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DECK - Q3 2013 Deckers Outdoor Corp. Earnings Conference Call

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OVERVIEW:

DECK reported 3Q13 net sales of \$387m, operating income of \$46.5m, and diluted EPS of \$0.95. Expects 2013 revenue to increase approx. 8% over 2012 levels and EPS to be \$3.80. Expects 4Q13 revenues to increase approx. 14.5% and diluted EPS to increase approx. 32% over 2012 levels.



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PRESENTATION

Operator

Good afternoon, ladies and gentlemen and thank you for standing by. Welcome to the Deckers Outdoor Corporation third-quarter fiscal 2013 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 remind everyone that this conference call is being recorded. I will now turn the call over to Linda Pazin, Vice President of Investor Relations and Corporate Communications.

Linda Pazin - Deckers Outdoor Corp - VP of IR and Corporate Communications

Welcome everyone joining us today. Before we begin, I would also like to remind everyone of the Company's Safe Harbor policy. Please note that certain statements made on this call regarding the Company's expectations, beliefs, and views about its future financial performance, brand strategies, and cost structure are forward-looking statements within the meaning of the federal security laws. These forward-looking statements are intended to qualify for the Safe Harbor from liability established by the Private Securities Litigation Reform Act of 1995. These statements relate to the Company's anticipated revenues, expenses, earnings, gross margin, capital expenditures, brand strategies, and cost structure, as well as the outlook for the Company's markets and the demand for its products.



The forward-looking statements made on this call are based on currently available information, and because its business is subject to a number of risks and uncertainties, some of which may be beyond its control, actual operating results in the future may differ materially from the future financial performance expected at the current time. Deckers has explained some of these risks and uncertainties in its earnings press release and in its SEC filings, including the risk factors section of its annual report on Form 10-K and its other documents filed with the SEC. Listeners are cautioned not to place undue reliance on forward-looking statements which speak only as of the date hereof.

The Company undertakes no obligation to publicly release or update the results of any revisions to forward-looking statements. With that, I'll now turn it over to President, Chief Executive Officer, and Chair of the Board of Directors, Angel Martinez.

Angel Martinez - Deckers Outdoor Corp - CEO, President, and Chairman

Thanks, Linda. Thank you to all joining us today. With me on the call are Zohar Ziv, Chief Operating Officer, and Tom George, Chief Financial Officer.

We feel very good about the third quarter as there were many aspects of our performance which demonstrate that we are successfully executing our strategic plan. The initiatives we've implemented over the past several years continue to gain traction. These include our recent efforts to directly address the external challenges we faced in 2011 and 2012 as we build a more diversified global business, better able to develop, market, and deliver our expanding product line to consumers worldwide. In fact, we're becoming a more dynamic organization as we invest in our brands and take advantage of our growing direct-to-consumer footprint and omnichannel capabilities, while better managing our inventory and capital allocation priorities.

The innovation engine that fueled the UGG brand's revolution from a regional, domestic women's wholesale brand into a global multichannel luxurious comfort brand over a 35 year history, is stronger than ever. We're on pace to deliver another year of record total Company revenue and we expect to surpass the \$1.5 billion mark.

In the footwear industry it's all about product and we have a great product offering for fall 2013. This year's UGG brand line is the most diverse that we've ever developed. With the warm start to the past two fall seasons, it became clear that we needed a more robust footwear offering to better bridge the gap between late summer and the start of the holiday season. I'm pleased with how quickly our team has responded.

This year we've introduced a much wider array of compelling year-round boots and casual shoes. Sell-through in the third quarter was strong, led by the [Ka-Bar] collection and driving mocs. We also infused the classic collection with new specialty items that have driven heightened interest and solid demand early in the back half of the year. Our fashion boots are retailing well, including the Jardin and the Dandelion. And our slipper business has performed very well year to date, which we believe bodes well for another strong gift-giving season.

We're increasingly using digital and social media platforms to drive repeat purchases and reach new consumers by better connecting with our target consumers. This year's Fall Heritage campaign featuring the new tag line Feels Like Nothing Else launched in mid-August and the impact was immediate and powerful, resulting in a dramatic rise in internet traffic and page views driving online sales growth. To date, North America e-commerce sales are up approximately 15% year over year, and global e-commerce sales excluding China are up 21% year over year for the UGG brand. The campaign goes global in November and December, launching on multiple platforms including social, mobile, digital, and out-of-home, and supported by a wide range of major marketing events that showcase our brands in very innovative ways.

In addition, the launch of the men's campaign featuring Tom Brady on September 3 generated significant interest and exposure. Total media impressions on that day topped 67 million, and men's e-commerce revenue spiked above 40% for the first three days of the following -- following the launch, compared to the week prior. Interest continues to be very healthy and we will leverage this campaign through the remainder of the year.

We also launched UGG by You online, giving consumers the ability to customize select products, including the iconic classic short. The consumer response out of the gate has been very positive. The initiative was supported across social channels with great success, with all posts linking back to e-commerce. The UGG by You Facebook post triggered an increase in fan acquisition of over 176% on a global basis. Overall engagement on our Facebook page was up 200% globally and the UGG by You post on Instagram reported the highest engagement of any photo to date. Going

forward, we plan to continue to allocate more marketing dollars to digital programs that we believe will drive traffic and increase conversion and efficiently showcase multiple products in dedicated environments to further build awareness for our expanded product offering.

Looking back at last year, the biggest impact on our results was the dramatic increase in sheepskin cost between 2010 and 2012. The rapid response to moderating our exposure to our largest commodity best exemplifies our organization's ability to innovate by effectively and creatively responding to external challenges.

UGG Pure has had an immediate impact on enhancing our product line and will result in reduced costs going forward. A premium and natural material, UGG Pure is real wool, woven into a durable backing. This year, UGG Pure is being used in select linings and foot beds, replacing a portion of our table grade sheepskin. In the future we plan to expand UGG Pure into new product categories and further integrate it into our footwear line.

What makes UGG Pure so appealing is that it's a first class wool material that delivers the luxurious comfort and feel that the UGG brand is known for, while allowing us to offer our products at more attractive price points. In addition, UGG Pure is more abundant and its quality more consistent than traditional sheepskin. Our near-term plans to expand the use of UGG Pure in the linings and foot beds in additional SKUs next year, to further enhance the overall product experience, expand product margins, and sharpen our casual and fashion price points. The benefits of UGG Pure will also extend beyond the brand's core footwear business into adjacent categories like home, and allow us to target new consumers, particularly in China, through I Heart UGG, a subbrand featuring more accessible opening price points that we plan to test in the fall of 2014.

The global strength of the UGG brand, the evolution of our product lines, and the further strengthening of our leadership team have created significant global expansion opportunities, particularly within our direct-to-consumer business. Over the past few years, we've made successful in-roads into increasing our presence in Europe, particularly the UK, and then Asia, where our initial efforts have focused on China and Japan.

Our comprehensive direct-to-consumer strategy represents a concerted effort aimed at elevating our markets, expanding our revenue streams, increasing our exposure to more attractive retail margins, and creating a true multichannel platform that not only drives direct in-store and e-commerce sales but also serves to efficiently and effectively promote our brands, including our new lines of footwear and related merchandise. The contribution from our direct-to-consumer operations continues to grow. This year the segment will represent close to 33% of overall sales, up from 22% just three years ago.

