25-Oct-2018

Deckers Outdoor Corp. (DECK)

Q2 2019 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good afternoon, and thank you for standing by. Welcome to the Deckers Brands Second Quarter Fiscal 2019 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, Director, Investor Relations and Corporate Planning. Please go ahead.

Erinn Kohler
Director, Investor Relations & Corporate Planning, Deckers Brands

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.

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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 and 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 Factor 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.

With that, I will 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. I'm pleased to report that our team delivered a very strong second quarter. Each of our key growth drivers; HOKA ONE, ONE, UGG Men's and UGG Women's spring/summer and transitional product continued to gain positive traction in the marketplace and contributed to our success over the past three months.

The organization's continued hard work is evident in our results. Sales in the quarter were $502 million, up 4% to last year and non-GAAP earnings per share was $2.38, up 55% to the same period last year.

Our earnings per share beat in the second quarter was significant. And as you may have seen in the press release, we issued earlier this afternoon, it was fueled by a number of factors, including improved gross margins and lower than planned SG&A expenses. Additionally, we repurchased $125 million of our stock in the quarter, which also aided in the upside to earnings per share.

Steve will walk you through details on our results a little later in the call. However, I would like to touch on a few notable items. First, gross margin was up 350 basis points to last year and came in at 50.2%. The increase in gross margin largely came from our domestic wholesale business driven by tight management of airfreight cost, better full-price selling and favorable mix of products sold in our wholesale channel, benefits from improved material input costs, and improved gross margins in our growing DTC business in which we once again saw positive comps in the second quarter.

Second, non-GAAP SG&A expense came in at $161 million, up 2% to last year, which was lower than expected mainly due to savings in our logistics and warehouse expenses due to the regional mix of sales shift in the quarter, timing as we pushed marketing expense into the second half of fiscal 2019, and savings in our shared service function. Our strong performance year-to-date combined with an updated view on our projected gross margins has led us to increase our financial outlook for fiscal 2019, which Steve will outline in a minute.

Before turning to performance by brand and channel, I think it's important to quickly highlight our first half result versus the first half of last year. Sales were $753 million, up 9%, and non-GAAP SG&A as a percent of sales decreased 180 basis points to 41.9%. These results are further demonstration of continued execution of the plan

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we laid out in May 2017. There is still work ahead of us, but I'm confident that our organization will continue driving the plan and our business forward.

Looking at our performance by brand group, starting with the Fashion Lifestyle group, UGG sales were $396 million in the second quarter, down 1% to last year. As we outlined in our call in May, UGG is implementing a classic allocation and product segmentation strategy in the U.S. for the fall season. While this impacted a portion of the sell-in this quarter, we believe this change in distribution strategy has the ability to drive a pull model, leading to better sell-through and less promotional activity in the brand's largest market.

For the second quarter, UGG's global wholesale sales were in line with expectations on the strengths of the sales in the U.S. and Asia-Pacific offset by some weakness in Europe. At the same time, the brand delivered solid DTC performance, led by e-commerce with brick-and-mortar results coming in as expected.

As we continue to refine our product segmentation and go-to-market strategy, UGG is focusing on the initial release of certain new products exclusively in our DTC channel. For example, UGG recently launched the Fluff Yeah Slide in our DTC channel, which is a year-round transitional product engrained with UGG DNA. We experienced strong sell-through almost immediately with the product quickly becoming the top seller on ugg.com. And as demand continue to strengthen we quickly allocated incremental marketing dollars to fuel the momentum.

The strong launch in our DTC channel combined with our strategic digital marketing efforts led to strong sell-through in reorders with our wholesale partners. The swift action by the UGG team to capitalize on the successful products [indiscernible] (00:06:53) the changes we're making to the business are allowing us to be more nimble, leverage our omni-channel capabilities, and quickly react to consumer interest.

The fall/winter 2018 season marks the UGG brands 40th anniversary and the marketing campaign around anniversary is continuing to drive the momentum in UGG brand heat. This milestone is a confirmation of the brand's strength in the marketplace and with our consumers. Looking to the future of the brand, as we said previously, our focus is on developing compelling product, leveraging our DTC infrastructure for speed to market, creating a deep relationship with our consumers and bringing a new and younger consumer into the brand. This fall/winter season shows progress on that front as we have successfully launched new compelling product, including the Fluff Yeah Slide and Neutra Sneaker, both non-classic products which are experiencing strong sell-through.

Partnering with new retailers, we're bringing a fresh prospective and new consumer to the brand, including Urban Outfitters, SIX:02, JD Sports and Foot Locker and reach new and younger consumers predominantly through our social media channels, as according to YouGov brand impression in the U.S. is up 59% with 18 to 34-year-old women in our fiscal 2019 to-date. I believe this along with clean channel inventory and the classics allocation and product segmentation strategy, position the brand well for successful holiday season.

Next within our Performance Lifestyle group, HOKA sales in the quarter increased 28% to $52 million. The brand once again drove strong year-over-year growth on a successful updates to the Clifton and Bondi franchises. Also on the product side, the Hupana which has been out for a few seasons achieved triple-digit growth over last year. The shoe has performed well since its launch, but this is the first time [indiscernible] (00:08:43) top 10 styles. The success of the Hupana is a great example of the brand's depth and further demonstrates that HOKA can continue to grow through category expansion and product innovation.

On that front, I think it's important to stress the fact that we are growing the HOKA brand through a strategy centered on focused and disciplined growth. All the product and distribution decisions are being made to increase

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brand awareness, drive brand heat and create long-lasting relationships with our consumers, all with an eye on product quality and performance. This is driving strong full-price selling and increased e-commerce penetration, as well as providing the brand a long runway for future growth.

Turning to Teva. Sales were $22 million in the quarter, up approximately 1% to the same period last year. Results were driven by domestic DTC and international wholesale as favorable summer weather predominantly in Europe and Japan aided performance. These are partially offset by the reduction in legacy Ahnu U.S. wholesale sales as we rolled the Ahnu brand into Teva at the beginning of calender 2017. Core Teva U.S. wholesale sales were up mid-single-digit year-over-year.

