Crocs, Inc.
Fourth Quarter 2018 Earnings Conference Call
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CONFERENCE CALL PARTICIPANTS

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Erinn Murphy, Piper Jaffray
Mitch Kummetz, Pivotal Research Group
Sam Poser, Susquehanna International Group
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PRESENTATION

Marisa Jacobs:

Good morning, everyone, and thank you for joining us today for the Crocs Fourth Quarter 2018 Earnings Call. Earlier this morning we announced our fourth quarter results, and a copy of the press release can be found on our website at crocs.com.

We would like to remind you that some of the information provided on this call is forward-looking, and accordingly, is subject to the Safe Harbor provisions of the Federal securities laws. These statements include, but are not limited to, statements regarding future revenues, gross margin, SG&A as a percent of revenues, operating margins, CAPEX, and our product pipeline. Crocs is not obligated to update these forward-looking statements to reflect the impact of future events. Adjusted SG&A, income or loss from operations, net income or loss attributable to common stockholders, and earnings or loss per share are non-GAAP measures. A reconciliation of these amounts to their GAAP counterparts is contained in the press release issued early this morning.

We caution you that all forward-looking statements are subject to risks and uncertainties described in the risk factors section of our Annual Report on Form 10-K. Accordingly, actual results could differ materially from those described on this call. Please refer to Crocs’ Annual Report on Form 10-K, as well as other documents filed with the SEC, for more information relating to these risk factors.
Joining us on the call today are Andrew Rees, President and Chief Executive Officer, and Anne Mehlman, Executive Vice President and Chief Financial Officer. Following their prepared remarks, we will open the call for your questions.

At this time, I'll turn the call over to Andrew.

**Andrew Rees:**

Thank you, Marisa, and good morning, everyone. Ahead of last month’s ICR conference, we updated you on our fourth quarter performance, so you know we had a very successful year. The more detailed results reported this morning are further evidence of our success. At ICR we spoke about our expectations regarding 2019 revenue growth. Today we are raising those expectations. We now anticipate revenue growth of approximately 5% to 7% in 2019 and, excluding the impact of store closures, our 2019 revenue growth would be 7% to 9%.

During the balance of this call, Anne and I will cover a number of topics. We will highlight our tremendous progress in 2018, the strength of our brand and our products, and delve more deeply into our priorities and guidance for 2019.

We had an outstanding 2018 as we returned the Company to top-line growth. We grew revenues in each quarter, and for the full year grew revenues 6%, or 12% excluding the $60 million impact from store closures and business model changes. Both our Americas region and our e-commerce channel set new revenue records.

Our initiatives to improve the quality of our revenues materially improved our margins. In 2018 we expanded our gross margin by 100 basis points to 51.5%, our highest level since 2013. Over the past three years, we have improved our gross margin more than 450 basis points. We have successfully completed our SG&A reduction plan by eliminating approximately $75 million of annualized expenses from our cost structure between 2017 and 2018. In 2019 we realized approximately $10 million in additional cost reductions. We’re reinvesting some of those savings into marketing and our e-commerce business to further strengthen our brand and drive incremental sales growth.

With strong gross margin improvement and much of our work related to expense reductions behind us, our focus now and going forward is on accelerating sustainable, profitable, top-line growth as we further strengthen our brand and continue to deliver compelling product.

We’ve reported before that the heat around our brand continues to build. Results from our 2017 and 2018 annual brand surveys show dramatic increases in our brand desirability, relevance, and consideration. The pace and scope of our collaborations further speak to our increasing brand heat. We wrapped up 2018 with two Post Malone collaborations that sold out in minutes and generated significant consumer awareness and interest amongst his millions of followers.

Our 2019 collaborations are off to a great start. We’ve already rolled out four collaborations with edgy, L.A.-based streetwear brands, Pleasures, Left Hand LA, Chinatown Market, and PizzaSlime. Each drop featured a highly original take on the Classic clog and brought us great visibility with fans of those brands. All four sold out in minutes. We look forward to unveiling additional exciting collaborations throughout the year.

With the second quarter launch of the next-generation of our Come as You Are campaign, we’re featuring five exciting new brand ambassadors, selected for their relevance in our five key markets. We will introduce impactful new marketing content designed to further raise our profile and drive sales.

Product, of course, is at the heart of our recent success and is key to our future.
Clog relevance, sandal awareness, and visible comfort technology were central to 2018 and remain equally important in 2019 and beyond. New colors, graphics, and embellishments have transformed clogs into a must-have year-round silhouette. Our Jibbitz charms allow our customers to personalize their clog selections to reflect their distinct personalities. In Q4 we grew clog revenue 17% and full-year growth was 13%. With a vibrant spring/summer 2019 collection and impactful marketing, clog sales will continue to grow as we drive demand across a diverse group of global consumers.

With respect to sandals, we are two years into a major initiative to grow sandal awareness. In 2018 we continued to take share in this large highly fragmented category that is clearly in sync with our brand DNA. During Q4, sandal revenues grew 11% and generated 15% of our footwear revenues. Full-year 2018 sandal revenues grew 19% and generated 23% of our footwear revenues compared to 20% in 2017. Consumer demand for our comfortable and attractively priced sandals is growing, and wholesale accounts are responding in kind. We continue to see sandals as a key component of our future growth.

