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Estee Lauder Cos., Inc. (EL)

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MANAGEMENT DISCUSSION SECTION

Operator: Good day, everyone and welcome to the Estée Lauder Company Fiscal 2016 Fourth Quarter and Full Year Conference Call. Today's call is being recorded and webcast.

For opening remarks and introductions, I would like to turn the call over to the Vice President of Investor Relations, Mr. Dennis D'Andrea. Please go ahead, sir.

Dennis D'Andrea
Vice President-Investor Relations

Good morning, everyone. On today's call are Fabrizio Freda, President and Chief Executive Officer and Tracey Travis, Executive Vice President and Chief Financial Officer.

Since many of our remarks today contain forward-looking statements, let me refer you to our press release and our reports filed with the SEC where you'll find factors that could cause actual results to differ materially from these forward-looking statements.

To facilitate the discussion of our underlying business, our full year comparisons have been adjusted for the impact of the prior year implementation of our strategic modernization initiative and the discussion of our financial results and expectations are before restructuring other charges. You can find reconciliations between GAAP and non-GAAP figures in our press release and on the Investor Relations section of our website.

During the Q&A section, we ask that you please limit yourself to one question so we can respond to all of you within the time scheduled for the call. And I'll turn it over to Fabrizio now.

Fabrizio Freda
President, Chief Executive Officer & Director

Thank you, Dennis, and good morning, everyone. Our company had a very successful year in fiscal 2016. We delivered excellent financial results with adjusted constant currency net sales growth exceeding 7% faster than global prestige beauty growth and adjusted earnings per share rose 13%.

We also made progress on our strategic objectives by further diversifying our business, strengthening our multiple engines of growth and advancing our creativity of innovation. This year, new products represent nearly one quarter of our sales, an all-time high. Additionally, we designed and launched Leading Beauty Forward, a multi-year initiative to increase our efficiency, speed to market and agility. Our strong performance confirmed our resiliency during a volatile fiscal period that began with MERS in Korea and ended with Brexit in the UK.

In between, we experienced sharp currency fluctuations, disruptive geopolitical events, including increased terrorism and slowing economies in some of our key markets.

In global prestige beauty, we also faced tougher competition and changing consumer behavior. Nonetheless, we successfully navigated these new challenges while also strengthening the company's fundamentals. Making us confident, we can sustain our strong and profitable growth and achieve our long-term goals.

Our best growth came from our makeup category, especially M•A•C, our luxury brands, the Euro, Middle East and Africa region, and the online and specialty multi-channels. Our ability to grow so strongly in such a dynamic landscape is a testament to our more balanced and better diversified business and strategic ability to identify and anticipate changing consumers' and industry trends. That is what defines and distinguishes our company.

Another of our key attributes is our increasing agility. During the year, we saw a variety of markets impacted by unexpected economic, political and social events. During those times, we made sure our resources were aligned with other areas having better growth potential. Another key strength is our multiple engines of growth, throughout our more than 25 brands that span categories, channels and countries. These allowed us to achieve double-digit growth in some brands, channels or market while balancing lower growth in other areas.

For example, continued political unrest in Hong Kong caused a sharp drop in Chinese tourists who travel to other countries instead. Our brands quickly responded by increasing the range of products appealing to Chinese consumers in key touristic doors in the markets they visited across Asia and Europe.

Fiscal year 2016 was also marked by rapid changes in global prestige beauty. Thanks to our 10-year compass, we had anticipated many of the trends. And we are well-positioned to meet consumer changing desires and shopping habits. For instance, we have increasingly invested in digital marketing and e-commerce, which was our fastest-growing channel this past year. Our global E&M commerce sales surpassed $1 billion for the first time, a milestone we are very proud of and we expect our strong online growth to continue.

We made progress on our strategy, as we strengthened many of our brands and diversified our portfolio. Our compass pointed to the growing interest among millennials for more specialized brands. So we nurtured the ones in our portfolio into significant competitors. Several of them including Jo Malone, Tom Ford, Smashbox, M•A•C, La Mer powered much of our growth and gained share. As makeup sales soared across the industry, Smashbox and M•A•C grew sharply, driven by their creativity and strong consumer demand.

Our specialized luxury brands were big winners and we acquired By Kilian, which strengthens our standing in the fastest growing area on fragrance, the ULTA prestige tier. Additionally, we made a minority investment in a successful Korea skin care brand, Dr. Jart+, which give us an interest in a local brand in that very influential market.