On the product side, Teva saw success with the Ember Moc, which was initially released last year in limited quantities. In the second quarter of this year, the Ember Moc was at top five product for Teva globally and is a great compliment to Teva's [ph] stand in-line (00:10:06) and is a natural fit with the core Teva consumer.

Now to performance by channel. Wholesale sales were $408 million in the second quarter, up 4% to last year. Results were driven by UGG Asia-Pacific wholesale and distributor in HOKA global wholesale performance, which both saw strong double-digit growth year-over-year. HOKA International wholesale growth was strong across both Europe and Asia-Pacific. And as I previously mentioned, International growth is a major initiative for the brand, and the team is making exceptional progress.

Also contributing to the wholesale growth in the second quarter was Koolaburra as the new brand grew sales over 250%. The brand is still in its early days, but it's quickly taking shelf space in the U.S. family value chain.

These positive results were partially offset by continued weakness in the UK, largely within UGG wholesale. The UK marketplace remains challenging due to weak consumer demand for apparel and footwear, along with macroeconomic uncertainty due to the upcoming Brexit.

Next, DTC sales in the quarter were $94 million, up 3% to last year. DTC comps increased 4.8%, led by the strength of UGG U.S. and HOKA and Teva global e-commerce.

As we continue to allocate marketing dollars towards digital as well as launch DTC exclusive and early release product, owned e-commerce sales will continue to drive growth. I previously touched on our successful initial DTC exclusive launch of the Fluff Yeah for the UGG brand in the quarter.

For HOKA, we continue to see strong owned online sales growth as consumers become more familiar with the brand and are converted into the brand from its social platform, digital marketing and storytelling efforts. I'm encouraged by the consumer engagements these efforts are producing, and I'm confident this trend will continue.

Before handing the call over to Steve, I want to say how encouraged I am with our year-to-date progress. And I believe the UGG brand is well positioned ahead of its holiday selling season with clean channel inventory, segmented products and a thoughtful allocation of core Classic.

Our organization is executing well on our long-term strategy, and I'm proud of the work the teams have done to elevate our brands, right-size our cost structure and set the organization on the path of profitable mid-single-digit future growth.

With that, I'll pass the call over to Steve to provide more details on our second quarter results and our guidance for the third quarter and full fiscal year 2019.

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Steven J. Fasching

Chief Financial Officer, Deckers Outdoor Corp.

Thanks, Dave, and good afternoon to everyone. Before getting into the details, I would like to note that throughout this discussion where I refer to non-GAAP financial measures, I'm referring to results before taking into account non-recurring charges that our management believes are not core to our ongoing operating results.

Also note our non-GAAP results are not adjusted for constant currency. A reconciliation between our reported GAAP results and the non-GAAP results can be found in our earnings release that is posted on our website under the Investors tab.

Now to our results. For the second quarter, as Dave mentioned, revenue was $502 million, up 4% to last year and above the high end of our guidance range. The year-over-year increase was largely due to continued growth in HOKA globally across both wholesale and e-commerce.

Higher UGG domestic e-commerce sales and Asia-Pacific wholesale sales as well as increased Koolaburra sales, these gains were partially offset by softness in UGG European wholesale sales and lower retail sales due to recent store closures.

Gross margins were 50.2%, up 350 basis points over last year. The year-over-year increase in gross margins were driven by a significant reduction in airfreight usage for inventory brought in during the quarter, better full-price selling in our wholesale channel combined with the benefit of a growing DTC sales, lower material cost as we continue to benefit from our supply chain initiatives, in-quarter savings from vendor support marketing that will be shifted from the second quarter into the third quarter to support the UGG brand 40th anniversary campaign and the benefit from foreign currency in the quarter.

Non-GAAP SG&A expense were $161 million, up 2% from last year. As a percent of revenue, non-GAAP SG&A expenses were 32.1%, down from 32.6% last year. The variance to last year was largely driven by increased variable expenses on higher sales, which were partially offset by a decreased retail store cost as a result of recent store closures, lower depreciation and amortization charges and slightly lower marketing expenses which are now anticipated to be utilized in the back half of fiscal 2019.

Non-GAAP earnings per share came in at $2.38 compared to $1.54 last year and well above our guidance range of $1.60 to $1.70. The majority of the year-over-year increase in earnings per share was from $0.37 from higher gross margins, including the impact of reduced airfreight usage, $0.17 from our share buyback activity over the last 12 months, $0.13 from a lower expected full year tax rate of 21% and $0.12 from higher sales.

Non-GAAP adjustments in the quarter were approximately $0.7 million and were primarily related to restructuring costs, organizational changes and charges incurred in connection with the refinancing of our prior credit facility.

Also, a note on our tax rate. In the second quarter, our GAAP tax rate was 17.2%. This effective tax rate for the quarter is much lower than our expected full year non-GAAP tax rate of approximately 21% due to several discrete tax credits, which impacted the second quarter's reported result.

Turning to our balance sheet, at September 30, cash and equivalents were $182 million, down from $231 million at September 30 of last year. Inventory was down 7% to $515 million from $556 million at the same time last year. And we had $71 million in short-term borrowings under our credit line compared to $133 million last year.

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We remain committed to delivering on our share repurchase plan. In the second quarter, we repurchased 1.1 million shares of our common stock at an average price of $117.07 for a total of $125 million. Of the $400 million that was authorized by our board last year, $116 million remained available as of September 30, 2018.

Now, moving on to our financial outlook, for the third quarter of fiscal 2019, we expect revenue to be in the range of $805 million to $825 million as we are seeing more order shift into the third quarter from the fourth quarter as our wholesalers want to take spring product earlier. And we expect non-GAAP earnings per share to be in the range of $5.10 to $5.25.

I think it's important to touch on a few assumptions inherent in our third quarter guidance that we previously mentioned, but we are seeing upside in gross margins as a result of our cost improvement effort.

Last year's third quarter gross margins had the benefit of a strong wholesale reorder and incremental DTC sales due to favorable weather that drove upside. Last year's favorable conditions are not anticipated to occur this year at the same magnitude, which is a potential offsetting headwind to gross margin. Also, the savings and marketing spend we incurred in the first half of fiscal 2019 have been shifted into the back half of the year and is expected to be utilized in both the third and fourth quarters.