Last year we brought new product to market to address the growing demand for visible comfort technology. Our LiteRide launch far exceeded our expectations. This was achieved through a globally integrated digital marketing campaign. We spent much of the year chasing product as LiteRide quickly became one of our top five collections. This year we anticipate LiteRide sales will increase materially, and we’ve geared up to meet growing demand. We’re also excited about the introduction of LiteRide for kids this fall. For spring/summer 2019 we introduced another new product, Reviva, a sandal collection incorporating strategically placed bubbles in the foot pad that massage with every step. Reviva is just getting into the market, and the initial response from consumers has been enthusiastic. We will continue to introduce new products to keep our collections fresh and relevant.

Turning briefly to our distribution channels, I’m pleased with the progress we’ve made in 2018. During Q4, wholesale revenues grew 10% as customers increased orders to keep pace with strong demand. Clogs were the standout, and despite increasing the amount of lined product available, demand exceeded supply. Within wholesale, growth was most robust amongst our e-tail accounts. Distributors, the other leading component of our wholesale business had a good quarter as well, as they continue to refine their assortments and marketing to enhance growth.

Our DTC comp, which combines our retail and e-commerce results, was up 16%. Our e-commerce channel grew 19%. This was our seventh consecutive quarter of double-digit e-commerce growth with our best fourth quarter e-commerce revenues ever. We’re driving these strong e-commerce results by continually improving the customer experience on our sites and enhancing the effectiveness of our global digital marketing activities.

At retail we delivered our sixth consecutive quarter of positive comps, increasing 13% globally. We closed a net 175 locations over the past two years, completing our store closure plan. As a result, over half of our remaining stores are outlets, our most profitable format.

On a full-year basis, we delivered strong results in each channel. We grew our wholesale business 8%, our DTC comp was 14%, and our retail comp was 11%. Our e-commerce business grew 23% and made up 17% of our total sales, up from 15% in 2017. These results reflect the growing brand heat and consumer demand I discussed earlier.

I’m especially pleased with the growth of our digital commerce activity. This consists of our e-commerce business which has two parts, sales on our own websites and sales we make on third-party marketplaces, plus the e-tail portion of our wholesale business. We embraced digital commerce early on, believing we would win by allowing consumers to shop wherever and however they wanted, and we’ve
been investing to build our global team and technological capabilities in this area. Ecommerce is the fastest-growing portion of our business, and we expect that to remain the case going forward.

Marketplaces are our newest e-commerce initiative. We are currently active on eight sites, five of which came online late last year. This year we expect to launch on approximately five more sites. We expect marketplaces to become increasingly important to us since they provide another venue of direct access to our global consumers.

Before wrapping up, I want to tell you about another important project. We are investing in a new distribution center in Dayton, Ohio, to support our long-term growth and provide better service to our customers. This new facility will replace our existing facility outside of Los Angeles. At 550,000 square feet, it’s approximately 40% larger than our current facility, and there’s room to expand. Additionally, the new facility will incorporate automation, enabling us to increase our throughput by 50% to support our future growth plans. Another critical benefit associated with this move is greater speed to market given Dayton’s central location. I’m very pleased about this move which will take place in phases and is expected to wrap up in the fourth quarter of this year. In 2020, when the new distribution center is fully operational, we expect a benefit to gross margin of approximately 100 basis points.

2019 will be an exceptionally busy year as we focus on the opportunities we have identified to deliver further sustainable profitable revenue growth. From a product perspective, clogs, sandals, and visible comfort technology will continue to be the key drivers of our growth. From a channel perspective, we expect e-commerce to once again be our fastest-growing channel. At wholesale, our e-tailers, and distributors present the greatest opportunity, while our retail business will keep benefiting from our prioritization of outlets. From a regional perspective, we expect the strong momentum in the Americas to continue, while we expect Asia to have the greatest long-term growth potential.

Our global marketing organization will continue to drive the brand heat that helps fuel this growth with content from our great new brand ambassadors and attention-grabbing collaborations, along with the increasingly effective digital marketing.

2019 is off to a strong start. We believe we are well-positioned to deliver top-line growth and profitability that in turn drives incremental shareholder value.

At this time, I’ll turn the call over to Anne to review our fourth quarter results and guidance.

Anne Mehlman:

Thank you, Andrew, and good morning, everyone. I'll begin with a short recap of our fourth quarter and full-year 2018 results. For simplicity, I'm going to limit my remarks to our non-GAAP results. Please refer to our press release which includes reconciliations of non-GAAP to GAAP results.

For 2018, our results far exceeded what we had guided to at the beginning of the year. We made important progress with respect to growing revenues and improving our operating margin. We strengthened our balance sheet and simplified our capital structure. In terms of the fourth quarter, revenues were $216 million, up 8.5% from a year ago, including a negative currency impact of approximately $6 million versus the fourth quarter last year. Store closure and business model changes reduced revenues by approximately $7 million in the quarter. Absent that $7 million impact, revenues would have grown almost 12%. This marks our fifth consecutive quarter of double-digit revenue growth once you adjust for store closures and business model changes, demonstrating the strength of our underlying business.
I do want to note that because fourth quarter sales significantly exceeded our expectations, inventory currently available for purchase is limited. This is reflected in our first quarter revenue guidance which I’ll turn to momentarily.