Our two big multi-category brands stabilized overall, as they each ended the year with flat sales. However, both brands have restarted solid growth in makeup. Estée Lauder makeup sales rose in every region, led by foundations and lip products. Its longstanding Double Wear foundation continued to be a best seller worldwide.

In skin care, its innovative Advanced Night Repair PowerFoil Mask helps to accelerated sales of the ANR franchise in China and generated buzz and photos on social media. The brand's global net sales reflected strong growth in the European region and emerging market offset by decline in Asia-Pacific largely due to Hong Kong.

Clinique also advanced on many fronts. Its makeup sales were up sharply on a global basis and Pep-Start Eye Cream was a top seller in several markets. Clinique created digital campaigns featuring millennial influences that contributed to solid sales growth in the specialty multi-channel and in Europe. These gains were offset by declining in U.S. mid-tier department stores and Hong Kong.

Looking at our business geographically, sales in emerging markets rose 15% overall, and 25% excluding China. To fuel our momentum, we further emphasized our local relevancy and products in social media. These past years, our brand reached many new consumers in emerging markets. Jo Malone entered Brazil, for example. We launched our first e-commerce operations in Mexico and La Mer had a terrific growth in Russia.

Our channel strength reflected industry trends and we invested in areas with the best traffic and growth. Sales in our online business rose 27% reflecting solid gains in brands and retailers' sites. We opened more sites for our brands and with retailers globally to widen our product availability. Orders and conversion grew more than 20%. We continue to selectively expand our brands in specialty multi-retailers globally to broaden our consumer base.

For example, in North America, Estée Lauder introduced the millennial-oriented Estée Edit collection in Sephora, while Origins launched in select Sephora stores inside JCPenney and plans to roll out to full distribution there this year. In Europe, Smashbox continued to broaden its presence in boots in the UK and entered the specialty multi-retailer [ph] Lot Gardenia (09:10) beauty in Italy.

We strengthened our capabilities particularly in R&D, information technology, digital and consumer insights. Across our brands, creativity and innovation remained a priority. Approximately 24% of our sales came from new products and our investment in research and development climbed in line with our sales growth. Our global patent portfolio has increased 40% in the last four years, primarily in skin care and strategic areas with high consumer interest. Our newest patents cover technologies that will anchor high quality products that we expect to have broad appeal and delight global consumers.

We also launched Leading Beauty Forward to reduce costs and free up resources to invest in the areas that will help fuel our growth including retail, innovation, digital, social media and new consumer-facing activities. In this fast-paced environment, we want to improve our speed and flexibility as we go to market and serve global consumers in creative and contemporary ways.

In this new fiscal year, our actions fall into two broad areas. The first is increasing the reach of our target consumers throughout white space opportunities across geographies and channels. The second is enhancing our consumer engagement with new experiences and innovative high-quality products and services which will encompass digital marketing, disruptive in-store merchandising, compelling creativity and omnichannel offering.

Our brands have numerous opportunities to attract new consumers in every region. M•A•C is one of our largest brands, but isn't as widely distributed as other brands. It has approximately one-tenth the doors of Estée Lauder and Clinique and about half the distribution of several direct global competitors. So there are millions of untapped new consumers the brand can potentially reach.

Many of our small and medium-sized brands are now poised for global expansion. For example, in travel retail, Jo Malone today is available in less than half of Tier 1 airports. So there is a lot of runway left to reach additional traveling consumers. Online, Jo Malone has e-commerce website in just eight countries compared to 26 for Clinique. In fact, Jo Malone expect to launch E&M commerce in approximately 10 new markets this year.

As our consumer coverage increases, we are carefully watching same-store sales growth as well. We expect new points of distribution, same-store growth and pricing to each contribute approximately the same amount to our total sales growth this year. Freestanding stores are expected to account about one-third of our new distributions this year.

As our brands broaden their reach, they will emphasize fast-growing, image-building channels. In the online world, our focus is on mobile and omnichannel. Consumers expect a seamless integrated experience across channels, platforms and social media. We are implementing new technology and digital experiences, including online booking for in-store appointments, omnichannel loyalty programs and high-touch mobile services.

With sales in specialty multi-retailers on a fast track, we will increase the number of doors we are in and widen the scope of our brands in the channel to reach the consumers who shop there. For example, Clinique plans to roll out more ULTA locations and enter some Sephora stores inside JCPenney. Estée Lauder, meanwhile, will reach new shoppers with a curated selection of products in ULTA in 30 stores and on ULTA's website.