This contribution will further expand as we execute our strategy to efficiently grow our store footprint and invest in our online presence and direct marketing initiatives. We believe the benefits of this strategy will become increasingly evident as we continue to innovate how we interact with consumers, while carefully managing our capital outlays and operating expenses.

Developing new markets and successfully managing our growing multichannel global business has required upgrades to our infrastructure. Our investments reflect the changing omnichannel retailing landscape that is being fueled by new technologies that are reshaping the way the consumers shop. Over time, we believe these investments will result in higher margins as our DTC business becomes a more significant contributor to our business mix and we deliver greater DTC specific product across our global footprint.

On the technology side, we're in various stages of implementing tools to better connect and cultivate our consumer base. These include key functions like CRM, loyalty programs, and in-store level marketing tactics, as well as omnichannel capabilities such as Infinite UGG, which gives stores the ability to place an order on our website for items that are not in stock in the store. These functions will allow us to better optimize our inventory and improve our logistics costs to drive expense leverage.

On the brick and mortar side of the equation we've taken steps to improve our site selection methodology, reduce our new store buildout cost, and enhance our store labor management capabilities. We're also focused on elevating our merchandising acumen to drive conversion across all channels. We've steadily improved our storytelling capabilities in stores, and online through enhanced visual presentations, video content, and DTC specific product. With added resources we expect to be able to react faster to current trends and generate even more consumer excitement for our growing portfolio of products.

Our recent tests -- recent results, rather, reflect our success in executing our DTC to integrate our retail store and e-commerce operations. These are complementary initiatives that effectively address the demands and shopping patterns of today's consumer. Tom will provide some more color on our retail performance and investment strategy in a moment, but I'll highlight that Q3 saw a strong uptick in the performance of our China stores as the localized merchandise and inventory management initiatives put in place have started to take hold.

Looking ahead, to ensure that we are best positioned to execute our DTC strategies we are continually developing DTC expertise within our current staff, as well as looking to add new leadership on a global and regional basis. Little over a year ago, we brought on Dave Powers as the President of Direct-to-Consumer. Dave has spearheaded significant positive change throughout our retail and e-commerce operation, which will benefit this fast growing segment of our business for years to come.

We recently appointed [Justine Sue] to the newly created position of VP Global Merchandise Management for DTC. She will be responsible for driving the go-to-market process of our direct-to-consumer channel in close partnership with the brand teams across stores and online, while providing oversight and guidance to the DTC regional teams. Justine joins Deckers following similar roles with Coach, Ralph Lauren, Prada, and Tory Burch. We've also added Gary [Kukimoto], a 10-year retail executive with experience at global brands including Gap, Coach, and Nike as Director of Direct-to-Consumer Japan.

And we recently appointed Michael Wellman as Vice President DTC China. Michael's a seasoned industry veteran with experience in both DTC and distributor retail in China with Nike, Adidas, New Balance, and Disney stores. He brings deep knowledge of market dynamics as well as an understanding of what it takes for western brands to be successful in China. These Executives significantly strengthen our management resources and provide us with exceptional creative drive and business acumen as we execute our strategic plan.

During the third quarter we opened 15 UGG brand stores, most of which are in Asia. Our expansion included a concept store in Shibuya, one of the busiest shopping districts in Tokyo that sees 3 million commuters a day and a center for fashion and culture. This store truly showcases the ground breaking features we're adding to our stores, upgrading the experience and integrating technology and e-commerce functions into the shopping experience.

The store was designed to showcase our product, technology, and marketing assets in a way that integrates our classic heritage with the digital world. The exterior facade includes a large LED screen to tell our seasonal stories as well as a digital interface display for window shopping, meaning that the store is virtually open 24/7. Inside we've developed the virtual coordinator mirror that assists consumers with their footwear selection combined with several apparel option suggestions. We plan to incorporate elements of the Shibuya store in our future openings as we continue to fine-tune the in-store experience. We have posted a presentation on the investor page of our corporate website, Deckers.com, that captures the Shibuya store experience and I encourage everyone to check it out.

Also of note, we remodeled and expanded our flagship UGG brand concept store in Honolulu. This is a top location for us and we believe it's only going to get stronger with the addition of our second dedicated UGG for Men door, which follows the successful blueprint of our initial men's store on Madison Avenue.

We remain on track to end 2013 with 113 total UGG brand locations. Of the 36 total stores we expect to add this year, 24 are in Asia, and that's where we see one of the greatest opportunities for expansion going forward. We're still significantly underpenetrated throughout the region, particularly in China, which lacks a traditional wholesale model. Although Asian consumers have readily embraced e-commerce and mobile shopping applications, they still prefer to include brick and mortar in their total shopping experience. As a reminder, our buildout costs are generally lower in Asia and leases are typically shorter than in the US and Europe.

Our plans not only include concept stores but outlets as well. With regard to our outlet strategy, we're in the process of rolling out to all regions an updated outlet store model that incorporates a new design, improves merchandise mix, and enhances marketing and visual materials. As noted, Tom will provide more details on our retail business model in a moment.

But let me turn briefly to our other brands where innovation is also driving improved results. Beginning with Teva, where the brand's fall offering has performed well at retail. Under the direction of our new brand President, Jeff Bua, we're in the process of repositioning Teva around its Originals



line to better leverage the brand's authenticity and heritage to penetrate new casual footwear categories for both spring and fall. For spring '14 the expanded Originals line has already generated strong prebook demand and new distribution wins, most notably all Nordstrom doors for men and select locations for women.

For next year's product offering, we plan to include a line of canvas casual footwear aimed at markets that remain warm year-round. In addition, we plan to infuse alternative upper fabrics such as corduroy and wax canvas into select Teva fall and winter products in an effort to appeal to consumers in colder climates. We believe we have a sound long-term strategy in place to build the brand's presence both within and beyond the outdoor category.

The Sanuk brand saw similar strong sell-through of its expanded closed toe footwear for men, particularly in the department store channel, where the brand has been building a stronger presence. On the women's side, Sanuk's yoga franchise remains a very strong performer with healthy post season reorders on the Yoga Sling in response to broad sell-out of the product at retail. 2014 will mark the first full spring collection delivered under Deckers' management, and the first full line under the direction of the brand's global director of product, Trisha Hegg.

Our plan is to capitalize on the growing momentum of our women's sandal business with more key product in the yoga franchise, including some pull-forwards into spring from summer. We also plan to broaden our consumer appeal with a larger offering of trend-right canvas casuals, a category that we believe represents a considerable growth opportunity for the brand.

Underscoring my belief is the early response from retailers, both existing accounts like Nordstroms and Dillard's, Journeys, and DSW, as well as planned expansion into the action sports youth lifestyle channel, led by Zumiez, Tilly's, and Pac Sun. We believe that Sanuk is in a unique position to be one of the only handful of brands that can successfully thrive in such broad range of major retailers, a position we'll continue to successfully leverage in the years ahead.

Tom will now review the third-quarter financials in more detail and discuss our updated outlook for the year. Tom?