We sold 11.6 million pairs of shoes, an increase of 5.9% over last year’s fourth quarter. Our average selling price for footwear during Q4 increased 2.2% to $17.93. ASP gains were achieved through less discounting and selective price increases. For 2018 in total, we sold 59.8 million pairs of shoes, 3.4% more than in 2017, at an average selling price of $17.71, up 2.3% from the prior year.

In the Americas, revenue grew by 15% to $121.6 million in the fourth quarter, including a negative currency impact of $2 million. We saw exceptional strength across all channels, particularly in our North American direct-to-consumer business, which benefited from the growing demand for our Classic clog. The strength we’ve been seeing in our DTC business for some time now is clearly migrating to our wholesale business. Wholesale revenues increased 9.6%. In North America in particular, we had a very good quarter as we worked closely with wholesale customers to boost sell-through rates.

Our Americas DTC comp was up 21.2% following on the heels of a 21.6% increase in Q3. Our retail comp was outstanding, coming in at 17.3% and representing our seventh quarter in a row of positive comp growth. Total retail revenues grew 13.4% despite having seven fewer stores than in last year’s fourth quarter. E-commerce revenues increased 28.3% as site traffic surged. Active customers increased over last year, and the number of new customers grew even more dramatically. During 2019, our focus will be on maximizing clog growth and expanding our sandal penetration in the Americas among wholesale customers, while driving our DTC growth.

In Asia, revenues for the fourth quarter were $56 million, down $1.5 million or 2.5% from fourth quarter of 2017, with currency negatively impacting the quarter by $1.9 million. Strong wholesale results were more than offset by the impact of store closures and lower e-commerce sales in China. Wholesale revenues increased 5.1% on stronger sell-throughs. Our Asia DTC comp was 2.7%. Our retail comp was up 6.2%. Retail revenues declined 13.6% as we operated 33 fewer stores compared to the same time last year. E-commerce revenues decreased 4.8%. While we continue to see strong e-commerce growth across much of the region, in China, our 11/11 and 12/12 sales declined. Participation in these festivals has continued to become more competitive and expensive. In response, we limited our participation to preserve margins while focusing throughout the year on other festivals and events we find to be more profitable and impactful. During 2019 we will continue working to drive greater brand recognition across Asia and grow our owned markets, China, India, Japan, and South Korea, particularly through our e-commerce and marketplace activities. At the same time, our distributors will be pursuing top-line growth and expansion across their respective territories.

In EMEA, revenues grew 5.1% to $37.4 million over last year’s fourth quarter, with currency negatively impacting the quarter by $1.8 million. Strong wholesale and e-commerce results more than offset the decline in our retail sales. Additionally, Black Friday and Cyber Monday were more important in this region than in prior years. Wholesale revenues grew 13% as e-tailers and distributors also performed well in this region. Our EMEA DTC comp was 16.1%. Our retail comp was 4.7%, driven by higher conversion. We are very pleased with these results coming on the heels of an exceptionally strong Q3. We did operate 24 fewer retail stores, which accounted for the 28.7% reduction in retail revenues. Our e-commerce business grew by 23.1%. Traffic to the site increased materially as our brand heat rose, and we delivered a better online customer experience. In EMEA, our 2019 focus is on delivering growth through digital commerce and on distributors scaling their businesses. The addition of new wholesale customers will also help drive growth in this region.

Moving to the other items on the P&L, our gross margin was 46.2%, coming in 80 basis points higher than in the fourth quarter of 2017 and in line with our guidance. We continue to benefit from strong sales of

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high-margin clogs, the strength of our DTC business, and lower promotions. Our non-GAAP SG&A expense was $109.2 million. As a percent of revenue, non-GAAP SG&A was 50.6%, a 530 basis point improvement over our non-GAAP SG&A in the fourth quarter of 2017.

Our operating loss on a non-GAAP basis was $9.4 million. This was an improvement of approximately 55% compared to Q4 2017, and it reflects our success increasing revenues and gross margin while limiting the expenses in our smallest quarter. It was also our best fourth quarter results in the last five years. Our non-GAAP net loss per share was $0.10 compared to non-GAAP net loss per share of $0.27 in the fourth quarter of 2017.

Our balance sheet continues to be very strong.

Inventory at year-end was 4.5% lower than at the same time last year, reflecting our strong fourth quarter performance.

During the fourth quarter we repurchased approximately 1.2 million shares of our common stock on the open market for $26.1 million at an average share price of $21.05. During 2018, in total we repurchased approximately 3.6 million shares for $63.1 million at an average share price of $17.44. This leaves $156 million available under our plan for future share repurchases.

As a reminder, in connection with the transaction we entered into with Blackstone in December, we acquired half of our preferred shares that represented 6.9 million shares of our common stock on an as converted basis. The remainder of the preferred shares were converted into approximately 6.9 million shares of our common stock.