In travel retail, global passenger traffic is forecasted to grow mid single-digits. We expect our net sales to surpass traffic growth, led by many of our mid-sized brands that have opportunities to enter additional airports all over the world. We are working closely with department stores to bring more traffic to beauty, both in-store and online.

We will elevate the consumer experience in department stores with differentiated customized services such as makeup lessons from our expert advisors for which there is a strong demand. Although department stores have been challenged in the U.S., they continue growing internationally, including the UK, Western Europe, Australia, Canada or Latin America.

Social media is integral to every beauty brand today and an important component in winning with millennials. To engage consumers, our brands plan to utilize more global and local influencers, beauty consultants and makeup artists to amplify their messages. Estée Lauder is collaborating on a makeup collection with fashion designers and influencers, Victoria Beckham, and she is promoting it to her 12 million Instagram followers.

Our brands are increasing their media spending and devoting more resources to digital, which allows them to target their communications to potential new consumers with relevant messages, thanks to better data and new technologies. Approximately 30% of our total advertising spending is now digital, up 15% from last year.

Our brands are doing interesting activities in the digital space. Estée Lauder launched the interactive global content network based in New York. It works like a newsroom. And Bobbi Brown held its first live video on Facebook, celebrating its 26th anniversary and a new campaign which attracted nearly 1 million viewers.

Innovation remains paramount, as our brands pursue high-growth subcategories. One area is skin care with instant benefits such as masks from some of our brands that make skin glow. In addition, Clinique's Pep-Start HydroBlur Moisturizer [indiscernible] (16:05) blurs skin imperfections on the spot. And Estée Lauder Revitalizing Supreme+ Wake Up Balm creates instant morning radiance.

We plan to accelerate our growth in skin care. The recent launch of Estée Lauder Advanced Night Repair Ampoules should help drive the brand's important franchise. Clinique created a collection around Pep-Start, with the addition of moisturizers and cleansers and La Mer is rolling out a new formula of its core moisturizing line.

With new innovations and consumer engagement activities, we believe we can further strengthen our leading position in makeup. Estée Lauder is building on its Double Wear Foundation with an innovative cushion stick. Clinique introduced Superbalanced Silk Makeup, an entry price foundation with sun protection. And M•A•C Instant Curl Lash Mascara has a customizable brush.

We also plan to propel our fragrance business, particularly in the ultra-prestige tier where we have a large and desirable portfolio. Jo Malone highly anticipated major fall launch is Basil & Neroli and Tom Ford's newest entry in its signature collection is Orchid Soleil.

Prestige beauty is a driving consumer area and its growth continues to exceed mass beauty in key countries. Underlying demographic trends are positive. The middle class in emerging markets, millennials and Ageless consumers had a big appetite for prestige beauty, and those populations are increasing. We operate in an unpredictable global environment and carefully monitor ongoing issues such as the ramification of Brexit on our business.

We are aware that unforeseen challenges will arise. However, we have comfort in knowing that we have many strengths that underpin our financial performance. Our diversified business is anchored by multiple engines of growth, a wealth of creativity and the ability to quickly react and adapt to events and trends, making us optimistic about our long-term success.

Over the next three years, we expect to generate sales growth of 6% to 8% and double-digit EPS increases in constant currency. This year, we expect to once again outplace global prestige beauty growth and gain share despite external headwinds and challenges. In fiscal 2017, we forecast constant currency sales growth of 6% to 7% with double-digit EPS growth.

I want to thank my executive team and every one of our employees for their hard work and passion. They are one of the key reason we have performed so well and continue to be so confident about our future.

Now I will turn the call over to Tracey.

Tracey Thomas Travis
Chief Financial Officer & Executive Vice President

Thank you, Fabrizio, and good morning, everyone. First, I will review our fiscal 2016 fourth quarter and full year financial results and then cover our expectations for the fiscal 2017 first quarter and full year.

As a reminder, my commentary excludes the impact of restructuring and other charges. Additionally, the fiscal 2016 full year comparisons have been adjusted for the impact of the prior-year implementation of our strategic modernization initiative.

Net sales for the fourth quarter were $2.65 billion, up 7% in constant currency compared to the prior year. Incremental sales from our newest brand acquisitions contributed approximately 50 basis points of this growth.

Our business was quite strong in Europe, the Middle East and Africa, despite macro events in France, Germany and Turkey as well as the U.K. Brexit vote.

Net sales rose 12% in constant currency, with double-digit growth in most countries, notably the U.K., Germany and most of the region's emerging markets. Our sales declined in France due to a large drop in tourism and in the Middle East because of continued economic uncertainty.