Tom George - Deckers Outdoor Corp - CFO

Thanks, Angel. For the third quarter net sales increased 2.7% to \$387 million, compared with \$376 million a year ago. This year's results include international sales of \$148 million, an increase of 10.3% compared with last year, and domestic sales of \$239 million, a slight decrease from a year ago. Looking at sales by brand, UGG brand sales increased 1.3% to \$337 million, Teva brand sales increased 0.6% to \$18 million, and Sanuk brand sales increased 0.5% to \$18.4 million. Sales of our other brands increased 81.3%, to \$13.3 million.

By channel, wholesale sales decreased 1.5% to \$319 million. In terms of UGG wholesale, European UGG wholesale sales increased low-single digits, while Asia-Pacific was essentially flat. Domestic UGG wholesale was down high-single digits, which was in line with our plan and reflects a shift in the mix of channel revenue to our direct-to-consumer business, as well as the timing of fall holiday shipments to many accounts as a result of the past two mild starts to winter.

Turning to our direct-to-consumer division. Retail sales increased 34.5% to \$52.6 million, and e-commerce sales increased 12.2% to \$14.9 million. Same store sales increased 1.9% for the 13 weeks ending September 29, 2013, compared to the same period a year ago. The increase in retail comparable sales was driven by high teens increase in China, a low double-digit increase in Japan, a low single digit increase in European comps, and partially offset by a low single digit decrease in US comps.

For all stores opened at least 12 months at September 30, 2013, the average sales per square foot was approximately \$1,425, and total square footage at the end of the third quarter was approximately 280,000 square feet, compared to roughly 180,000 square feet at the end of Q3 2012, representing an increase of about 56%. Going forward, we are targeting slightly smaller, less capital intensive locations as we continue to fine tune our model to maximize performance.

Gross margin for the third quarter was 43.2%, compared to 42.3% in the third quarter last year. The 90 basis point increase was primarily attributable to a shift in the mix of channel revenue with a greater contribution coming from our direct-to-consumer division this year, compared with last year.

With regard to sheepskin cost, the fourth quarter will benefit from the reduction in prices we negotiated in September 2012. We recently completed our sheepskin negotiations for fall 2014. Taking into account the increased usage of UGG Pure, which will increase from about 10% of our total sheepskin usage in 2013 to approximately 25% in 2014, our overall sheepskin cost per square foot will decrease approximately 10% compared to 2013 costs. All else being equal, we believe this will contribute to roughly 100 basis point improvement in 2014 gross margins over projected 2013 levels. However, it's important to note that UGG Pure currently will not be used to replace our premium twin face sheepskin, which represents more than half of our total annual sheepskin usage and an even higher percentage of our total annual sheepskin cost.

Total SG&A expense for the quarter was \$120.4 million, or 31.1% of net sales, compared to \$99.7 million or 26.5% of net sales a year ago. The dollar increase versus a year ago was primarily due to approximately \$12.5 million of additional expense related to our retail operations, most of which is for the new retail stores that were not open during the third quarter last year. SG&A expenses were lower than previous guidance for the third quarter, due primarily to the timing of certain expenses, the majority of which will now take place in the fourth quarter.

Operating income for the third quarter was \$46.5 million, compared to \$59.6 million last year. We recorded income tax expense of \$12.6 million in the third quarter, compared to \$15.9 million in the third quarter last year. Our tax expense for the third quarter was below our projections due to a lower nonrecurring tax rate. Third-quarter diluted earnings per share was \$0.95 versus \$1.18 a year ago, and compared favorably to our guidance of approximately \$0.70. The upside relative to our guidance was driven primarily by lower operating expenses including marketing dollars, which we shifted into the fourth quarter to take better advantage of the busier holiday selling season. This year's third quarter also benefited from the aforementioned lower tax rate which was worth approximately \$0.06 in earnings per share versus guidance.

Turning to the balance sheet. At September 30, 2013, inventory decreased 8.6% to \$444.6 million from \$486.2 million at September 30, 2012. UGG brand inventory decreased by \$52.7 million or 11.7% to \$399.1 million. Teva brand inventory increased \$2.4 million to \$21.6 million, and Sanuk brand inventory increased \$3.9 million to \$12.5 million. Our other brands inventory increased \$4.8 million to \$11.4 million. The decrease in UGG brand inventory was driven by the sell-through of our carryover inventory.

At September 30, 2013, our cash and cash equivalents increased 36.5% to \$84.1 million, compared to \$61.6 million at September 30, 2012. At September 30, 2013, we had \$245.5 million in outstanding borrowings under our credit facility, compared to \$275 million a year ago. The increase in cash and cash equivalents and the decrease in outstanding borrowings year over year are attributable to improved inventories and cash provided by operations, partially offset by \$36 million in cash payments for common stock repurchases made in the fourth quarter 2012, and also \$75.2 million of cash payments for capital assets, which includes \$33.8 million of retail expansion, \$30.7 million for the new headquarters facility, with the balance at \$10.7 million for IT infrastructure and maintenance as well as other expenditures. During the quarter we did not repurchase any shares of the Company's common stock and currently have \$79.3 million available under the \$200 million stock repurchase program announced in July 2012.

Now moving on to our outlook. Based on third-quarter results and current visibility, we still expect 2013 revenues to increase approximately 8% over 2012 levels. We are raising our full-year EPS outlook from \$3.73 to \$3.80 to reflect the \$2 million tax benefit recognized in the third quarter. We now expect diluted earnings per share to increase approximately 10% over 2012, up from our previous guidance of approximately 8%. For the full year, we still expect UGG brand sales to increase by approximately 7% to 8%, Teva brand sales to be flat to slightly down, and Sanuk brand sales to grow approximately 5%. Our other brand sales are still expected to generate approximately \$39 million in 2013.

Our forecast is still based on gross margins of approximately 47% and SG&A as a percentage of sales of approximately 34%. For the year, capital expenditures are projected to be approximately \$85 million to \$90 million, with \$30 million for retail stores, and approximately \$50 million for the corporate facility, IT, and other maintenance. And we are still man to refinance our corporate headquarters by securing long-term financing. For the fourth quarter of 2013, we still expect revenues to increase approximately 14.5%, based on -- and based on the shift of certain expenses out of Q3 into Q4, we now expect fourth-quarter diluted earnings per share to increase approximately 32% over 2012 levels, compared to our previous guidance of approximately 38%. I'll now turn it back to Angel for his closing comments.



Angel Martinez - *Deckers Outdoor Corp - CEO, President, and Chairman*

Thanks, Tom. Across our portfolio of brands, we're creating great choices for consumers. With our strong network of wholesale partners serving as the bed rock of our distribution model, we'll continue to reach our target consumers where they've traditionally shopped for their footwear needs. At the same time, our growing DTC platform and enhanced omnichannel capabilities are enabling us to increasingly connect with existing and target consumers in a more intimate environment to introduce our evolving product lines.

And our all of our product and distribution strategies are being supported by more effective, more compelling, and more personalized marketing than ever before. The goal of all these efforts is to consistently provide consumers with great choices, reach consumers through their preferred methods of interaction, and ultimately sell and deliver them product in the most margin accretive way possible. This is about controlling our own destiny, by investing smartly, and continually innovating how we conduct business so that we can fully leverage our growing asset base to deliver improved returns to our shareholders. Operator, we're now ready to take questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

At this time we will go to Randy Konik with Jefferies.