We ended the year with $123.4 million in cash. We used approximately $195 million in connection with the Blackstone transaction and borrowed approximately $120 million against our credit facility for that transaction. At the end of 2017 we had $172.1 million of cash and no outstanding borrowings. Earlier this month we amended our credit facility to raise our borrowing capacity from $250 million to $300 million.

During 2018 we generated $114.2 million of cash from operating activities, 16.2% more than in the same period last year.

I am also really pleased to call out a significant accomplishment in 2018. We grew our revenues and gross margins while reducing expenses, bringing us much closer to achieving our double-digit EBIT margin target. In 2017 our non-GAAP operating, or EBIT margin, was only 3.4%. In 2018 it was 7.7%, our best level since 2013. Our non-GAAP 2018 EPS increased 560% to $0.86 a share compared to the $0.13 a share delivered in 2017.

As we turn to guidance, I want to remind you that our guidance is on an as-reported basis based on current currency rates.

For 2019 we now expect our revenues to grow 5% to 7%. This includes a negative currency impact of approximately $20 million. E-commerce and wholesale growth are expected to more than offset the lower retail revenues resulting from store closures. We continue to estimate that store closures will reduce our 2019 revenues by approximately $20 million compared to 2018, without which our revenues would grow by 7% to 9%.

We expect our 2019 gross margin to be approximately 49.5% of revenues compared to 51.5% in 2018. This decrease results from higher freight costs and declining purchasing power associated with the strengthening of the U.S. dollar. It also includes nonrecurring charges associated with our distribution center relocation project which accounts for approximately 100 basis points of the reduction.
SG&A for the full year is expected to be approximately 41% of revenues compared to 45.7% in 2018. This guidance anticipates expanding our marketing investment and modest incremental SG&A associated with growing revenues. We expect to incur between $3 million and $5 million of nonrecurring charges in 2019 in connection with various cost reduction activities.

We expect our operating income margin, or what we refer to as our EBIT margin, to be approximately 8.5%. This includes nonrecurring charges associated with our new distribution center and SG&A cost reduction initiatives. Excluding those nonrecurring charges, we expect to achieve our interim target of a low double-digit EBIT margin which marks a significant milestone in our multiyear journey.

Our CAPEX spend is going to increase substantially this year as we make investments to drive operational efficiencies, improve the customer experience, and enable future growth. CAPEX for 2019 is estimated at approximately $65 million compared to $12 million in 2018. The distribution center project will account for approximately $35 million of the total. The balance relates to IT and infrastructure investments, some of which were deferred from last year, along with routine CAPEX. Depreciation and amortization is expected to be slightly below 2018’s $29.3 million.

In terms of income taxes, excluding any unexpected impact arising from the 2017 Tax Act, we expect a rate of approximately 25%.

Turning to the first quarter of 2019, we expect revenues between $280 million and $290 million compared to $283.1 million in last year’s first quarter. Our guidance incorporates the loss of approximately $6 million of revenues associated with our reduced store count and approximately $10 million of negative currency impact. This guidance also reflects the Easter shift which results in direct-to-consumer sales associated with the holiday shifting into Q2. Finally, the impact of strong demand in last year’s fourth quarter is constricting inventory available for certain at-once orders.

Gross margin for the first quarter is expected to be approximately 45.5% compared to 49.4% in last year’s first quarter. This decline is driven by four things. First is higher freight costs, including the use of air freight to replenish fast-selling items following our stronger-than-anticipated fourth quarter. Second is the negative impact of the stronger U.S. dollar. Third is the Easter shift from Q1 to Q2 which results in higher margin direct-to-consumer sales associated with the holidays shifting to Q2. Fourth, nonrecurring costs associated with the relocation of our distribution center will reduce our gross margin by approximately 50 basis points.

SG&A is expected to be between 37% and 38% of revenues compared to 40.2% in last year’s first quarter. This includes approximately $1 million of nonrecurring charges relating to various cost reduction initiatives. We incurred $2.5 million in nonrecurring charges in the first quarter of 2018.

In summary, I’m very excited about our plans for 2019 as we continue to drive growth and achieve our interim target of a low double-digit adjusted EBIT margin, which marks a significant milestone in our multiyear journey.

At this time, I’ll turn the call back over to Andrew for his final thoughts.

Andrew Rees:

Thank you, Anne. In 2018 we demonstrated that the course we embarked upon back in 2016 was the right one to revitalize our business and strengthen our financial position. We’ve significantly improved brand engagement, enhanced clog relevance and sandal awareness, and improved the way we operate
from a segment and channel perspective. These advances took incredible commitment and teamwork across the whole organization. I want to convey my sincere thanks to our whole team.

2019 is off to a great start, and I'm confident in our ability to maintain the positive trajectory of our business. We will continue to build on our strong clog tradition and expand our sandal business with on-trend, comfortable, and affordable sandals. We will upgrade our supply chain and maximize the growth potential across our three channels while improving our top and bottom line.

Operator, please open the call for questions.

Operator:

Certainly. Again, if you'd like to ask a question, please press star, one on your telephone keypad. To withdraw your question, press the pound key.

Your first question comes from the line of Steve Marotta with CL King & Associates. Your line is open.