Next, for fiscal year 2019, we are updating the financial guidance that we provided on the July call. We now expect sales to be in the range of $1.935 billion to $1.96 billion. Our outlook at the brand level has been updated to include, UGG sales still expected to be down low single-digit, HOKA is now expected to be up in the mid to high 30% range, Teva is now expected to be down low single-digit and Sanuk is now expected to be down mid-single digit.

Turning to the remainder of the P&L, gross margins are now expected to be approximately 50% for this year, which includes certain one-time benefits achieved this year. SG&A as a percent of sales are now expected to be slightly better than 37%.

Operating margins are now expected to be in the range of 13% to 13.2%. And we are raising our non-GAAP earnings per share which are now expected to be in the range of $6.65 to $6.85 on a share count of approximately 30 million shares.

Our guidance for the third quarter and fiscal year 2019 excludes any potential non-GAAP charges as well as the effect of any future share repurchases. Also, we had a tax adjustment in the second quarter which is reducing our expected tax rate for the year. And our guidance for fiscal 2019 now assumes an expected tax rate of approximately 21%.

Our anticipated SG&A expenses for the remainder of fiscal 2019 have increased and we intend to reinvest a portion of the higher gross profit dollars achieved in the first half of the year into marketing. The reinvestment will largely be in HOKA and UGG, our key growth drivers, in an effort to strengthen our relationship with our consumers and prepare the organization for future growth.

Additionally, to remain competitive, we have increased our U.S.-based distribution center labor cost. During this period, we also provide an update on our sheepskin pricing. We continue to see stable prices in sheepskin market and we expect our sheepskin cost for fiscal 2020 to be similar to this year and not too materially affect our gross margins. This does not constitute our gross margin guidance for next year as our sheepskin costs are only one component of our gross margins.

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Overall, and as demonstrated by these results, we are extremely pleased with the progress we have made on our operating profit improvement plan. And with our updated guidance, we are now on track to deliver a 13% operating margin a year ahead of what we initially projected. As we move toward the back half of this plan, we will continue to optimize cost and strategically reinvest in our growth opportunities as we drive the business forward.

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

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

Thanks, Steve. I'd like to reiterate how encouraged I'm by the organization's continued execution under our long-term plan. Looking ahead, we will drive organic growth for our three growth drivers of HOKA, UGG Men's and UGG Women's, spring and summer and transitional products.

Supporting these growth drivers will be the focus on developing best-in-class digital marketing capabilities, product innovation and speed to market. At the same time, we remain committed to generating industry-leading operating margins and returning value to our shareholders through share repurchases and other accretive reinvestments into the business.

I'm confident the team can continue delivering, as we have over the past several quarters, and I look forward to updating you on our progress in February. As always, I'd like to thank all of Deckers employees around the globe for contributing to our strong performance during the second quarter.

We will now open the call for Q&A. Operator?

QUESTION AND ANSWER SECTION

Operator: We will now begin the question-and-answer session. [Operator Instructions] And our first question will come from Dana Telsey of Telsey Advisory Group.

Dana Lauren Telsey
Analyst, Telsey Advisory Group LLC

Q

Good afternoon, everyone, and congratulations on the impressive results. As you think of the UGG business and down 1% to last year, how much of that was due to either weather or the new product segmentation strategy? Where do you expect that to be going forward? And where you wanted to be? And how do you think that influences either top-line channel with global wholesale sales and also margins? Thank you.

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

A

Dana, this is Dave. I'll speak to that from a strategic standpoint and then let Steve give a little more color on that. As we came out of last winter, it was important for us to take advantage of the fact that we had strong sell-through and a pretty clean channel.

It's something we've been working on for quite some time. And as we went into the quarter coming up this year, we made the decision to take advantage of the inventory opportunity and resetting the marketplace with Classic. So, the product segmentation has been something in the work for a while at making sure each account has

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something unique and special and is right for their consumer. And then, the allocation strategy is really getting control of the Classics business.

The way we're looking at this year is making sure that we have each account holding the right level of inventory. It's something that we think can create a little bit more demand and excitement and pull strategy in the marketplace. And so far that allocation strategy seems to be working well.

It is a headwind coming into this year versus last year as you noted, but we think it's the right thing to do for the long-term health of the business and setting up the brand in the marketplace [ph] 3 million as (00:25:17) premium positioning.

Steve, do you want to comment on the specifics of it?

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

A

Yeah. Dana, so we think the strategic decisions we made, which include the allocation, which include segmentation, we also included some retail store closures. We think that's worth about $50 million of revenue. So, by putting that strategic decision in place, so segmentation allocation and reduced retail stores, we think we've given up kind of $50 million of revenue in the current year.

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

A

And I would also add on to that, [ph] as we could remember (00:25:49), there's point of distribution in the marketplace than there has been in the past, and we have some pretty key new strategic accounts in the Sports Lifestyle and UGG sector that are emerging for us as well.

Dana Lauren Telsey
Analyst, Telsey Advisory Group LLC

Q

And the new accounts that you talked about, whether it's Urban Outfitters or Foot Locker, what do you see as the potential of those accounts? Could they replace any of the other existing accounts?

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

A

I think – right now, I think they're mostly incremental to our top five or 10 wholesale retail accounts. It's the younger consumer that we're targeting. We're getting new distinct products specific for those channels into the marketplace. As you heard from the call, the commentary styles like the Fluff Yeah and the Neutra Sneaker are resonating well. There are a little bit more accessible price points but still have the UGG DNA. So, I think, over time they can be meaningful, whether some of those are top 10 are not remains to be seen. But I do think that they're mostly incremental to our core distribution today.

Dana Lauren Telsey
Analyst, Telsey Advisory Group LLC

Q

Thank you.

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

A

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Thank you.

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

Thank you.

Operator: And the next question will come from Camilo Lyon of Canaccord Genuity.

Camilo Lyon
Analyst, Canaccord Genuity, Inc.
Q

Thank you. Hi, guys. How are you? Great quarter.

