was historically we've had a conservative balance sheet. Now that we're executing well on our long term plan, and we got to see further improvement in profitability going forward and further working capital improvements. We feel that it's an appropriate point in time to consider and evaluate the concept of some long-term debt. And we'll start slow, i.e. we think the company can easily support 1 time EBITDA. So that's more of an evaluation of some initial thoughts around raising some long term debt. That doesn't necessarily mean we'll always maintain that 1 times EBITDA.

Operator: Our next question comes from the line of Bob Drbul with Guggenheim Securities. Please proceed with your question.

Andrew Roberge
Analyst, Guggenheim Securities LLC

Q

Hi. Good afternoon. This is Andrew Roberge on for Bob. Our first question is just kind of...

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

A

Hey, Andrew.

Andrew Roberge
Analyst, Guggenheim Securities LLC

Q

Hi. How are you? Could you guys just talk about how your business is doing on Amazon right now? And then maybe also flow that into – I know you guys just recently entered Macy's and how that's doing in Macy's?

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

A

Sure. Happy to comment on those. So as you know, we started with Amazon early this year in January with the spring line, and then we filled in product over the last Q1 and actually the end of Q4, we sold an inventory to take them into fall. I would say that we are proceeding well. We're [ph] exceeding (43:18) on plan. The conversations with Amazon from [ph] Tracy and the (43:26) teams, our North American sales teams have been healthy, they've been strategic, and I would say they've been in the best interest of the brand. So we continue to monitor that relationship, the presence of the brand closely with Amazon and meeting with them on a regular basis to make sure that we have the best possible presentation and we have the right inventory at the right time for that consumer.

Pretty much the same situation with Macy's. Again, we've been working closely with them over the last year. The 30-store test that we did last year proved well. We're now in 200 doors with the women's line, all full-service doors, no self-service doors, and we're in 50 men's doors with Macy's as well. That business is proceeding on plan. I know from visibility to the Herald Square concession that we have that it's strong, and we think that'll continue to be a great access point for the consumer, and a healthy, robust business for us over time. So heading into Q3, we feel good about both of those right now, and I think that's going to continue to be a long-term partner for us.

Andrew Roberge
Analyst, Guggenheim Securities LLC

Q

Great. And then, kind of if we can shift here on e-commerce, DTC operations, can you just talk about your – the UGG Closet and UGG Rewards, how's that performing, what, against your expectations, and then maybe how many members you now have?

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

A

Yeah. So I'll talk about the Closet first. As you know, that's a short term window that we open up on certain weekends throughout the year to help us clear carryover inventory or closeout inventory. That's been a great vehicle for us to better maintain healthy margins on closeout inventory versus selling that in the channel. We are monitoring that. We don't want that to get too big, and we do look at it in the context of the full marketplace, not specifically just the e-commerce business. So it helps us manage closeouts across the entire marketplace in North America.

So we'll continue to use that as a tool, but the other great benefit of the Closet is that it allows us to bring new consumers into the brand, and we gain their information so we can continue to cultivate that relationship with them. It does bring new consumers into our database, which is a great side benefit of that. And that is in line with our loyalty program. We launched our loyalty program last year. I think we're up to about 650,000 loyalty customers right now. We're starting to lap the first year of loyalty programs with them, so we can now go out to, I think, about a third of that list in Q3 with incentives to bring them back to shop again. And we're going to continue to focus to build that program because it's a great way to stay connected, and further engage with that consumer and cultivate them for the long term. So, so far so good on both those initiatives.

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

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

Q

Hi. Thank you. Good afternoon. Can you hear me okay?

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

A

Yes.

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

A

We can, yeah.

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

Q

Great. Thank you. First of all, I think you guys have done a better job on closeouts. There was a question on UGG Closet. Can you talk about just how you're managing the balance of the promotions going forward across those sites, and is it really a different consumer that you're seeing between the two sites? It sounds like you're continuing to offer promotions across both.

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

A

Yeah. We continue to offer sale items on our full site, but the Closet is specifically one in that you have to sign up to enter the site, and then there's additional closeouts at really further discounts than you would see in the main site. So think about that as an outlet versus a full priced store, it's probably the best way to think about it. And it's not entirely new consumers, but it is – we do see more and more new customers coming in because it's an opportunity to access the brand at a lower price point versus the full priced product that we have in the marketplace. So I think they work well hand in hand and it allows us to keep our full price experience elevated and premium while still allowing us to clear in a profitable way from a digital online perspective.