Our global travel retail channel delivered an 11% net sales increase, reflecting strong retail trends in many tourist destinations, partially offset by continued weakness in Hong Kong and in Brazil.

Currency volatility and terrorist activity continue to affect travel and consumption patterns and we saw a moderation in passenger traffic to Europe in the quarter. Sales in the Asia-Pacific region grew 6% in constant currency. Australia was a standout, growing strong double-digits while China, Korea and Japan grew mid to high single-digits. Our net sales in Hong Kong continue to decline, but less than in the previous quarter.

Net sales in the Americas increased 3% in constant currency. Latin America grew more than 20%, led by Mexico and Brazil and Canada rose mid-single-digits. Sales in the U.S. rose low single-digits. Our sales through both online and specialty multi-channels continue to rise double-digits. However, declines in tourist-driven retail doors and continued weakness in the brick-and-mortar business of mid-tier department stores curtailed growth.

Makeup sales again led product category growth, rising 12% in constant currency. M•A•C, Smashbox, Clinique, Bobbi Brown and Tom Ford achieved double-digit makeup growth, and Estée Lauder rose mid-single-digits. Foundation, lip products, kits and palettes have been very popular among all consumers.

Hair care sales increased 5% in constant currency. Aveda benefited from the launch of Invati for men products, and Bumble and bumble experienced solid growth in Germany and in France. Skin care sales grew 3% in constant currency, led by growth from La Mer and Origins. These increases were partially offset by Estée Lauder and Clinique, reflecting continued weakness in U.S. mid-tier department stores as well as in Hong Kong.

Sales of fragrance products rose 2% in constant currency. Jo Malone was the largest contributor to growth as sales rose strong double-digits. Our recent acquisitions, Le Labo and Frédéric Malle, are growing rapidly, and By Kilian provided incremental sales.

Our gross margin was unchanged from the prior year. Favorability from pricing, lower obsolescence and supply chain savings were offset by channel mix, currency and new products. Operating expenses, as a percent of sales, declined 10 basis points. Higher store operating costs associated with our retail store growth was offset by lower selling and shipping costs and cost savings from our SMI program.

As a result, operating income rose 7% and operating margin improved 10 basis points. On a constant currency basis, operating income grew 9%. Net earnings increased 7% to $163.1 million, diluted EPS of $0.43 was 9% above the prior-year, reflecting higher earnings and a small benefit from a lower share count and lower effective tax rate. Earnings per share for the quarter included $0.04 of dilution from acquisitions and $0.01 of unfavorable currency translation. On a constant-currency basis, EPS increased 11%.

Switching to our full year, details of our performance are largely covered in the press release, so I will focus on some of the highlights. With strong net sales up 7%, our gross margin improved 10 basis points. Manufacturing favorability and lower obsolescence were partially offset by product category mix and currency.

Our full year operating margin declined 40 basis points to 15.5%. While the decrease included slight dilution from the recent acquisition of By Kilian the decline was almost entirely driven by 50 basis points from the impact of adverse currency. We continued to benefit from our cost savings and sales growth leverage.

We ended fiscal 2016 with an effective income tax rate of 28.3%, a 200-basis-point improvement from the prior year. Net interest expense rose to $55.1 million from $45.7 million in the year earlier, reflecting the increase in debt from our May 2016 bond issuances, partially offset by higher investment income.

In fiscal 2016 we realized approximately $135 million in restructuring and other charges, $54 million of it related to the transformation and modernization of our global technology infrastructure, which is largely complete and approximately $81 million in charges for our Leading Beauty Forward initiative.

Operating cash flow was $1.79 billion, representing a slight improvement over the prior year adjusted for the SMI shift. We invested $525 million in capital projects, two thirds of which was in consumer facing areas such as counters, retail stores and E&M commerce sites.

We repurchased 10.5 million shares of our stock for $890 million and paid $423 million in dividends to stockholders, increasing our dividend rate by 25%. In total, we returned approximately 104% of free cash flow to stockholders, contributing to our 6.4% total stockholder return for the fiscal year, which compares with 4% for the S&P 500 for the same period. Additionally, we invested in an acquisition and a minority interest and we increased our balance sheet leverage by issuing $600 million in senior notes at favorable rates.

Overall we are very pleased with the performance we delivered in fiscal 2016. Our 7% net sales growth and 13% EPS growth in constant currency are strongly aligned with our long-term goal and we have laid the foundation for a more efficient and effective organization to leverage growth with the launch of Leading Beauty Forward.