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

Good.

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

How are you doing?

Camilo Lyon
Analyst, Canaccord Genuity, Inc.
Q

Doing great. Thank you. Wanted to understand a little bit deeper the outlook that you provided, just specifically as it relates to the implied fourth quarter guidance. I think you said something around retailers wanting to shift [ph] spring receipt (00:27:24) since the third quarter. Probably the first time I've heard that given how weather is now starting to extend longer into the season. So I'm just trying to understand that dynamic a little bit more and how that influence the guidance?

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

Yeah. One of the things that we've been working on for a little while, Camilo, is setting up – we used to be called the resort collection drop in the last couple of weeks of December. Traditionally there'll be kind of a drop between holiday and then spring.

And we've been working closely with our key accounts and also DTC to develop products that we think can sell in that last two to three weeks of Christmas heading into the New Year. So, some of that shift is accounts thing, yes, they want to sign up for some of that additional sales. We're also fast-tracking opportunity [ph] based on (00:28:17) early success of the Fluff Yeah, and that's business that we're chasing into Q3. So that's really the main driver. It's not hugely significant to the total quarter, but it is a good indication that there is additional opportunity there.

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

Yeah, I think also, Camilo, as you look at the revenue numbers, so you'll see with the range that we guided revenue of $805 million to $825 million, which is above last year's $810 million, that's where – kind of underlying

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to that, we've got to decrease low single-digits in UGG with the strategic decisions that we were kind of just talking about.

So that is actually – we're assuming slightly lower year-on-year UGG revenue. And then that's getting offset with increases in HOKA and Koolaburra. So that's kind of how you get to that range with a little bit of that UGG pull forward into Q3.

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

Yeah. And then fewer retail stores in the quarter than last year too.

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

Yeah.

Camilo Lyon Q
Analyst, Canaccord Genuity, Inc.

And so, with that Q3 expectation for UGG to be down low single-digit, does that incorporate, A, reorder expectation that is below your cancellations [ph] or greater (00:29:27) cancellations versus reorders? Because I think that's what you had anticipated [ph] earlier into the year (00:29:32)?

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

Correct. Yeah. So that's still the assumption for Q3, so net cancellation.

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

Yeah.

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

So, again, just to kind of talk about that, what we said is, we're taking a more conservative approach this year given the impact that weather had last year both on kind of a promotional cadence as well as revenue.

So, as we talked about last year, we thought the weather contributed about $30 million of wholesale additional reorders and about $10 million in DTC. So we're not picking that same level up again kind of this year as we're a little more conservative around weather until we see how it plays out.

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

Yeah. And then, the DTC comp within that is at this point low single-digit, again, contemplating the increased demand we had last year due to the weather in the last few weeks of the quarter.

Camilo Lyon Q
Analyst, Canaccord Genuity, Inc.

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Got it, okay. So, it's great to be conservative from the standpoint early in the season. My second question is on – just more of a fine-tuning question. You talked about shifts in non-recurring items both in gross margin and marketing. Could you quantify what those words so we understand what the underlying rates are for the business and how the shift in marketing expenses are going to play out, and if that's a roughly 50/50 split between Q3 and Q4?

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

A

Yeah. So I think – maybe if we kind of take a step back in terms of what happened in Q2 and how we're flowing that through that, I think that kind of helps set up how we're looking at the year. So, with the strong [ph] beat (00:31:03), which was largely driven by gross profit dollars, which a little less than half of that was the airfreight, and that was just kind of strategic planning that helped really drive that improvement. So, not always to say that we can achieve that same level, but we flowed that through in terms of gross profit lift.

On the full year, so the 49% moving to 50%, that's basically the flow-through of the $20 million that we're seeing in gross profit. What we're then doing is taking a portion of that to reinvest in marketing. So that's what you're seeing kind of the lift in the SG&A in the back half, which is the 30% we've guided to.

Camilo Lyon
Analyst, Canaccord Genuity, Inc.

Q

Got it.

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

A

And then some of the timing from Q2 is being put into the back half.

Camilo Lyon
Analyst, Canaccord Genuity, Inc.

Q

Okay. So, like $10 million for SG&A Q3 and Q4 of that $20 million that you're taking from gross margin?

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

A

Correct.

Camilo Lyon
Analyst, Canaccord Genuity, Inc.

Q

Okay.

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

A

And the other thing – go ahead, Camilo. Sorry.

Camilo Lyon
Analyst, Canaccord Genuity, Inc.

Q

I was just going to clarify, and there is also a separate SG&A shift in addition to that?

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

A

Right. So, the SG&A savings that you're seeing in Q2 is largely timing, and that's moving to back half.

Camilo Lyon
Analyst, Canaccord Genuity, Inc.

Q

Got it, okay. And then, just lastly, on the ability to the reality of achieving your 13% EBIT margin in the year ahead of plan, can you give us kind of a framework to think about, now that you've got the business really hitting on all cylinders, what's the outlook or what's the potential or what's the possibility of this business and the EBIT margins that you can generate? Is this continuing to grow at this rate, [indiscernible] (00:32:54) on the EBIT margin rate, or is there further opportunities to raise that EBIT margin profile?

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

A

Yeah. This is Dave. I think, longer-term, we're not prepared to kind of put those kind of targets out there yet. But we do think there is a little bit more opportunity, safe to say. I think it's also important though, and this is one of the reasons that we are reinvesting some of the operating profit dollars now since we are ahead of plan, is we do have growth drivers that we have been incubating that are showing signs of promise.

And so, I think it's very important that we take the opportunity to invest in marketing, particularly in the UGG Men's business and the UGG Women's spring and summer in transitional business, and then particularly in HOKA. HOKA, as you can see from the results, it's still continuing to take off. We think this has tremendous upside, but it's still relatively low awareness. And so, we want to take the opportunity now to invest in that business to create the awareness that will help fuel growth for the company back up to mid-single digit starting in FY 2020.