Randy Konik - *Jefferies & Company - Analyst*

Angel, can you talk to on a -- you talk about the accelerating trends of sell-through in the classic and slipper collection. First can you give us some color on do you see that across all channels of distribution and across all geographies? Just a little more color on how the sell-throughs are going on and is that a comment starting into the fourth quarter or not? That's my first question.

Angel Martinez - *Deckers Outdoor Corp - CEO, President, and Chairman*

Okay. We're very happy with the trends as we see them now. Certainly, the cooler weather in the US aids in everything. There's always a benefit to having chillier evenings.

Some of the enhancements we've made to the classic line, I think if you go on the website you'll see there's a lot more color than there's been in the past, there's a lot more diversity of detail and treatment. We've got product that's exclusive to our DTC operation. We have product that we've done exclusively with certain customers. So there's just a bigger variety of classic product.

We don't have the same kind of feeding frenzy that we had over the original core classic and basically three colors. I remember a few years ago it was chestnut, black, and sand. Those were the three colors that were in constant demand. Now we have a much broader and appealing assortment of product.

We've also done some special things with for example, Swarovski crystals, that we've got on variety of products that allow for more customization at the store level. Consumers can now go online and create their own UGG customized product which is a unique and new thing we're doing. So generally speaking, there's a lot more effort and energy to diversify what people see when they encounter UGG classic product. We're very happy with the trend so far.



Randy Konik - *Jefferies & Company - Analyst*

And then just comments on geographically?

Angel Martinez - *Deckers Outdoor Corp - CEO, President, and Chairman*

Geographically, what I just said is consistent. We're seeing the same sort of benefits around the world in every market we're operating in, which that bodes well. That actually says a lot about our merchandising team and our ability now to interpret information from consumers worldwide and identify those areas and opportunities that we may have in some markets that we don't have in others.

To give you an example, in Japan the classic mini is a very strong men's item in a variety of color ways that I really -- you only would see in Japan. And that was something we identified early and we've been in a position to go after that business and it's working quite well.

Randy Konik - *Jefferies & Company - Analyst*

Great. I guess last question, if I may. Are you in a position where -- you know how you took in your European distribution to an owned nature. Are you able to get leverage on that yet? It sounds like Europe is starting to stabilize, obviously the numbers internationally are turning back up. What is the opportunity there from a margin improvement standpoint for both Europe and then onto the overall part of the Company from the financials? Thanks.

Tom George - *Deckers Outdoor Corp - CFO*

Yes, Randy. Good question. As that UK business has stabilized and we're also starting to see the beginnings of some stabilization in the Benelux business as well. We are starting to see the opportunity for leverage on that entire regional office that covers all of Europe. So there is more opportunity going forward in that region, but that's about all we can say about it right now.

Randy Konik - *Jefferies & Company - Analyst*

Great, thanks a lot.

Operator

At this time we'll take a question from Eric Tracy with Janney Capital Markets.

Eric Tracy - *Janney Capital Markets - Analyst*

Hi, guys. Good afternoon. Congrats on a nice quarter. I guess if I could, first, just as we think about the gross margin, a point of clarification if I heard correctly, the 100 basis points expectation year over year for '14, is that solely the UGG Pure contributions as you take that from 10% to 25%, or is that a combined UGG Pure, plus the lower just overall sheepskin cost?

Zohar Ziv - *Deckers Outdoor Corp - COO*

This is Zohar. It's the latter. The 100 basis point is the combination of greater utilization of UGG Pure and the overall lower cost of sheepskin that we purchased.

Eric Tracy - *Janney Capital Markets - Analyst*

Okay. Okay. And then I guess on a follow-on to that, maybe without having -- I'm sure you're not going to give specifics on this, but as we just think about the sort of mix shifts, right, from DTC becoming a greater contribution, international is turning you just alluded to some of the potential leverage, improved profitability, any reason to think that we shouldn't start to migrate back to that 50% gross margin? Are there some headwinds that perhaps I'm not thinking about?

Tom George - *Deckers Outdoor Corp - CFO*

You hit on all the right levers. We do have all the right initiatives in place to be able to drive gross margin expansion. So there are those opportunities. I think it's best that we get through this fourth quarter and conclude our planning process and then we can give more specific visibility around those numbers.

Eric Tracy - *Janney Capital Markets - Analyst*

Okay. And if I could just squeeze a last one for Angel. In terms of kind of strategy between the domestic wholesale business and DTC, I understand sort of the shifting into 4Q becoming more heavy, but on an annualized basis, how should we be thinking about the wholesale business? Is it a stabilization mode next year? Is there potential in your mind to reaccelerate that. Or is there an acceptable level of cannibalization of DTC relative to wholesale.

Angel Martinez - *Deckers Outdoor Corp - CEO, President, and Chairman*

I think you're starting to see a pretty significant shift in how consumers want to access brands. There's clearly a consumer base with our wholesale customers, Nordstrom has their customers, Dillard's has theirs, Journeys has theirs, those retailers are doing a good job of keeping those consumers in their fold.

Then there are consumers who want to access brands via a direct relationship, and the benefits there for us are pretty clear, obviously from a margin point of view, but actually more important from a relationship point of view, meaning that we're able to personalize the relationship with the brand, we're able to give consumers a more customized experience. We're able to be the go-to place for all of their purchasing when it comes to UGG, and I think the two things work in tandem and the net effect is that it's going to grow the market for our brand.

We're in a very good position in that we have a pretty dominant voice when it comes to anything sheepskin globally, and our purpose here and our mission is to use that voice to reinforce all of the options that the UGG brand offers for the home, for kids, for men, for women, and on a year-round basis. We can do that in a very unique way. Retailers being constrained by real estate, certainly having to devote shelf space to many other brands have only a limited capacity to do that. Our goal is always to drive the consumer to their preferred destination, whether it's -- we use our co-op money to drive consumers to Nordstrom, and by the way, Nordstrom this past year, between I think August and October, they had 16 pages of UGG specific advertising that went out to their consumer base, which clearly is a huge benefit to Nordstrom and those consumers are establishing a foundation of trust in the brand. They're accessing it through Nordstrom. But many of them will also come to us directly.

I think what's happening is a real big shift in how consumers want to access this. We're focused on every vehicle that we can implement to make sure that that relationship with consumers is expanded.

Eric Tracy - *Janney Capital Markets - Analyst*

That's great. That's really helpful. Thanks, guys and best of luck.



Angel Martinez - *Deckers Outdoor Corp - CEO, President, and Chairman*

Thank you.

Operator

And at this time we'll move to Erinn Murphy with Piper Jaffray.

Erinn Murphy - *Piper Jaffray & Co. - Analyst*

Great. Thank you and congratulations to you all. I guess the first question Angel for you, if you could elaborate a little bit more on the importance of digital as you think about the direct-to-consumer business and your strategy there. You talked a little bit earlier about the changes you made in the stores with endless aisle and I'm just noticing a lot more kind of robust content driven e-mails as well.