Now looking ahead over the next few years, we plan to continue to focus on our strategic priorities with an even greater emphasis on speed and agility in the context of a rapidly-evolving prestige beauty landscape. The recent Brexit vote has added a layer of uncertainty that will most likely not be fully understood for some time. And we believe the risk of other economic and political disruptions will remain high as we start our new fiscal year. Nevertheless, our strategies are sound and as a result, over the next three years, we expect our business to continue to become even more balanced and diversified by product category, brand, geography and channel.

Prestige beauty is expected to grow at 4% to 5% annually for the next few years and we remain committed to our goal of exceeding the growth of global prestige beauty by at least one percentage point annually. We also expect to continue to drive value from our existing cost-saving programs and we expect to begin realizing some of the initial benefits from Leading Beauty Forward in fiscal 2018 and generate annualized net benefits of $200 million to $300 million upon full implementation of the program.

With the recent approvals of the first initiatives under Leading Beauty Forward, we can now develop more effective organization structures to enable increasing improvements in consumer engagement for our brand as well as develop more efficient and effective processes for many of our corporate functions, including the initial organization design of a potential shared service support structure. We expect to approve further initiatives throughout the next few years.

All of these efforts should permanently reduce the run rate of the areas addressed under the program and provide funds for continued investment in capabilities that more directly support the sustainability of our profitable top line growth.

It is more important than ever that we maintain the financial and operational flexibility to compete effectively in the dynamic prestige beauty industry. We must be able to nimbly allocate the appropriate amount of resources as consumer preferences, travel corridors and exchange rates continually shift. Balancing cost savings, sales leverage and reinvestment for future growth, we expect operating margin expansion of approximately 110 basis points to 150 basis points in constant currency through fiscal 2019.

We remain committed to our goal of growing EPS double digits in constant currency each year, which we have delivered consistently for the last seven years.

Working capital improvement also continues to be a focus, and we expect improved cash-to-cash cycle performance across accounts payable, accounts receivable and inventory. Over the next three years, we plan to free up $400 million in additional cash, which would increase our growth in cash flow from operations in excess of our earnings growth. We are targeting inventory days to sell of approximately 150 days by the end of fiscal 2019, a marked improvement from today's levels.

Now let me next focus on our outlook for the fiscal 2017 full year and first quarter. In fiscal 2017, sales are forecasted to grow 6% to 7% in constant currency. We expect all product categories and regions to grow led by the makeup category and the EMEA region. By channel, growth is expected to continue to be strongest in online, specialty multi, freestanding stores and travel retail. As Fabrizio mentioned, several of our brands will accelerate their expansion in specialty multi-retailers and online, which should enable us to reach new consumers as they increasingly shop multiple channels for prestige beauty products. The impact of this activity and the cadence of our new product launches are expected to produce stronger top line growth subsequent to our first quarter.

Our estimate reflects current spot rates given the recent volatility we have experienced the last two years. Those spot rates are $1.12 for the euro $1.31 for the pound and $1.01 for the yen.

We continue to achieve cost savings from our SMI program. In fiscal 2017 we expect to generate approximately $150 million in savings primarily from indirect procurement, A&P optimizations, supply chain initiatives and selling effectiveness, some of which will be used to invest behind our newly acquired brands and omnichannel capabilities.

We anticipate our tax rate will range between 28% and 29%. Diluted EPS is expected to range between $3.38 and $3.44 before restructuring charges, including approximately $0.08 of dilution from currency translation. In constant currency, we expect our EPS to rise by 8% to 10%.

In fiscal 2017, we expect to take restructuring and other charges of $80 million to $100 million with about $35 million to $45 million in the first quarter. We expect to update these estimates when additional initiatives are improved. And as a reminder, total program costs beyond fiscal 2017 over multiple years are anticipated to be in the $500 million to $600 million range.

In fiscal 2017 we expect cash flow from operations of approximately $1.8 billion, relatively flat with last year with the inclusion of the impact of Leading Beauty Forward. Capital expenditures are planned at approximately $550 million or 4.5% to 5% of sales. With respect to our capital structure, we have room to grow our dividend while maintaining a sustainable payout ratio. And as of June 30, we had approximately 18 million shares remaining in our buyback authorization. We will continue to assess the need for greater leverage to support our strategies, including shareholder returns.

For the first quarter of fiscal 2017, we expect sales to rise approximately 2% to 3% in constant currency. Translation could hinder growth by approximately one percentage point. We expect our small-to-midsize brands to continue to be strong contributors in many global markets owing to their increasing appeal with multiple consumer groups across various channels. We also expect continued growth to be generated in many developed and emerging markets, particularly in Europe.