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

A

And I think, the other thing is, as we look at that strategic reinvestment, its invariable expenses. So everything we've talked about, the shift of moving fixed expense to variable, is playing out and is playing out kind of ahead of schedule. So we have levers in place to protect the profitability of the business. So that's what gives us comfort around that 13% this year.

Camilo Lyon
Analyst, Canaccord Genuity, Inc.

Q

Fantastic. Excellent. Good luck, guys, in the holiday season.

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

A

Okay.

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

A

Thank you.

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

Great. Thanks.

Operator: The next question will come from Jim Duffy of Stifel.

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

Thanks. Good afternoon, guys.

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

Hey, Jim.

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

I know a lot of hard work went into the margin progress, so congratulations to the team.

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

Thank you.

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

It does seem like the gross margin has been a nice source of upside within that. Last quarter, for instance, I think you said 90% of the cost of goods opportunities you identified $150 million savings had been realized. Do you see good further opportunity in the gross margins?

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

Yeah. I think from my standpoint as I look at, we've got most of it now kind of under our belt. So, there is not too much more. You're not going to see a similar cadence of improvement on the gross profit. Kind of when we laid out our plan, we said that the gross profit improvement was largely going to be what comes first. Kind of from an upside where it would come from would be depending on the promotional environment. So, this year, we've assumed a higher level of promotion this year versus last year. If that plays out where we are less promotional, there's probably a little bit upside on the gross profit.

But in terms of the workaround the plan that we have in place in terms of material optimization moving production outside of China, a lot of that heavy lifting. And then this quarter benefiting probably a little more than we were really from airfreight is really what's driving that improvement in the quarter that we're able to flow through to the full year then.

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

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Yeah. And I also think on top of that, [ph] just a better handle (00:36:02) on the inventory control, meaning that the inventory through the pipeline into the marketplace, and you should see less volatility in the margin going forward. We have pretty firm handle on the cost savings going forward. We're migrating production out of China into Vietnam, and that is going well. So we feel pretty good about – really good about the progress and then good about how things play out going forward.

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

That's a great segue. My next question, I wanted to ask what you're doing so much better and different from an inventory management standpoint that had always been a little bit of a wild ride with you guys, and it seems like you've really tightened things up. Can you speak to some of the operational factors behind that?

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

Yeah. I think, the first thing we've been focused on a last couple of years is just better visibility across the organization and holding the teams and ourselves accountable for our top and bottom line. We've also spent a lot of time on the supply chain process and pre-season planning so that we are efficient how we bring and when we bring product into the DC and to the consumer. So that's going to play out in better terms.

As we're starting to see in the business, but I really think the planning teams and the work that they've been with the factories and flowing product differently has and will have a big impact on that going forward, continuity planning, level loading at the factories and just-in-time inventory into the DCs.

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

And then, any more of those nice one-time upside opportunities in [indiscernible] (00:37:34)?

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

Well, I think...

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

We pulled out lever this quarter.

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

Yeah, we pulled out lever this quarter. I mean, the air was a big piece and, again, not to say that we can do that every quarter. It was again, to your point, much better planning on our part to be able to flow product in and get it out, but you'll always have to airfreight some products in [indiscernible] (00:37:58).

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

Another good strategic decision we made towards the tail end of the quarter to not spend that money on airfreight knowing that we were still able to deliver the sales for the quarter and then create an opportunity to reinvest some of that back into the business what you're seeing.

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

Q

Very good. Thank you, guys.

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

A

Thanks, Jim.

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

A

Thanks, Jim.

Operator: The next question comes from Chris Svezia of Wedbush.

Christopher Svezia
Analyst, Wedbush Securities, Inc.

Q

Thanks very much and congrats on the quarter.

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

A

Thanks.

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

A

Thanks, Chris.

Christopher Svezia
Analyst, Wedbush Securities, Inc.

Q

So, I'm just curious just [indiscernible] (00:38:33) but just on the gross margin, I know you called out there's roughly – I think you said 150 basis points or so related to freight, but there is also a lot of other structural things you've talked about that were driving the business on...

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

A

Right.

Christopher Svezia
Analyst, Wedbush Securities, Inc.

Q

....product DTC, et cetera.

As we sort of move forward, what today within the model? What's sustainable as you go into the back half? And what goes away or what offsets that to get to what is implied sort of a flat gross margin? I would assume Q4 gross margin is going to be down or at least implied in the guidance. Can we just talk a little bit about that what goes away or what are we missing here as we move sort of forward to the back half of the year?

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

A

Yeah. So, I think one of the things that we benefited from and I can walk through, so clearly airfreight was the big one. Some of our vendors support marketing that we typically have in Q2 moved into Q3, so that's a bit of a headwind in Q3. And that's largely around our UGG 40th anniversary event. So to put more marketing dollars that flow through our gross margin into Q3 versus Q4, so that's a switch. So you're seeing a benefit in Q2 as we move some of the dollars in this year into Q3 as we support that 40th anniversary.

Some of the other things that you saw DTC mix helped us in Q2. We did get a little bit of benefit from favorable foreign currency, so that came in a little bit better than what we were planning, and then our product cost came in. And while we have that factored into our guidance, we did see a little bit more of that in Q2 than what we anticipated. So that gave us kind of a bit of a lift.

I think, as you begin to look at the back half, a lot of that is baked into our guidance. So when you think about Q3 and you think about rates and kind of our ability of kind of where the guidance is versus where we can go.

Last year, we benefited largely from very favorable weather conditions that helped drive a strong wholesale reorder, which held full-price margins in place. We also benefited from stronger DTC sales. As wholesale ran out of product, they came to DTC. So, with a more conservative approach this year around Q3, we're seeing kind of headwinds that we're facing in that respect. That's partially being offset by continued improvements in our supply chain that we have factored in. And so, that's kind of how we get to what's in the guidance for the margin.

Christopher Svezia
Analyst, Wedbush Securities, Inc.

Q

Okay. And just to be clear, it looks like putting all the words in your month, but Q3 would be more of a flattish to up slightly, then Q4 would be down somewhere in that 100 basis points to kind of get to your view, just given that comparison for Q4 is pretty significant. Am I thinking about that right?

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

A

More flattish in Q3 so not so much upside because of the favorability that we experienced last year. So that would give a little more room on Q4.