Steven Marotta:

Good morning, Andrew, Anne, and Marisa. Congrats on the fourth quarter and a productive year. I just have a couple of questions. First, as it relates to the new DC being opened by the end of '19, can you quantify the duplicative costs associated with that within '19? Also, Andrew, I believe that you mentioned that when the new distribution facility is completely operational; it will be additive by about 100 basis points of gross margins. Is that for all of 2020, or is it going to be by mid-2020 that will be the run rate? If you could just add a little bit of color on the ramp of the DC.

Andrew Rees:

Yes. Thank you, Steve,, happy to do that. Look, I think this is a really important investment for Crocs. It shifts our nexus of distribution from the West Coast to the center of the country. We're making a substantial investment in a much more sophisticated DC operation than we've run in the past, which will run at a lower cost. It'll run at a lower cost for a couple of reasons. One is obviously the land and the building is more economical in Dayton, Ohio, than it is on the West Coast; labor rates are generally less; and probably more importantly, the automation means that we'll run the DC with substantially less labor. So, the 100 basis points of improved gross margin, will be in effect for the whole of 2020.

In terms of one-time costs or the costs that we're going to incur, Anne will address that.

Anne Mehlman:

Yes. Hi, Steve. The 100 basis points of margin improvement, as Andrew said, for next year is on an annual basis. We actually have 100 basis points of headwind this year. If you think through our full-year gross margin guidance, our adjusted gross margin guidance is 50.5% if you exclude the DC cost, which is about 100 basis points.

Steven Marotta:

All right. That's very helpful. Thank you very much. Maybe a follow-up, and then I'll jump back into queue. Was there any delta on the negative currency expectations for the current fiscal year from a revenue standpoint since ICR? I don't recall you talking about negative currency implications on Fiscal '19 revenue at ICR.
Anne Mehlman:

Yes. We did talk about the fact that our current expectation at ICR included a negative impact of currency. It really hasn't changed much. If you remember, currency is going to more strongly impact us in Q1 and Q2. The vast majority of the $20 million is going to be in Q1 and Q2. The way I would think about that is at current currency rates is approximately $18 million out of $20 million is going to be in the first couple of quarters of the year.

Steven Marotta:

That's very helpful. Thank you very much. I'll jump back in the queue and take everything else offline.

Anne Mehlman:

Thanks.

Andrew Rees:

Thanks, Steve.

Operator:

Your next question comes from the line of Jonathan Komp with Baird. Your line is open.

Jonathan Komp:

Hi. Thank you. I wanted to follow up on the near-term guidance and the first quarter. I don't know if you're willing to quantify the impact from being tight on some inventory or the Easter shift; or maybe differently, if you could comment on roughly the first half growth that you see just to give us a sense of that first-to-second quarter shift that you're projecting.

Andrew Rees:

Yes. Jonathan. I think the first thing is let's start with the year. For the year, obviously, we're raising our revenue guidance. We've previously talked about that being mid-single digits. We're now giving you 5% to 7% growth for the year, and that's really due to what we see as continued strengthening of the brand. We continue to see very strong demand and increasing demand, I would say particularly in the U.S., but, frankly, also in our other regions, so we feel really great about that.

From a Q1 perspective, there are a number of things. I would say the biggest damper on Q1 from a revenue growth perspective is really the currency and the business model changes. Currency is about $10 million of headwind in Q1. Business model changes are also the largest in Q1. We think that's about $6 million, so that's about $16 million of headwind just in Q1. In addition to that are the Easter shift and some constraints in our supply, particularly around our Classic clog. Frankly, I think constraint around supply is kind of a high-class problem. We're not overly concerned about that, and we are spending the money to accelerate supply and have done a number of critical things to improve that quickly.

I do think it's counterproductive to quantify that, but if we think about the first half, I would say our first half is very consistent with our full-year guidance.

Jonathan Komp:
Okay. Excellent. Then maybe just a follow-up on the DC and the capacity and throughput expansion; pretty significant expansion for both, and I’m wondering how we should view that in terms of your views on the U.S. growth potential and any thoughts on how far you expect that capacity to cover the growth that you see.

Andrew Rees:

Yes. You’re right; pretty substantial. I think the overall square footage of the DC, as we’re building it out, is 40% bigger than our prior facility. We also have the expansion room built into the footprint, so we can build bigger at relatively low cost when we need to. The automation just gives us dramatically higher throughput with lower labor. So, it’s a big investment. Obviously, it’s significant CAPEX, and obviously, we’re making that investment because we believe we have a significant growth runway here in the U.S. I think also, being closer to our customers will dramatically improve our e-commerce customer service by being able to reach our customers far more quickly and far more efficiently. We think it’s a very important investment, and it will fuel our future growth.

Jonathan Komp:

Okay. One last one if I could just squeeze in on the gross margin for ‘19, it does look like underlying you’re assuming some decline, and I know you called out a couple of factors. I’m just curious about the decision to not take pricing to the level that you need to offset those pressures. Thanks.