Partially offsetting these growth drivers in the quarter are some macro issues that we expect to impact our results. Our U.S. business continues to be affected by low traffic in mid-tier department stores and tourist-driven doors and we are facing a difficult comparison to the prior-year quarter, which was our strongest quarter in the U.S. when Estée Lauder and Clinique launched major skin care products and M•A•C had exceptionally strong results. Our cadence of product launches reflect smaller programs for all three in this year's first quarter. The Middle East is projected to decline as distributors adjust inventory levels to reflect sluggish consumer spending. And we are experiencing weak sales in France as the threat of terrorism curtails travel and domestic spending in the near term.

For the first quarter, our EPS forecast is between $0.73 and $0.77 before restructuring charges. The adverse currency translation on sales for the first quarter equates to about $0.03 of EPS. And as a reminder, the size and quarterly cadence of our new product launches and our programs changes from year to year. We continue to focus on delivering annual results in our overall long-term sales and profit growth plans.

We look forward to another successful year ahead for our company and for our brands. We are fortunate to operate in one of the highest demand consumer categories today. Our brands are among the most desirable in the industry and we believe our team is the most talented in the industry with their incredible creativity, passion for the business and depth of knowledge on what products consumers aspire to have. This winning formula continues to support our confidence in our plan despite a volatile political, economic and currency environment.

And that concludes our prepared remarks. We'll be happy to take your questions at this time.

QUESTION AND ANSWER SECTION

Operator: The floor is now open for questions. [Operator Instructions] Our first question today comes from Jason English from Goldman Sachs

Jason English
Goldman Sachs & Co.

Q

Hey. Good morning, folks. Thank you for the question.

Fabrizio Freda
President, Chief Executive Officer & Director

A

Good morning.

Tracey Thomas Travis
Chief Financial Officer & Executive Vice President

A

Hi, Jason.

Jason English
Goldman Sachs & Co.

Q

Hello. So, I guess, two questions if I could. And both of them margin related. It seems like just sort of backing into the implied margin, I apologize if you gave the detail in some of the prepared remarks but it looks like you're looking for sort of a flat margin year at the EBIT line this upcoming year. Is that true? And if so, maybe what are some of the puts and takes that get you there?

And then sticking on margins, there was really good progress a couple years ago, and seen fragrances sort of march higher. We had a setback last year. We've kind of stalled at margins this year with some weakness in the back half of this year. Maybe what's going on with the margin progression and the plans to sort of improve profitability on fragrances?

Tracey Thomas Travis
Chief Financial Officer & Executive Vice President

A

So in terms of the overall margin, it's impacted primarily by currency again this year, so this is the third year in a row where we've had a fairly significant impact from a margin standpoint on currency. And that's the primary driver. We certainly have some of the mix impact related to makeup and skin care going on as well this year. So some of it is mix impact and some of it is the currency impact. As I indicated, we still do have our cost savings programs to offset a lot of the unfavorability that we're experiencing and we continue to work on other initiatives to improve the margin.

On fragrance, one of the things that we've spoken about, Jason, in the past is much of our growth is coming from some of our fragrance brands that have higher margin characteristics. So Jo Malone is a very profitable fragrance brand for us. Our newer acquisitions, because of some of the purchase accounting, don't yet have the margin characteristics of a Jo Malone but we certainly expect that they will once we get past the purchase accounting impact in the next year or two years.

Jason English
Goldman Sachs & Co.
Q

Awesome. Thank you.

Operator: Our next question comes from the line of Steph Wissink from Piper Jaffray.

Stephanie Schiller Wissink
Piper Jaffray & Co. (Broker)
Q

Thanks. Good morning, everyone. I just have a follow-up question on Leading Beauty Forward. Could you just give us some sense of the cadence of the savings and the reinvestment? Should we assume, on a quarterly basis, that they're pretty well in sync, or will there be some timing inconsistencies we should be planning for based on the costs and then the reinvestments? Thank you.

Tracey Thomas Travis
Chief Financial Officer & Executive Vice President
A

So, no, this – what we had spoken about as it relates to Leading Beauty Forward, we don't expect to see any savings from the program until next year. So this year we don't expect to see savings from the program. As far as the restructuring this year, it could be a bit lumpy in terms of quarter-to-quarter depending on when, say, projects are approved under the program.