Christopher Svezia
Analyst, Wedbush Securities, Inc.

Q

Okay. Got it. And the marketing is more shifted to Q4?

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

A

Yes. So that's more of a Q4 event. Because as Dave said, that's more around strategic initiatives to drive long-term health so we're not necessarily seeing that driving kind of near-term sales.

Christopher Svezia
Analyst, Wedbush Securities, Inc.

Q

Got it. Okay. And Dave, just a general question for you. Just as you think about you hit your profitability target 13% plus already, and I'm just curious can you talk about mid-single-digit top line growth, you're sort of just a

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breath away from that this year. Just sort of maybe help us along when you can potentially hit that level of growth, just sort of your thought about hitting mid-single digits on a more consistent basis?

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

A

Yeah. I think we're pleased with the progress we've made obviously in the first half of this year ahead of expectations and trending well. When you lay that into a full year mix of business, it's not as significant, but we do think there is continued upside in Q1 and Q2 going forward with the success of HOKA spring and summer product. We're shooting to get to that mid-single-digit growth rate starting in FY 2020. We're not putting any of that out there yet. But that's where our sights are set. That's where we're making some of the reinvestments here now into the business. And so, I'd say, you can start to see that in the early days of 2021.

Christopher Svezia
Analyst, Wedbush Securities, Inc.

Q

Okay. Thank you and all the best. Appreciate it.

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

A

Thank you.

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

A

Thanks, Chris.

Operator: The next question comes from Omar Saad of Evercore ISI.

Omar Saad
Analyst, Evercore Group LLC

Q

Thanks for taking my question. Great quarter. Thanks for all the information.

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

A

Thanks, Omar.

Omar Saad
Analyst, Evercore Group LLC

Q

I just wanted to ask question about weather, sorry. But it's been a pretty warm fall. Obviously you guys have a product that's seasonally affected of course. As weather is churning, we're hearing some data points around accelerations happening at retail. It feels like there could be some pent-up demand back on the heels of cooler weather. Just wondering if you have any thoughts on that topic? Thanks.

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

A

Yeah. I think we're pleased with how the quarter has started off. We have – like I said, we have clean inventory in this channel. We've got great segmentation out there. And where there is some colder weather, we are seeing a

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little bit of impact on the sales, which is great to see, which means the product is right and is resonating for the consumer.

Always cautious to comment on weather expectations. I do know that last year was kind of a perfect storm, so to speak, just in terms of weather and timing, particularly in the back half of December going into January. So, I guess, best to say that we feel good about how we're positioned with the clean inventory channel, the allocation, segmentation, new accounts, product resonating. And if the cold weather comes, I think we're in really good shape for that.

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

Yeah. And I think, again, just to be clear on that, our expectation on weather is more conservative than what we saw last year. So we're not expecting a repeat of last year.

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

Yeah.

Omar Saad
Analyst, Evercore Group LLC **Q**

Got it. That's really helpful, guys. Dave, can I also ask you about Amazon, I think, the stock is under pressure this afternoon, that might have been a little bit of a [ph] sale pressure (00:44:52), I'm not sure. But it's a relatively new business for you guys. How do you see the role of that channel? Is it offensive? Is it defensive? Is there any impact on other channels or overlapping? How do you think about segmenting product there? Thanks.

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

Yes. So, I have to give the teams a lot of credit for the way they're managing that account. That was a major decision that we made a couple of years ago to sell directly through Amazon channel. And so far, it's been working well. There have been very straightforward with the rest of our accounts and the expectations for Amazon. We've identified them as I believe the core account versus premium, so they're not getting the full breadth of the line or saving that for DTC and some of our premium accounts. And we're controlling the inventory there in a really very positive way, I would say.

I think it's interesting to see that despite opening up Amazon, we're still seeing healthy business in some of our key accounts, e-commerce business at the same time. So, I think there is a channel opportunity there, but it's not massive. We want to make sure that we monitor that within the mix of our key partners, and we're servicing that consumer correctly for their consumer.

But so far, I would say, we're pleased with how it's managed. We are tightly monitoring that. We have teams on it every day as we are with our top strategic accounts across the board. So – so far so good, but we're – the sanctity and the premiumness brand is first and foremost versus driving massive upside growth within the Amazon channel.

Omar Saad
Analyst, Evercore Group LLC **Q**

Thank you. Best wishes for holiday.

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

All right.

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

Thank you.

Operator: The next question comes from of Mitch Kummetz of Pivotal Research.

Mitch Kummetz
Analyst, Pivotal Research Group LLC
Q

Yeah. Thanks for taking my questions. Just wanted to drill down some of these puts and takes a little bit more. So, starting with the gross margin, is there any way to kind of normalize what that was before the quarter? It sounds like there are clearly some benefits that were a little bit more one-time in nature. So, is there any way you can kind of address that?

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

Yeah. So, what I would say is, Mitch, if you kind of look at the $20 million, right, roughly about $3 million to $4 million kind of the lift, it's kind of $19 million to $20 million. $3 million to $4 million of that is really volume, so that's kind of the higher sales that we expected. So when you get kind of beyond volume, then you're at a rate of, call it, kind of $15 million to $16 million.

We're seeing a little less than half of that is really kind of related to that not using airfreight this year compared to, say, what we used last year or anticipated for this year. And then, you get into kind of a couple of the other items that I talked about. So we have vendor support marketing, which is a part of gross margin. That's couple of million dollars that moves into Q3 out of Q2. And again, that's really related to the 40th anniversary, and then similar amounts with DTC mix product costs beneficial in Q2 and then some on the FX upside that we saw in Q2 but didn't plan.

Mitch Kummetz
Analyst, Pivotal Research Group LLC
Q

Got it. I appreciate that color. And then, on the Q3 gross margin outlook, Steve, I think you said kind of flattish – you talked about the benefit that you saw last year from the strong full price selling. It sounds like you expect to be – you were thinking you would end up being a little bit more [ph] promotional (00:48:21) this year at least that's kind of in the guide.