Anne Mehlman:

We have taken some pricing, as you know, on our Classic clog, both in Europe and the U.S. and we’ll continue to evaluate pricing as it makes sense. From an underlying gross margin factor, if you think through the adjusted gross margin of 50.5% for the year excluding the one-times of 100 basis points from the DC, the other 100 basis points, we have about 40 basis points of FX for the year and about 60 basis points of freight, which includes higher freight costs and use of accelerated freight to help us replenish some of our core styles, as Andrew discussed, in Q1.

We still feel good, though, from a long-term perspective, that low 50s is the right level for our gross margin, and that also is supported by the new DC investment in the U.S. where we get 100 basis points of favorability starting in 2020.

Jonathan Komp:

Okay. Thanks for the perspective.

Andrew Rees:

Great. Thanks, Jonathan.

Operator:

Your next question comes from the line of Erinn Murphy with Piper Jaffray. Your line is open.

Erinn Murphy:

Great. Thanks. Good morning. I’ve got two questions and then a follow-up. First just on the teen phenomena, or the Gen-Z phenomena you’re seeing, are there pockets of the U.S. that you still haven’t
feel you’ve seen that teen surge yet? I'm just curious how you think about the sustainability of that trend broadly.

Then my second question is really related to the DC. Again, you talked, Andrew, a bit about the speed-to-market opportunity. I’m curious how your modeling, what that could look like in 2020 and beyond, whether it’s two-day shipping or kind of just a closer connectivity to the consumer. Any kind of help there on what the true benefit will be to the everyday consumer.

Andrew Rees:

Yes. Okay. Well, let me take the Classic trend and the traction that we are seeing with our younger consumer group first, and Anne can then talk a little bit about the DC. In terms of traction with the younger consumer group, we’ve clearly seen it’s stronger in the Midwest and the East. It’s not as strong on the West. From our experience with these kinds of things, they do spread across the country, so we think we’ve got incremental traction or incremental opportunities for traction in the U.S. I would say it’s the combination of the Classic and personalization. We are seeing that get traction in other parts, particularly Europe, other parts of our global distribution.

Frankly, we don’t see this as a short-term trend. We see this as a real connection to a generation and a consumer group. We’re offering them a product which has incredible value, and I think the whole personalization aspect with the use of Jibbitz to make it really important for them has been really important.

We plan to continue to invest in the marketing activities and the stimulation activities that have driven this, whether that be collaborations, whether that be social media, whether that be digital connectivity with these customers. And I think we’ve seen with parallel brands, done the right way and executed the right way, this is not a one season, one year opportunity. This is a multi-year growth opportunity.

Anne Mehlman:

Then on our DC, as Andrew discussed, as our e-pincommerce business continues to grow, we feel it’s even more important for us to be centrally located, and that allows us to reach our customers sooner. We are not discussing going to a two-day ship promise. We have great e-tail partners that can offer you accelerated shipping options. We feel we don’t need to be that fast, but we will be more in line with industry standard, not from upgrading our promise, but more that it’s just faster because we’re centrally located. So, we gain speed to market by being centrally located, and we naturally speed up our shipping to our customers.

Erinn Murphy:

Okay. Thank you. Then just my clarification on the inventory being fairly tight exiting the fourth quarter, when do you expect inventory to be in a better position? Q1’s gross margin, obviously the low water mark, how much of the pressure is air freight? I know you said freight in total for the year is 60bp, but I’m imagining that bucket is a lot bigger in the first quarter given your air freighting right now. Thanks.

Anne Mehlman:

Yes. On inventory we’re really proud of the work we’ve done over the past few years to improve our working capital. We view lean inventories as key to ongoing brand strength, but we do obviously have a little bit of shortage in Q1, and we feel like that is encompassed in our full-year guidance, and we’re confident in our outer quarters. It’s mostly in the Classic, and it’s mostly in the U.S. that that’s impacting.
From an air freight perspective, when you think through the margins in Q1, we didn’t break it out. Currency is about 80 basis points in Q1, and the remainder is mostly freight, and then we have the Easter shift, which does shift the higher margin direct-to-consumer sales to Q2.

**Erinn Murphy:**

Got it. Okay. That’s helpful, Anne. Thank you and all the best.

**Anne Mehlman:**

Thanks, Erinn.

**Operator:**

Your next question comes from the line of Mitch Kummetz with Pivotal Research. Your line is open.

**Mitch Kummetz:**

Thanks for taking my questions. I guess I just have a few housekeeping ones. First one, so in this press release you guys are giving a non-GAAP reconciliation for the quarter and the year. I’m curious, on a go-forward basis, are you going to be doing that as well?

**Anne Mehlman:**

Yes. Good question. We will. We felt like it was necessary especially because we have the large accounting charges associated with Blackstone, and we’ll need to bridge that for the remainder of the year.

**Mitch Kummetz:**

Okay. Will you provide some sort of reconciliation for the prior quarters to 2018 so that we have kind of a comparable basis to look at that?

**Anne Mehlman:**

What we’ve provided in our release will be similar for what we will provide all year. When we do report on Q1, we will provide a similar walk for Q1 of 2018.