So maybe just, how has your consumer responded to some of these updates so far. As we think about this platform as we go into the holiday, what are some of the unique things that you're doing to really just drive mind share and conversion? That's my first question. Thank you.

Angel Martinez - *Deckers Outdoor Corp - CEO, President, and Chairman*

Well, thank you. Digital is, it really sounds almost trite to say it now but it's the future. It's really what is happening when it comes to marketing specifically. The idea that the consumer is a one dimensional consumer, I think that's a real dead notion.

I talked about relationship. The key opportunity we have is to use the digital technology to fundamentally cement that relationship. You've seen that we have increased our assortment of home products now. We've got a variety of customization opportunities as I mentioned. You'll see more of that going forward. You're going to see us begin to dial in a very predictive sort of model for specific kinds of consumers that will begin to identify through their shopping patterns and their communication with us.

So we're just scratching the surface on this. We made a commitment to the direction a you few years ago. We've been ramping this up. We're very proud of what we've done with the Shibuya store. You're going to see more of that roll out. We're opening an UGG store that will be part of our -- we're calling it our Deckers brand showcase. It will be in our home headquarters here come first quarter, and that's going to be a real showcase for how we think the digital world is going to impact retail. The two things are really inseparable now and it's hugely important.

Some of the things that we're doing versus in past years that are being facilitated by this sort of digital connection. Obviously we can get our brand campaign out, Feels Like Nothing Else is going to go out not only in our old formula, which was predominantly print, but now it's going out with social media, it's going out through PR, it's going out through a variety of other techniques. So Feels Like Nothing Else will be more prevalent during the holidays.

We also have a holiday campaign where we're launching specific product. I mentioned UGG by You which is the customization. You're going to see that targeted to consumers who have shown an interest in those color ways and those kinds of products. I mentioned the Swarovski crystal in the stores. We're doing that. We've got -- the Feels Like Nothing Else campaign is really a DTC ramp-up. We've never done a DTC holiday campaign. You're going to see that beginning now, very shortly.

The holiday line itself has been expanded, so we've got conversations we can have with consumers around new product. On the last call I talked about dropping product more frequently in the year. Now we're able to augment the product drop with news. That's now news on Facebook. That's now news on Twitter. That's now news on Instagram, and that's a reason to engage the brand. All of these things combined are really giving us a much more enhanced relationship with the consumer.



Erinn Murphy - *Piper Jaffray & Co. - Analyst*

That's really encouraging. Thank you for that. And then I guess just Tom, just a quick follow-up question. On the same store sales for the quarter you mentioned the US was negative. Clearly, traffic has been very volatile.

If you could just elaborate a little bit more about the comp components during the quarter, traffic versus ticket, versus conversion. And then did the cadence change as we progressed throughout the quarter from July to September? And then just if you could compare that with what you saw in Europe throughout the quarter in terms of more of that cadence, that would be great. Thank you.

Tom George - *Deckers Outdoor Corp - CFO*

All right. This was a big second question. I think what we saw in the US is it was mostly traffic-driven like many of the other retailers. We saw even some positive improvements in ticket and conversion in that.

In terms of cadence throughout the quarter, really nothing really comes to mind there. I think it was pretty consistent there. Europe really pleased with that positive comp there, and I think we're seeing the same thing there, even in spite of some traffic kind of pressures, they've been able to increase conversion and that kind of thing.

And then real excited about China, how we've rebounded there and you're starting to see the benefits of all our initiatives there related to inventory, merchandising, managing the stores, store locations, buildout efficiencies, really pleased about that, and obviously Japan is very strong, really excited about the performance there. So in a very low sort of smaller third quarter, we're really excited about the progress we made with our retail stores.

Erinn Murphy - *Piper Jaffray & Co. - Analyst*

That's great. Best of luck for the holidays, guys.

Angel Martinez - *Deckers Outdoor Corp - CEO, President, and Chairman*

Thank you.

Operator

At this time we'll move to Taposh Bari with Goldman Sachs.

Taposh Bari - *Goldman Sachs - Analyst*

Good afternoon, guys. Was hoping -- looks like you nailed the revenue guide, I was hoping you could talk more about the composition of UGG sales during the quarter, specifically around sell-through, reorders, if there were any delivery shifts worth mentioning in the quarter.

Tom George - *Deckers Outdoor Corp - CFO*

Yes, Taposh. As we indicated, the UGG wholesale business on the US side was down as planned, it was a little bit like high, I think high-single digits. Of course, the retail business worldwide for UGG was strong. Our e-commerce business was strong. Our international wholesale businesses was on balance. I think Europe was up some. A little bit flat in Asia, and that's primarily due to some timing as well as some work we're doing on our wholesale distribution in Japan because the fourth quarter we expect that Asian wholesale business to be up. In terms of any shifts, a little bit of that but nothing really of significance relative to expectations. Does that help?

Taposh Bari - *Goldman Sachs - Analyst*

Yes, that helps. And then Angel, you mentioned the strength of the slipper business here during this transition period. I guess the question is what have you guys done differently with your accounts to make that more of a year-round business? And as we think about that business now versus the fourth quarter, which is obviously a very giftable time of year, how do we think about that being an incremental purchase, call it in December and January versus what's being purchased today?

Angel Martinez - *Deckers Outdoor Corp - CEO, President, and Chairman*

Well, the slipper business is like the world's best known secret, I suppose, if you're one of our retailers, because we have a very powerful slipper business, obviously the price points are significant. It's by far the best quality slipper assortment on the market.

We've done a lot to enhance the assortment. We've addressed price point issues. We've got some under \$100 men's slippers that you can access and that's exciting to consumers. We've also got trends happening. We've got young kids wearing slippers on the street as sort of part of a fashion statement.

We've got in the UK for the first time this past year, we've got great traction on men wearing slippers, the slipper idea was not really something that was a category, not really a viable category, was considered sort of throw-away product. We've managed to create a viable and important category in the UK and that's only going to grow.

So what I'm really interested in, what I find very fascinating is this idea if you sort of were to say that slippers is your cool weather flip flop, we started playing around with this idea with college kids a few years ago and it's worked. You see kids on college campus as soon as the weather cools off they're in their UGG ascots and other slippers and their flip-flops are in the dorm room. It just bodes well for slippers being a year-round product, not just a gift-giving product, and then you add the gift-giving spike to that and you have a very powerful franchise that we only look to grow globally.

Taposh Bari - *Goldman Sachs - Analyst*

Okay. Great to hear. Good luck.

Angel Martinez - *Deckers Outdoor Corp - CEO, President, and Chairman*

Thank you.

Operator

At this time we'll take a question from Scott Krasik with BB&T Capital Markets.

Scott Krasik - *BB&T Capital Markets - Analyst*

Hey, everybody. Thanks and congrats. Angel, without seeing I Heart UGG it's a little bit hard, but can you talk about its opportunity, is it's less weather sensitive, if it's focused on China is it going to be sold in the UGG stores that exist now, and how are you segmenting it?



Angel Martinez - Deckers Outdoor Corp - CEO, President, and Chairman

I Heart UGG is going to be sold in Asia. It's going to be sold in our own stores here and in selected wholesale partners here and other markets around the world. It is a junior line.