So I know gross margin was up 170 bps on last year, can you remind us how much of that was weather-related, how much of that is that you seem you give back and then like how much is the supply chain benefit continued into Q3? Does that all makes sense those questions?

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

Yeah, it does. So, basically I think what we're seeing, last year we kind of – or the difference, I would say, that we're looking at, say, this year versus last year, is probably around 50 bps hit as being more conservative around

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weather. Probably a similar type offset with the continued improvements in supply chain initiatives, so there's two kind of offset.

Mitch Kummetz
Analyst, Pivotal Research Group LLC

Q

Got it. Okay, great. And then, lastly, just thinking about the sales impacts kind of last year to this year in the third quarter, I think you mentioned you picked up $30 million on reorders relative to, I think, when the guide was $10 million on DTC, plus this year you got the store closures and the segmentation strategy which on an annual basis is like $50 million, I would guess. Probably half of that hits in Q3, just kind of sizing up UGG. How much impact UGG has on the third quarter?

So, I mean, my math is that that gets you like down $60 million, $65 million, is that how you're thinking about UGG for the quarter? I know you've not given specific UGG guidance on the quarter, but [ph] just offset (00:49:47) to that or just help me understand that.

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

A

Yeah. I think you're a little too high on kind of the hit.

Mitch Kummetz
Analyst, Pivotal Research Group LLC

Q

Yeah.

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

A

So, more UGG kind of down low-single-digit year-on-year.

Mitch Kummetz
Analyst, Pivotal Research Group LLC

Q

Yeah.

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

A

It's kind of how we're looking at Q3.

Mitch Kummetz
Analyst, Pivotal Research Group LLC

Q

And is that all segmentation stores or is that also fewer reorders and less [indiscernible] (00:50:10)?

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

A

Yeah. I guess – yeah, it will be probably about $30-ish-million of less reorders, a little more conservative stance in terms of retail and e-commerce with combination of fewer retail stores.

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Mitch Kummetz
Analyst, Pivotal Research Group LLC

Q

Yeah. Okay. That's good. Thanks, guys.

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

A

Okay, thanks.

Operator: [Operator Instructions] Our next question will come from Rafe Jadrosich of Bank of America Merrill Lynch.

Rafe Jason Jadrosich
Analyst, Bank of America Merrill Lynch

Q

Hi. Good afternoon. Thanks for taking my question. I just wanted to follow-up on your comments on achieving the 13% operating margin a year early. I think savings from store closures was a big portion of the SG&A savings in that. Can you talk about where you are in that process and how many stores you have, how many you plan to close and where you could see additional savings there?

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

A

Yes, good question. Since we've been on this path, we've spent a lot of time with the retail teams optimizing profitability at a store level across the fleet. And I'm pleased to say that made great progress on that front. And the original target of $125 million we put out there a little over 18 months ago was the target kind of lying down too. As we're getting further along in the process of the cost savings initiatives, we're finding that there is some improvement in some of these stores. And we're basically looking at store level evaluating them if they can get above the internal threshold for [indiscernible] (00:51:54) profitability, which we said is about 20%. We're going to put those on the re-evaluation list versus closure list.

So, we continue to drive improvements into the fleet. We're continuing to evaluate to see what we think from a long-term perspective some of these growth drivers in men's and spring and summer can do to the profitability of the stores. But suffice to say, we will be closing more stores than we'll be opening over the next foreseeable future.

Rafe Jason Jadrosich
Analyst, Bank of America Merrill Lynch

Q

Thank you. And then, can you comment a little bit about what you're seeing in Europe right now?

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

A

Yeah. Europe is – there is obviously macro and economic challenges over there. The brand remained strong [indiscernible] (00:52:39) that we're seeing particularly in the UK, the macro level issue. So, we're remaining a little bit conservative there. We do feel good about similar setups that we have in North America with regards to segmentation in some of the new accounts that we've been fostering over there. But the [indiscernible] (00:53:01) is really a macro level issue that we're just taking a conservative look at Europe right now.

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Rafe Jason Jadrosich
Analyst, Bank of America Merrill Lynch

Q

Okay. Thank you. And then, just the...

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

A

That's really related to UGG. The HOKA brand is still seeing strength and growth opportunity at this point. So it's really an UGG issue with the mature business, particularly in the UK.

Rafe Jason Jadrosich
Analyst, Bank of America Merrill Lynch

Q

Yeah. And then, can you just talk about what FX assumption is [ph] as you bake (00:53:30) in to the guidance and remind us about how you hedge like how far out you're hedged right now?

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

A

Right. So basically – so, the guidance assumes current rate. We do put hedging in place at the beginning of the year. We don't hedge 100%, but we do hedge a large majority of our FX exposure. So, we will have – always have a little bit of FX exposure, but we hedge kind of for the year at the beginning of the year.

Rafe Jason Jadrosich
Analyst, Bank of America Merrill Lynch

Q

Calendar year?

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

A

Yeah, so our fiscal year. So, going into our fiscal year, we have our budget where we're basically hedging large majority of our exposure, but again not 100%. So we'll always get some fluctuation. And then, every quarter we'll be updating to current rates. But that will also take into account some of the hedge exposure too.

Rafe Jason Jadrosich
Analyst, Bank of America Merrill Lynch

Q

Okay. Thank you.

Operator: The next question will come from Erinn Murphy of Piper Jaffray.

Erinn E. Murphy
Analyst, Piper Jaffray & Co.

Q

Great. Thanks. Good afternoon. I was hoping you guys could talk a little bit more about what you saw from the Chinese consumer during the quarter, and maybe just kind of split it between what you're seeing in terms of Mainland trends versus what you're seeing with the Chinese cluster overall, inclusive of those traveling to Japan or Europe or elsewhere?

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

A

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Yes. So, the China market for us had a good quarter. I think, again, similar to what's happening in the U.S., some of the new products that's more seasonally relevant, again, like the Fluff Yeah and the Neutra Sneaker, [ph] Seasonal (00:55:10) slippers are trending and performing well, which is a good sign that they're resonating at a global level.

We are seeing a little bit of impact from the Chinese consumer on other markets, particularly in Japan. There is a lot of Chinese tourism happening in Japan right now, and the Japan business seems to be turning around versus last year.