**Mitch Kummetz:**

Got it. Then, Anne, on the 2019 EBIT margin guidance, I know you’re saying low double digits on a non-GAAP basis. I guess when I’m doing my math, I’m not quite getting there. I think that’s based on a gross margin of like 50.5% and excluding the $3 million to $5 million SG&A charges, I’m coming up with something like 9.9% at the high end. Am I missing something? Is there something else that gets you to low double digits?

**Anne Mehlman:**

I think within the revenue range you’re right around 9.9%, 10%.

**Mitch Kummetz:**
Okay. Then on also on 2019, can you maybe talk to us about interest and the share count, what’s baked in? I know that in the reconciliation today for 2018 it looks like pro forma interest is $5.6 million. Is that the interest expense that we should expect for 2019? Obviously, the share count changed and with the buyback., I’m just wondering what sort of average weighted diluted shares you’re looking for in 2019.

Anne Mehlman:

The best way to think through the average diluted shares is we ended the year with approximately 73-ish million shares on a fully diluted basis. We do have some dilution that will occur through the year, and we will continue to evaluate our program. But I think using an ending share count is the right way to think about it. From an interest perspective we haven’t guided where our interest is going to be, but we do pay LIBOR plus-175 basis points on our line, which is about 4.75% interest. Right now, we have $120 million at the end of Q4 financed on the line, and we will continue to look at our cash and think through the best use of that cash.

Mitch Kummetz:

Okay. Maybe I’ll just ask one for Andrew. There was a comment on a competitor’s conference call yesterday talking about an uptick with the flat business. I know that that historically is a core competency for the Company. I think that’s been a category that’s been a bit challenged the last couple of years. I’m just curious if you have any thoughts on that. Is that an opportunity going forward? Are you seeing an uptick in your business as well?

Andrew Rees:

That would be an opportunity. We are not really seeing an uptick to date, I would say. I would say you are absolutely right; historically we have had a very good flat business, and I think our manufacturing technique, our molded technology, and our aesthetic does lean itself towards flats. You’re also absolutely right that’s been a silhouette that’s been under a severe pressure for probably the last three to four years, to be quite honest. If that silhouette does rebound, it would be an opportunity for us. But, to be clear, we’re not really seeing it today.

Mitch Kummetz:

Got it. All right. Thanks. Good luck.

Operator:

Your next question comes from the line of Sam Poser with Susquehanna. Your line is open.

Sam Poser:

Thank you for taking my question. I just want to talk about the Easter shift, and how many dollars you foresee there in that shift from Q1 to Q2 because that’s a lot in your DTC business, which is a higher-margin, which would make me think that would also make up a lot of margin in the second quarter because of the nature of that business.

Andrew Rees:

Yes. I would say, Sam, we’re not breaking that out, but you’re absolutely right, the impact is in the DTC business. It’s particularly within the North American DTC business. It’s not as exaggerated, obviously, in Asia. It’s a little bit in Europe, but it’s very strongly in the North America DTC business. Yes, those are
higher-margin dollars, right, so our retail and e-com—and as you’ve seen in Q4 and for a number of quarters now, our comps in North America e-com, and retail have been exceptionally strong, and so that does shift dollars and margin into Q2.

**Sam Poser:**

Thank you. Then you’ve had some success with some of these collaborations, and there’s a bunch—Pleasures, Chinatown Market, and Post Malone. Are we going to see any scaling of that? They did very well, but it doesn’t sound like there were hardly any pairs of any of it out there. Do you have plans to scale that in any way to make it more meaningful or offer more of them? How are you thinking about that to continue to build the momentum of the brand?

**Andrew Rees:**

Yes. That’s a good question, Sam. I would say our approach is a portfolio of collaborations. Some of them will be niche and are really about exploring where you can take the Classic clog, where you can have it appeal to different consumer groups; some of them are niche and are small but do drive significant resonance and PR and activity around the brand; others will be bigger. As we look into ‘19, we have a portfolio of segmented collaborations that hit particular consumer groups. We have broader collaborations with other brands that are bigger in scale. We have collaborations planned with particular retailers that could be more significant in scale. So, it’s a portfolio and you’ll see—obviously we’re not going to talk about that in advance. Part of the power of this is the surprise and delight nature of it, but you’ll see that roll out through this year. Frankly, we are already filling the pipeline for next year.

**Sam Poser:**

Let me just follow up on that. Some of these shoes, as you mentioned, they sold out in, like, 5, 10 minutes. Given that kind of response, it’s telling you that there’s a tone of demand—I would assume you’re regarding Post Malone as a little more niche. But, I mean, maybe that niche is bigger than what you think it is versus a partnership with a retailer that may be good, but you might not see that kind of rate.

**Andrew Rees:**

I think what I would say, Sam, is Post Malone might’ve been a little bit less niche than you thought it was. We did sell a lot of pairs in a very small space of time. It’s a portfolio, right. It’s a portfolio, so you’ll see that evolve as we go through the year, and we’re very confident, both in the level of interest we’re getting from a very interesting group of brands, retailers, celebrities, personalities, that we can put together a very compelling portfolio that will keep a very broad range of consumers focused and interested, and we’ll also fuel our commercial appetite.

**Sam Poser:**

Okay. Then lastly, just to go back to the gross margin, if we think about the gross margin on the front half and back half, how does that break out? I mean, Q1 is going to be down net around 340 basis points. How should we think about the gross margin, and how it runs on an annual basis from the front half to the back half?