And just a reminder, in the program we're doing a fair amount of org redesign, so there are a lot of costs up front in order to realize the savings so that we can actually more permanently reduce costs going forward. So that's a bit of what's going on in fiscal 2017 as it relates to Leading Beauty Forward. We will start to see savings in fiscal 2018, more in fiscal 2019 and beyond fiscal 2019 is when we expect to achieve those run rate savings of net $200 million to $300 million.

Stephanie Schiller Wissink
Piper Jaffray & Co. (Broker)
Q

Thank you.

Operator: Our next question comes from Caroline Levy from CLSA.

Caroline Levy
CLSA Americas LLC

Q

[ph] Everyone. (39:43) It has to be on China. I was just wondering if you could help me understand what you're seeing in Hong Kong and Greater China as a whole. Because one of the calls we're making is that there'll just be more Chinese traveling domestically. Do you have the travel retail set up within China that will help you there, or do you have to build the traditional stores to capture the Chinese who are not traveling outside as much as they were? And then just within Korea, I think you're already lapping MERS, so I was just wondering if you expect accelerating growth there? I know you're doing much better. You are growing. But are you seeing some good trends there?

Fabrizio Freda
President, Chief Executive Officer & Director

A

So, Caroline, yeah, we love your questions about China. And so the answer is yes. I think you are right. I mean, first of all, the amount of Chinese consumer traveling abroad is very solid. As you know, is well above 100 million this year. 117 millions is the numbers we calculate and is growing. So, first of all, there is no, at least in our knowledge, any reduction of traveling. Now where they travel? You are absolutely right. Less of them travel to Hong Kong and more of them travel to different destination internationally. But it's also true that there is an enormous increase of travel within China and we are very well-positioned. We have – as you know, there are duty-free areas within China where we are very strong. For example, Hainan Islands, that are increasing. And there is more people traveling there.

On top of that, the fact that consumer travel touristically within the country offer us the possibility of continued building distribution in third tier and fourth tier cities where we are enjoying this internal travel, which, obviously, in this case is not duty-free. So both are true. Continued increase of external travel and increase of internal travel, and we are catering to both opportunities.

As far as Korea is concerned, we are doing very well in Korea. We are growing. For the year we've been growing more than the market, so we build market share and we continue to see very strong growth also in the Seoul Airport. And so the Korea trend in fiscal year 2016 has been very, very strong. And we expect the Korean market to continue to have a strong influence on Asia in general and the Korea consumers continue to be a high-demanding consumers that we use also to – as a benchmark for the kind of new ideas and new products that we go to launch in Asia or globally.

Tracey Thomas Travis
Chief Financial Officer & Executive Vice President

A

And, Caroline, we do see in the first quarter in addition to – we're lapping, as I mentioned, very strong growth in the quarter last year from the Middle East and France, and softer performance this quarter for obvious reasons that we spoke about. We are seeing very strong growth in Korea in the first quarter because we are lapping MERS.

Caroline Levy
CLSA Americas LLC

Q

That's great. And could you touch on Hong Kong at all? Just what the – what you see happening?

Fabrizio Freda
President, Chief Executive Officer & Director

A

Yes. Now, Hong Kong, as we said in the prepared remarks, is we continue to see decline in Hong Kong. And we continue to see reduced flow of tourists. But we see increased purchase and increase business with local consumers. So Hong Kong continued to lose tourists and continued to have a solid, actually increasing, business with local consumers. So I believe the market is in a transition and the same for Macau. And so we see declines, but declines at lower levels than declines we saw before.

Caroline Levy
CLSA Americas LLC

Q

Thank you so much.

Operator: Our next question comes from Mark Astrachan from Stifel.

Mark Astrachan
Stifel, Nicolaus & Co., Inc.

Q

Yes. Thanks, and good morning, everybody. Fabrizio, I wanted to ask about your acquisition strategy and your thoughts on whether continuing to purchase small brands makes sense, particularly as it seems your larger competitors are making some larger-scale deals? And then also, could you discuss fragrances, where you're focused compared to doing makeup, which seems to be a focus of some of your competitors, as well as perhaps skin care where you make a play perhaps for the improvement in that category relative to levels in recent years?

Fabrizio Freda
President, Chief Executive Officer & Director

A

Yeah, first of all, we agree. It's not about buying small brands. That's not the strategy. The strategy was to create a portfolio of the high-end artisanal fragrances that combined could change, really, the market and make the fragrance market again a market of high-end, consumer demand driven brands that can inspire the consumer in the world of fragrance and make it through the company, the company with the best portfolio in this growth area of the future. That was the acquisition strategy there. It's not about small brands or big brands. It was about building the most amazing portfolio of artisanal fragrance brands. We have done this.