If you come to the [Fannie] Show, we'll show it there. It's almost -- it's very difficult to describe until you see it. It has no chance of being confused with core UGG. And yet, it clearly has the DNA of core UGG. The colors are more vibrant. The designs are much more -- they're just younger. It appeals to the tween consumer. It's a female line. It is -- the price points are very sharp because of UGG Pure, we're able to do that.

And it's a beginning of understanding how to fully leverage what UGG Pure represents. By the way, the feel and the quality are just fantastic. Now clearly, it's not a product I put on, but all of the tests show us that the consumer will not be disappointed with this -- with the feel of this product, in no way is it inferior to the feel of our traditional UGG product. So we're quite excited about it.

As I said, it's a test. I said I think in the script it's a test for fall of '14, but it's going to open a market that in many -- I would almost tell you that we've not participated in because we've had a lot of knock-off people out there. We've had a lot of products that are inferior quality going after these lower price points and we're going to raise the bar on the quality and the fashion and the styling. So we think that's just incremental business for this brand in many ways.

Scott Krasik - BB&T Capital Markets - Analyst

That's great. And then just as you get into selling fall '14 here soon, did you learn anything from what you sold on the transitional product? What can you do better, what really worked from the transitional product, what won't you repeat, and how do you think that business is going to sort of grow and evolve?

Angel Martinez - Deckers Outdoor Corp - CEO, President, and Chairman

I think if you see fall '14 you'll see the learnings. Just very sharp price points. We found that we needed to do a better job of engineering the product and developing product and use of materials to sharpen those price points and make sure that we're not only competing, but at each price point that we have the best product, the best fashion, the best comfort, the best quality. That was a standard we set for ourselves and I think that there's no other standard that we can have. I'm very happy with the product that I've seen. I think people that see it will be too. We prelined it with customers who are also very happy with it.

It has -- everyone who sees it sort of -- it changes their perception of what UGG really is. So I even hesitate to use the term transitional anymore because it's now -- when you're a full year-round brand you're not transitioning to anything. You're just offering up great product every single season of the year and we're going to force the competition to meet our standard. That's a bold statement but I'm feeling pretty bullish about the product I've seen.

Scott Krasik - BB&T Capital Markets - Analyst

Can't wait to see it. Thanks.

Angel Martinez - Deckers Outdoor Corp - CEO, President, and Chairman

Thank you.

Operator

Moving forward, we will hear from Sam Poser with Sterne Agee.

Sam Poser - *Sterne, Agee & Leach, Inc. - Analyst*

Thanks for taking my call. A couple questions. Number one, my favorite question on inventory, will you give us a target of where you're aiming for the end of the year and what kind of turn you're looking for -- for next year? I mean, that's --

Tom George - *Deckers Outdoor Corp - CFO*

Good question. We're not going to give you year-end target. We are really pleased with the performance of all of -- the results of all our efforts and what we've been doing to manage our inventory. I think you're pleased probably with our number here at the end of the third quarter.

I think the best way to really look at our inventory and measure our improvement in our inventory is look on a moving 12 month basis what our turns are doing and how our turns are improving over time. I think that's the best way to look at our inventory results, because the business is changing. It's becoming more and more direct-to-consumer versus distributor and wholesale, and a lot of moving parts and we'll plan on continuing to improve on our inventory levels. That being said, we also want to make sure that we have appropriate inventory levels available to be able to capitalize on next year's first-quarter business.

Sam Poser - *Sterne, Agee & Leach, Inc. - Analyst*

Fair enough. Thank you. With the UGG wholesale, could you tell us what the UGG total wholesale dollars were or that increase for that part of -- in total, what the business was for the quarter?

Tom George - *Deckers Outdoor Corp - CFO*

So for the quarter, UGG total global wholesale was about \$274 million for the quarter, relative to \$284 million for the prior year, so it's down about low-single digits down on a global basis.

Sam Poser - *Sterne, Agee & Leach, Inc. - Analyst*

And do you expect that to turn around in the fourth quarter, given all these shifts? And I have one more question. Do you expect that to go positive in the fourth quarter?

Tom George - *Deckers Outdoor Corp - CFO*

We certainly do, yes, with everything we've got in place and the current order book and, yes, we expect that to turn positive in the fourth quarter.

Sam Poser - *Sterne, Agee & Leach, Inc. - Analyst*

And then looking at your -- sort of the way you've talked about next year, even with all of the transitional product and whatnot it's still going to be a back half, a very back half weighted business, especially when we're talking I would assume about the margin lift, the majority of that's going to come in the back half of the year with delivery of all this new product and so on. So the 100 basis points would be much more weighted to the third and fourth quarters.

Tom George - *Deckers Outdoor Corp - CFO*

That's right. Correct.

Sam Poser - *Sterne, Agee & Leach, Inc. - Analyst*

Okay. Thank you guys very much and good luck.

Angel Martinez - *Deckers Outdoor Corp - CEO, President, and Chairman*

Thanks, Sam.

Operator

Our next question will be from Omar Saad with ISI Group.

Omar Saad - *ISI Group - Analyst*

Thanks. Nice quarter, guys. Question on a lot of the new hires you highlighted in your prepared remarks, Angel. Seems like a pretty hefty influx of some serious talent here. I guess two questions around this are what's the catalyst for bringing a lot of these people in and creating some of these new roles? And then looking out, are there other kind of key positions and talent you're looking to add?

Angel Martinez - *Deckers Outdoor Corp - CEO, President, and Chairman*

Well, serious expectations require serious talent. We've got some very aggressive expectations for our business and we've been working on our go-forward plan. World class talent today is hard to find because there's so much competition for talented people, and I don't believe that we could you achieve our goals without the talent, without this level of competency.

I've always used the adage, something that I coined a long time ago, what got you here won't get you there. And if there is represented by our vision for this Company in the future, then we need the right people to help us get there. And we cannot compromise that. And then we have a culture that we want to protect and enhance and the culture has become a selling point.

A lot of people who come into the Company can go almost anywhere that they want. These are talented people who don't have trouble getting a job, but they've found that the Deckers culture is a good place to be. And we'll always look to add great talent and upgrade all of the people either through training and retraining and giving people an opportunity to grow within their position, or filling in from outside where we see an opportunity and grow a part of the business we have not really fully developed. We need the outside talent.

Look what Dave Powers has done in the year he's been here. He's done a wonderful job. That's not just Dave. We have Linda Pazin here who's done a great job. It's just really staying focused on your future vision and making sure that you're not compromising that vision by not having the best people you can find. I think that would be a big mistake that I should be held accountable to and I fully intend to deliver on that.

Besides, I do want to end up the dumbest guy in the room. That's my corporate goal when I retire from this role. So I've got to make sure that I've got a lot of heavy weights.



Omar Saad - *ISI Group - Analyst*

Okay. Well, hopefully you get to that goal because of the talent around you and not because of some degradation of your abilities. (laughter)

Angel Martinez - *Deckers Outdoor Corp - CEO, President, and Chairman*

I really don't want to do that, no.

Omar Saad - *ISI Group - Analyst*

One last follow-up. As we think about a lot of the new things, newness coming for next year around the UGG Pure, how that unlocks kind of some of the traditional blockages if you will, what you can do with the UGG brand, when are retailers -- when are you going to get the first kind of taste and sense of how that of stuff's going to work, and consumers are going to respond, or when retailers are going to see it? How is that going to -- if you think of a time line, how are we going to be able to measure that?