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

Okay, that's helpful. And just in terms of gaining the younger consumer, what is it that gives you guys confidence that you are kind of gaining traction with that younger consumer? And you did talk about adding some marketing spend in the third quarter, is that kind of targeted towards that initiative or can you give some more color behind the incremental spend for this fall?

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

Yeah. Happy to do that. So two things with the marketing this fall, one is we have really, really shifted our marketing spend online and digitally through social and influencers, and search, et cetera. And part of the overall marketing strategy, the brand, is to maintain our core customer base, but also cultivate a younger consumer. So you'll see that in the look and feel of the marketing itself, you'll see that on where we show up, the type of influencers we're using. And we're seeing some great traction with younger consumers from our Jeremy Scott launch, and our Phillip Lim launch, some of the work we've done with Foot Action, and some celebrities in the hip hop space are really helping bring new consumers into the brand. We're really seeing a dramatic shift in our men's business, which is being adopted by a younger consumer in new channels and we're going to continue to work on that.

The other thing that we did this fall from a marketings perspective is we've taken some of the savings through our cost savings plan that we did last year from a global perspective and pushed that marketing spend further into Q3 than earlier in Q2. So for example, last year we spent a lot of money in August/September promoting the brand, promoting the launch of Classics II. And what we decided to do this year is shift more of that marketing into the core season to get a further acceleration of the sales from that marketing spend. So you'll start to see really heavy marketing for the UGG brand starting to kick in, in the beginning of November more so than you did last year.

Operator: Our next question comes from the line of Erinn Murphy with Piper Jaffray. Please proceed with your question.

Erinn E. Murphy
Analyst, Piper Jaffray & Co.
Q

Great, thanks. Good afternoon. Dave, I guess my first question was for you. I was hoping that you could square away a couple of comments. In your prepared remarks you talked about the opportunity this holiday season to see a bigger full priced sell-through. What percent of your units are you currently selling full price versus where you want to be? And then just trying to square that away with the comment you guys made just on the overall promotional environment that you continue to see ongoing.

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

Yeah. Erinn, we haven't really disclosed that information of full price sell-through in previous years and it would be hard for me to say what we're planning right now off the top of my head. But generally speaking, you'll probably see, I would ,say a 10 to 20 percentage point improvement in full price sell through this fall than you did last fall. That's a combination of things. As I said before there's less closeouts and carryover product in the channel. And then we're selling in a more conservative approach. More so in kind of key classic categories so there is upside in inventory, as I said, in men's, in winter boots and some of the new product launches. But from a classics perspective, we've been really more conservative on inventory into the channel. So the plan there is to sell more at full price, optimize margins, and have a better overall online and brick-and-mortar experience for the consumer. Can you repeat your second question, Erinn?

Erinn E. Murphy
Analyst, Piper Jaffray & Co.
Q

Well, I was just trying to understand that comment. You were pretty confident in being able to sell more full price this holiday season, which your context helped with that, but then you also talked about your planning for a more promotional environment as you guys were kind of speaking to the guidance during the third quarter piece.

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

Yeah. So Erinn, that's not – that more promotional isn't in reference to last year, that's in kind of from the previous guidance. So while we have increased our guidance, kind of the question that was asked was more about what are the assumptions in the change from the previous guidance. So we've raised our guidance, and part of the Q3 guidance, what we've said is from what we had previously thought three months ago, we're just being a little more cautious about the promotional environment.

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

Yeah. Yeah, which is really led just from a general marketplace perspective not specific to the UGG brand

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

We're not seeing it right now, but we think at this point in time early in the quarter, its good – it's better to be cautious.

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

Yeah. Yeah.

Operator: That is all the time that we have for questions, I'd like to hand it back over to Dave Powers for closing remarks.

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

Thanks, operator. In closing, I think it's clear from our first half performance and recent actions that our management team and Board of Directors are committed to take the necessary steps to maximize shareholder value. We are confident that the course that we have set for Deckers will allow us to achieve this overarching goal. We have laid out a robust and well thought through plan that will provide brand enhancing growth and meaningful profit enhancement. It calls for right sizing our business, improving how we go to market, leveraging our supply chain and elevating our brand in key channels.

In this marketplace transition we feel that our plan offers the right combination of profit improvement and delivers meaningful shareholder value over the next couple of years. In the meantime, we are focused on executing our plan in elevating our brands and consumer experience globally. This is the right plan with the right team and the right brands. We appreciate your support and look forward to updating everyone on our continued progress during our third quarter fiscal call in February. Thank you.

Operator: Ladies and gentlemen, this does conclude today's teleconference. Thank you for your participation. You may disconnect your lines at this time and have a wonderful day.