**Anne Mehlman:**

Good question. On gross margin, the best way to think about it—again, our gross margins for the year are 50.5% on an adjusted basis which includes the 100 basis points of headwind from the DC one-times.
Then the FX, just like the revenue is, the FX impact on margins is going to be much more front-half weighted.

**Sam Poser:**

But then you’re offset by the mix issue in the second quarter.

**Anne Mehlman:**

Correct.

**Sam Poser:**

You expect gross margin to be down in both parts of the year but more down in the front half of the year; is that a fair statement?

**Anne Mehlman:**

I think we’re really confident in guiding our full-year gross margin, and I think the best way to think through it is FX does pressure Q1 and Q2. Like you said, you do have a little bit of a pickup in Q2 because of the DTC quarter, but it’s all-encompassed in our full-year guidance.

**Sam Poser:**

Right. Thank you very much. Good luck.

**Anne Mehlman:**

Thanks, Sam.

**Andrew Rees:**

Thanks, Sam.

**Operator:**

Your next question comes from the line of Jim Duffy with Stifel. Your line is open.

**Jim Duffy:**

Good morning. Hope you guys are all doing well. Andrew, a few questions for you. The team has done very well to revitalize clog demand; that’s proved a very effective strategy. I guess I’m curious how you’re thinking about that from here. Do you foresee clogs continuing to grow as a percentage of the mix, or do you see it’s strategic to try to push out growth from some of the other areas to build balance?

**Andrew Rees:**

Yes. I think that’s a really good question. Yes. I think we will continue to see growth in clogs. I think the differential between clog growth and sandal growth will mitigate, so it won’t gain as much share of our overall percent to total as it has in this year. I think as we look into ’19, we anticipate acceleration in our sandal business over ‘18.
Jim Duffy:

Great. Okay. I also wanted to ask you to speak more about the engagement with marketplaces that you mentioned. I believe you said that started in the second half of the year. Who were those earlier relationships? Was is the change in the nature of the relationships with marketplaces? What’s different about the engagement? Does that change the economics? Any help there would be great. Thanks.

Andrew Rees:

Yes. The way to think about that—and I’ll use an example probably to highlight it—there are a number of marketplaces around the world where we participate on a 1P basis. That means essentially we sell them wholesale; the marketplace takes ownership of the inventory; and then resells the inventory. There are an increasing number where we have augmented or paralleled that participation with a 3P relationship. That means we own the inventory; we manage the on-site presence for that portion of inventory; and so, yes, the economics are different. We sell at retail, and we incur all the cost to get the product to the customer, whether it will be directly from our own DCs or using their fulfillment operations. The 3P business will be included in our e-commerce business on a go-forward basis, so that shows up in our e-commerce segment. The 1P business shows up in our wholesale segment.

As we’re adding 3P marketplaces, and a good example would be Rakuten in Japan where we opened up that in the late fourth quarter of last year. It was a marketplace which we did not have a 1P relationship with historically, so it’s a new category for us, and our strategy there is really to take control of the brand in that environment. When we looked at that environment, there were other people selling Crocs on that environment. We felt like we needed to elevate how the brand showed up in that environment and, frankly, we could also take ownership of the economics of selling product on that environment.

I would say, as you look at the portfolio go-forward, it’s a combination of taking ownership of environments where we have not participated historically directly, and also complementing environments where we have an effective 1P relationship and we want to add a 3P environment. Really, the reason in that case to do that would be potentially to showcase product that might not historically have showed up in a wholesale type transaction. Does that make sense?

Jim Duffy:

It does. It makes good strategic sense. Are you indifferent from an economic standpoint as to whether it’s a 1P or a 3P sale? What would you prefer?

Anne Mehlman:

Yes. We talked a lot about that, whether we sell to one of our e-tailers which, as Andrew talked about, would be 1P showing up in wholesale, whether we sell directly on our own e-commerce website, or whether sell directly on a marketplace, which, Andrew talked about, as being 3P. We’re happy to connect with the consumer wherever the consumer shows up.

Jim Duffy:

Very good. Anne, the last one for you. Obviously fourth quarter demand came in much stronger than you’d expected, but given the replenishment nature of the business, does that make you think any differently about targeted inventory levels?

Anne Mehlman:
We're really proud of the work we've done with inventory. We hit a four-turn business last year, and we think that's about right. We believe that inventory supports the brand and supports the heat of the brand. Obviously we were a little bit short on our Classics, but the team is working to replenish, and we're looking at different capacity options to make that happen.

Jim Duffy:
Okay. Thank you, guys.

Andrew Rees:
Awesome. Thanks.

Anne Mehlman:
Thank you.

Operator:
The Q&A portion of the call has completed. I would now like to turn the call back over to Andrew Rees for closing remarks.

Andrew Rees:
Thank you. I'd just like to close out by thanking everybody for their continued interest in the Company. We are very excited about this year and the future, so we look forward to talking to you again in the future.

Operator:
This concludes the Crocs Incorporated Fourth Quarter Earnings Call. We thank you for your participation. You may now disconnect.