Angel Martinez - *Deckers Outdoor Corp - CEO, President, and Chairman*

It's going to be sort of gradual and incremental. We're going to you attack it a category at a time. When it comes to UGG Pure, I Heart UGG, you'll see -- and most people will see that really at the Fannie Show. But they've already seen enhancements and improvements to our fashion boots, the use of UGG Pure has allowed us to now create much sharper price points. We've been pre-lining fall '14 and there's been great response to that.

And as I mentioned earlier the slippers, the men's product, the use of materials, the use of UGG Pure, better engineering of the product, our development team has done a fantastic job. So we really have got back to what we call the celebration of the craft, the honoring of the craft of shoe making. And there's a lot of intangible reasons why you buy footwear. A lot to do with cues of quality that we're all sort of conditioned to understand and we really want to create some distance between us and other brands when it comes to the quality of our products.

Omar Saad - *ISI Group - Analyst*

Thanks, Angel.

Angel Martinez - *Deckers Outdoor Corp - CEO, President, and Chairman*

Thank you.

Operator

At this time we'll go to Mitch Kummetz with Robert Baird.

Mitch Kummetz - *Robert W. Baird & Company, Inc. - Analyst*

Thanks. First question, I want to just follow up on what Sam was asking about UGG wholesale. Tom, you mentioned that you expect it to be up in the fourth quarter. Do you expect it to be up across regions? Is there sort of a growth rate that you can give us?

And then on the same line, with regard to reorders and cancellations I know previously you had said you're assuming similar levels as a year ago. Is that still the case in terms of your Q4 guidance? And I've got a follow up.



Tom George - *Deckers Outdoor Corp - CFO*

For the wholesale business in the fourth quarter we expect it to be up low-single digits. That's more in the US relative to the rest of the business, the rest of the business we do expect it up, but not much at this point in time based on our guidance.

And we do have the same assumption relative to reorders and cancellations. We have a pretty cautious outlook there and are planning very little reorders and a similar percentage of cancellations at this point in time. We think it's just early enough in the season after two mild winters to still be cautious at this point in time with that assumption.

Mitch Kummetz - *Robert W. Baird & Company, Inc. - Analyst*

Got it. We appreciate that. And then second question on the retail business, can you say what comp is baked into your Q4 guidance?

Tom George - *Deckers Outdoor Corp - CFO*

On a global basis it's more of a low-single digit, low- to mid-single digit kind of comp.

Mitch Kummetz - *Robert W. Baird & Company, Inc. - Analyst*

Any color by geographic region?

Tom George - *Deckers Outdoor Corp - CFO*

We can give you a little bit of that. Another thing to point out, we're still -- keep in mind that on the comp base is still relatively low to the total number of stores that are going to be performing in the fourth quarter. So that doesn't move the needle.

I'll give you a little bit of flavor by region in the fourth quarter. I think in the US we expect that to return to more of a low- to mid-single digit positive, Canada's a few stores there positive there. Europe, sort of a mid-single digit kind of positive. China, high single, low double for China. And then for Japan, more a mid single digits and I could -- there's different comparison characteristics for everyone of those.

Mitch Kummetz - *Robert W. Baird & Company, Inc. - Analyst*

Got it. That's very helpful. Alright, that's all I had. Thanks. Good luck.

Operator

And at this time we'll take a question from Camilo Lyon with Canaccord Genuity.

Camilo Lyon - *Canaccord Genuity - Analyst*

Good afternoon, thanks for taking the question, guys. One point of clarification. Tom, when talking about the gross margin for next year is that 100 basis points strictly on the raw materials and the product costs? Because it doesn't seem like that would include some of the benefit you're going to get from retail mix.



Tom George - *Deckers Outdoor Corp - CFO*

It's just related to sheepskin cost only, so it doesn't consider any of the other cost inputs we may have and it doesn't consider the expansion of our direct-to-consumer business. So at this point in time it's just giving you guys some visibility of sheepskin only.

Camilo Lyon - *Canaccord Genuity - Analyst*

Perfect. Great. And then just on I Heart UGG could you elaborate on what you mean by sharp price points. Does that mean you're going to have sub \$100 product? And if so, does that mean that you would consider opening up your distribution into the mid-tier channel over time?

Angel Martinez - *Deckers Outdoor Corp - CEO, President, and Chairman*

The price points will be sub \$100. I think it's \$80 to \$120 is sort of the sweet spot. Variety of different styles. And as time goes on, it will expand from a category point of view, you'll eventually see an expansion of the sneaker line inside the I Heart UGG idea. As time goes on, we'll be able to address waterproof product at those kind of price points, which we feel are important. So UGG Pure really gives us flexibility we never had before.

Camilo Lyon - *Canaccord Genuity - Analyst*

So could you see yourselves going into the mid-tier channel like a Macy's competing at that price point that's pretty attractive for that consumer?

Angel Martinez - *Deckers Outdoor Corp - CEO, President, and Chairman*

Well, we don't plan to expand beyond our core distribution matrix. We think that our core customers right now would really love the opportunity to create a customer base and a following around I Heart UGG, but we're testing it.

We also think that for the DTC part of our business this is very important. It allows the consumer, this particular consumer who is obviously doing a lot of shopping online, certainly all their product research online, this consumer won't hesitate to buy the product via our e-commerce channel.

So when you have those things going for you I don't know that it's right now important to expand distribution from where we are. I think we're in a pretty good place. We're just looking to -- this will give us a chance to get some more real estate in different departments.

Camilo Lyon - *Canaccord Genuity - Analyst*

Got it. Sounds like an exciting opportunity. And then just finally, Tom, I think you mentioned that the -- there was a pretty consistent trend in your retail comps throughout the quarter. It's pretty surprising given that you didn't have any weather favorability early in the quarter. Why do you think that's happening? Is there a replacement cycle that's happening? What do you think would drive that sort of consistency throughout the third quarter?

Tom George - *Deckers Outdoor Corp - CFO*

One thing that I think what I said, actually, in terms of trends through the quarter, I don't think I really commented on that. But that being said, one of the things we had this year versus a year ago that did help smooth the business throughout the quarter is we had the transition product in our stores during the quarter, and we had it earlier than we had a year ago and I think there was some other product that we had earlier rather than later a year ago, offhand what type, what product that was. That helped throughout the quarter as well.

Camilo Lyon - *Canaccord Genuity - Analyst*

Got it. Best of luck in the holiday. Thank you.

Operator

(Operator Instructions)

At this time we'll take a question from Jim Duffy with Stifel.

Jim Duffy - *Stifel Nicolaus - Analyst*

Thanks. Good afternoon everyone. Could I ask a point of clarification. You say that the classic sales are improving as you get further into the back half of the year. That seems to be a general statement of seasonality, or are you exclusively saying that the September sell-through was better than year ago, October better than a year ago, et cetera?

Tom George - *Deckers Outdoor Corp - CFO*

Jim, good question. You're right, we do have some seasonality with that business but what we are seeing, because the inventory levels in the channel for our customers are cleaner than they were a year ago. We are seeing improved sell-through relative to a year ago.