So, it's something that for the UGG brand, things are still trending well with that consumer. I do know at a macro level, there is potential concern about what the trade wars are going to have for an impact on the Chinese consumer globally. But I think, for us, within the UGG brand, we're still seeing the brand resonating and the new product working at a global level.

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

A

Yeah. It's great to see as we continue to develop that market. And Asia-Pacific, the region was a good performer for us in the quarter. So we're continuing to see growth in those areas.

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

A

Yeah.

Erinn E. Murphy
Analyst, Piper Jaffray & Co.

Q

Okay. And then, maybe just kind of sticking with the trade war piece, what percent of your business today is impacted by that $200 billion of tariff that was put in place on September 17?

And then, I guess, have you seen as you kind of talk to other people in the industry, any retailers trying to kind of front run shipments before the end of the year – before we move out to 55% tariff in some other categories? And I know you don't have a ton of exposure in those, but just curious.

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

A

Yeah. So, we don't have a ton of exposure. Some of those new categories are tiny businesses for us in the scheme of things. And as I said earlier, the teams have done a tremendous job of migrating our production to other places beyond China to the point now where we're at over 70% outside of China. And for us, deliveries for FY 2019 are pretty much already on the [ph] water and on their way, if there're not already here (00:57:03) going into Q3. So we've been planning for that.

The exposure going forward, we feel, is pretty minimal. And I do know there's other – talking to our suppliers in China and Vietnam, we were just there a couple of weeks ago just in the marketplace, people are stumbling a bit. But as far as Deckers' business goes, we feel good about those liabilities being reduced from a China production standpoint and our ability to ship product in a timely manner to avoid any issues this year.

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

A

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Yeah. And then, just on the tariffs, Erinn. So, right now, anything that's been imposed, we have not been impacted by. And then just to give you a rough idea of where we're at, by the end of this calendar year, about 20% of the product from the products that we have will come out of China. And we expect to continue to reduce that going forward. So, we feel good about kind of our current level of exposure, and it's improving.

Erinn E. Murphy
Analyst, Piper Jaffray & Co.

Q

In that 20% out of China, is that all being shipped to the U.S. or is that as a total, so it's even a smaller piece that's coming to the U.S.?

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

A

Yeah. So it's 20% global, even less in the U.S.

Erinn E. Murphy
Analyst, Piper Jaffray & Co.

Q

Got it. Thank you, guys, very much.

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

A

Yeah. Thanks, Erinn.

Operator: And next we have question from Sam Poser of Susquehanna.

Sam Poser
Analyst, Susquehanna Financial Group LLLP

Q

Good afternoon. Thanks for taking my question. A couple of things. The gross margin guidance that you provided given that your inventory arguably is significantly cleaner than it has been from a dollar perspective in quite some time. Doesn't that help to offset some of the potential pressures because of the pull model that you are beginning to develop?

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

A

Yeah. I think we've related that into the guidance. And as we said, for the quarter total inventory down 7% obviously with the growth of UGG and Koolaburra. UGG is down even more than that. And so, we do feel good about that. I think the margin upside that we saw in Q2 from deliveries and shipments in the quarter is indicative of the kind of go-forward margin. But I think with the mix of DTC and fewer stores versus wholesale this year versus last year and also some of the assumptions around a little bit more promotional marketplace offset the upside that we are seeing. And I think it's all embedded into the guidance.

Sam Poser
Analyst, Susquehanna Financial Group LLLP

Q

And then two more things. One, you mentioned some of the fashion athletic accounts for Locker and others, what kind of response are you getting there and what kind of an opportunity do you think it is? And I've got one more quick one at the end.

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

A

Yeah. As you know, we've been cultivating accounts such as Foot Locker, Footaction, SIX:02 for a couple of years working closely with those teams. We are doing it in a thoughtful and strategic way starting with the Footaction doors. This is a first time ever that we sold into Foot Locker. We are doing it in a very thoughtful way similar to what we did with Macy's a couple of years ago with a small amount of doors as a test, lets test and learn, let's take those learnings and embed them into product and marketing and the partnership. And we're pleased with how things are performing and the response of both Foot Locker Inc. and their consumer so far.

So I think this is a meaningful opportunity. If we can really resonate particularly in men's with that in sports lifestyle consumer in that distribution over time, and as I said earlier in the call I do think it's incremental to places like Nordstrom and Dillard's. I think it could be meaningful for UGG particularly in Men's, but also in UGG Women's as well. And what's great about it is it gives us exposure and an opportunity to connect with that younger consumer, which we don't necessarily do in Nordstrom and Dillard's in traditional accounts. So I'm pretty excited about it and we also think about the opportunity for Foot Locker in Canada and Europe and then kind of like JD Sports, or JD over in UK as well.

Sam Poser
Analyst, Susquehanna Financial Group LLLP

Q

Thank you. And then lastly, back to the inventory for one sec, given the way the inventory is tracking, could you give us some idea of how – Steve may be how you're thinking about the inventory at the end of this quarter and at the end of the year? Also especially what are you doing to maybe offset that potential for them taking the other tranche, the $267 million even though it is a small part of your business impacted by the tariffs?

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

A

Yes. I think as we look at it and I'll kind of answer your question in context of Q2, we feel we've made some pretty significant improvement in Q2. So, inventory down 7% year-over-year. When you lay that into the context of the brand with the growth of HOKA and Koolaburra, we've got inventory increasing their. So the improvement within the UGG brand is even more impressive than the 7%. So we think we've made good progress with inventory. I wouldn't factor this same level of improvements kind of in the next two quarters. It's something we were going to continue to work on. But with a big inventory being brought in and movement in this quarter and next quarter, we're pretty pleased with this result. I wouldn't kind of extrapolate these result yet on to the next two quarters. Yeah.

Sam Poser
Analyst, Susquehanna Financial Group LLLP

Q

All right. Thanks very much. 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 Sam.

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Operator: And this concludes our question-and-answer session. The conference is now concluded. Thank you for attending today's presentation. You may now disconnect.

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