Jim Duffy - *Stifel Nicolaus - Analyst*

Good to hear. Okay. And then a question on the retail model. Seems you're seeing some variability in retail productivity. You mentioned targeting smaller, less capital intensive locations. Can you speak for a little about your thought process around retail returns and site locations and so forth?

Tom George - *Deckers Outdoor Corp - CFO*

Generally speaking we're -- one of the major thresholds we look at is obviously return on invested capital. For these retail stores we still want to target a one-year cash-on-cash payback relative to the capital investment. So to add to that, we're seeing in our Asian stores especially in China because of the smaller size and the more value engineering we're putting into our buildouts, we're starting to see buildout costs roughly 50% of what our original comp store fleet was in the US and Europe.

So that obviously can help significantly on returns on capital as well as there's less capital tied up in a Chinese retail store because you only have three year leases as well. So that's very helpful.

Angel Martinez - *Deckers Outdoor Corp - CEO, President, and Chairman*

Let me add to that because there's something else going on too. It's not just about Asia. I think given the sort of what I've been calling the omnichannel revolution, however you want to phrase it, it has an impact on what is the optimal size store.

How many square feet do you actually need when you have something called Infinite UGG and you don't have to carry every color way in a style, so that the consumer can have that shipped to their home and have it within 24 hours, it improves the productivity of the real estate that you have. So part of what we're learning is to understand what is the optimal store size in each region of the world. When you combine the DTC component, when you combine the e-commerce component to it and what does that mean going forward.



Location is critical. You do need to have stores located in the optimum traffic areas. But size of store, that's something that's I think going to change and it's going to change for a lot of people, not just us. We're trying to study that now.

Jim Duffy - *Stifel Nicolaus - Analyst*

Makes a lot of sense. Thanks for that perspective and good luck.

Angel Martinez - *Deckers Outdoor Corp - CEO, President, and Chairman*

Thank you.

Operator

At this time we'll go to Chris Svezia with Susquehanna Financial Group.

Chris Svezia - *Susquehanna Financial Group / SIG - Analyst*

Thanks for taking my question and taking all the time here. Two questions. I guess first I'm just curious, just to go back to the inventory, I think Tom in the last call you made some comment that you actually needed more inventories, so nice to see you down. But I'm curious is it just a timing situation where you ended the quarter, the inventories were where they were? I'm trying to back into what you said last quarter, based upon the growth that you're seeing for the UGG business, number of stores you opened, et cetera, why the inventory growth wouldn't be higher. It's nice to see it down. But I'm just curious if this is just a point in the time that the inventories suddenly look down or where they are at this point.

Tom George - *Deckers Outdoor Corp - CFO*

We're seeing continued improvements in inventory. You brought up a good point. Even with 36 more retail stores we were able to get the inventory down. That is because it's down not only in units, but also the carrying amount of the inventory, the carrying value roughly has a lower unit cost because there's some favorable sheepskin cost in the carrying value of the inventory that's going to benefit the fourth quarter.

So lot of different dynamics in the inventory level. But again, that reinforces to your point you need to look at the inventory more in terms of movement and trends and improvements relative to inventory at any one point in time.

Chris Svezia - *Susquehanna Financial Group / SIG - Analyst*

Thank you. And then the other question I have was just on the retail stores, if I just look at it over a period of time you guys have opened up a lot of stores, and if you sort of look at the EBIT contribution from the retail store piece it's been a bit of a headwind over the past couple years.

I guess the question is this. Would you guys consider potentially slowing your retail store growth to get those EBIT margins back up again, or are you doing enough to drive EBIT margin improvement while opening 30 plus stores? Just curious how we think about the EBIT margin contribution at retail given it only really makes money in that fourth quarter. Does that really start to change now? What do you need to do really start to get -- to move that needle?



Tom George - *Deckers Outdoor Corp - CFO*

Let me take the first part of it in terms of some of the analytics. Obviously the first stores opened were the most productive stores. That being said, our newer stores are very productive as well and great returns on capital. And as we talked about on the call, we've been developing an infrastructure to be able to scale this much bigger on a global basis.

So one thing to keep in mind here, we've opened a lot of stores over the last couple of years in the fourth quarter, this fourth quarter we have a lot of new initiatives and a lot of new learnings relative to product and marketing and to be able to really drive the business this fourth quarter. So at the end of the fourth quarter that might be the time to talk about EBIT margins and whatnot, EBIT margin contributions and how well the retail economics look. And then Angel, I think did you want --

Angel Martinez - *Deckers Outdoor Corp - CEO, President, and Chairman*

Chris, we are planning to slow down concept store growth in North America. We're fine tuning the model. As I said just a moment ago, what is the optimum store size? That's what we're needing to identify. Our growth in the near term is going to be around outlet stores, primarily in Asia-Pacific where we're severely underpenetrated.

But the most important thing is to understand what the new dynamic looks like, the wholesale environment combined with our own DTC efforts. And how consumers want to access brands. When you have Amazon now going to same day delivery, I think you have to be crazy to assume that's not going to have an impact on what the retail footprint looks like. I think for every brand in all of retail.

So we've always been cautious. We have been I think very judicious in the number of stores and where they're placed and being very careful not to have that one store too many that always seems to create the problem. So this is a science and an art because the brand relationship with consumers is part of an art. But all of this sort of becomes a very, very important area of conversation, very important area of experimentation which we're doing a lot of and really sort of dialing in precisely what's the best use of our resources to grow this brand, particularly UGG going forward.

Chris Svezia - *Susquehanna Financial Group / SIG - Analyst*

Okay. Thank you for that. Is it fair to say that you guys would consider continuing to open up that level of stores, but continue to shift the bias on the international side which in theory have better returns?

Angel Martinez - *Deckers Outdoor Corp - CEO, President, and Chairman*

I think in the end we're going to be as judicious as we can be. We're going to do what makes the most sense for our bottom line. I don't have an ego drive to have a gazillion stores in the United States if they're not going to work well. So none of us do. So we want the brand to be exposed in the appropriate way and we want the margins to be healthy and we want the sell-throughs to be great. That's our plan.

Chris Svezia - *Susquehanna Financial Group / SIG - Analyst*

All right. Fair enough. Thank you very much. All the best.

Angel Martinez - *Deckers Outdoor Corp - CEO, President, and Chairman*

Thank you.



Operator

The final question for today will be from Corinna Freedman with Wedbush Securities.

Corinna Freedman - Wedbush Securities - Analyst

Just a really quick one. Could you elaborate on the SG&A costs that have shifted from third quarter to fourth quarter. You might have mentioned the nature and the magnitude, but I might have missed it.

Tom George - Deckers Outdoor Corp - CFO

It's mostly marketing and it's roughly half relative to expectations, it's about \$3 million, it's mostly marketing.

Corinna Freedman - Wedbush Securities - Analyst

Okay. Thank you.

Angel Martinez - Deckers Outdoor Corp - CEO, President, and Chairman

Thank you all for joining us on the call today and we look forward to those of you on the East Coast having chilly evenings and chilly days. We'll speak to you next quarter. Thank you very much.

Operator

This does conclude today's conference call. Thank you all for your participation. You may now disconnect.

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