So you are also right that there is a growing makeup business around the world. We already have an amazing portfolio that – which some of our competitors didn't have. So we have M•A•C, Bobbi Brown, Smashbox. By the way, Smashbox was the first acquisition that we have done. It was exactly makeup. So now we agree with you that the future will see opportunities to continue growing in makeup and there will be opportunities for more makeup brands in our portfolio.

And in terms of skin care, we purchased GLAMGLOW, which is a skin care brand, and is a skin care brand, although small – but it is a skin care brand, in our opinion, with great potential to grow and to become big and also is focused exactly on the new skin care trends, so instant benefits like masks and specialty multi-channel dynamics.

And finally, we purchased a minority interest is one of what is the fastest-growing skin care brands in Korea today, which is Dr. Jart+, which was exactly the strategy. So I believe that the point is the strategy is not about fragrances or small brands, the strategy's about acquiring brands that fill strategic opportunities in our portfolio and this will continue to be the strategy.

Mark Astrachan
Stifel, Nicolaus & Co., Inc.

Q

Thanks. That's helpful. I just wanted to follow up then. So from a M•A•C or your overall makeup portfolio standpoint, are you seeing any impact from your competitors doing deals? Like, not to name specifics, but obviously, L'Oréal has talked about some of the brands that they have growing quite exponentially.

Fabrizio Freda
President, Chief Executive Officer & Director

A

Our M•A•C brand been growing double-digit, very strongly, globally, in fiscal year 2016 and we expect M•A•C to continue to grow double-digits globally also in fiscal year 2017. It is a super-strong brand. And there's a lot of markets where M•A•C is growing 20% to 30%. There are so many more consumers that the brand has now reached, so there is full potential. The competitiveness of the U.S. market in makeup has definitely increased. And in fact, we see the need of increasing the competitiveness in the makeup, also activity on M•A•C in the U.S. But for example, we saw the same opportunity on Lauder and Clinique a year ago, and I just want to repeat that in the last 12 months, Lauder and Clinique makeup in the U.S. grew double-digits, showing that when we focus on a specific market and a specific area, we can get the results. So yes, but there is an opportunity there and we are very focused on it.

Operator: Our next question comes from Olivia Tong from Bank of America Merrill Lynch.

Olivia Tong
Bank of America Merrill Lynch

Q

Great. Thank you. You guys have obviously done a great job over the years of growing well ahead of the category and Q1 expectations are for a fairly-massive slowdown. So can you talk through – you've already talked through some of the things that will impact Q1 but can you talk to the order of magnitude of things that will get better to get you from that 2% to 3% back up to the 6% to 7%, like how much is the new distribution like the JCP relationship, ULTA, et cetera, versus new store openings and improvement in macro travel retail, innovation, so if you could just kind of talk about order of magnitude of those things and then I have a follow up.

Fabrizio Freda
President, Chief Executive Officer & Director

A

Yeah. Sure. I'll start and then please Tracey add there any perspective. So the building blocks of fiscal year 2017, maybe that's the best way I can address your question, the building blocks is that the first building block is pricing. And as I said, out of the 6%, 7%, about two points will be pricing. A lot of the price increases of the year happen in January. And so already this 2% of pricing is skewed toward more the second part of the year. Then think of the distribution, so the second 2% of increase of the year is greater distribution reaching new consumers around the world. Now many of these new distribution, including the one in specialty that you just mentioned, are going to happen after October. Many of the freestanding stores in Europe that we [ph] thought, (49:47) the majority of the freestanding store we are going to open will happen in that period. And many of the new specialty multi doors in the U.S. will happen after October.

So that's the second different – that second positive which is going to happen more skewed ahead in the fiscal year versus the first quarter. The third big point is that as I said before to the previous question, we have a very solid new fragrance portfolio in the high-end. Now this fragrance portfolio, as you know, tend to have a huge opportunity to grow during holiday periods. And so all the holiday periods, not only Christmas but also Valentine, Mother's Day, happen to be after October and this will be another big extra acceleration element which is later in the fiscal year. Then we have all our innovation programs that Tracey said in her prepared remarks, our innovation schedule change in the year. We have less blockbuster initiative this year because we believe the consumer and the social media environment, which is developing, need more diffusion of newness versus blockbuster approach, so a lot of the innovation is more skewed as of October in our portfolio.

This is the other building block on the same door that will impact the same door 2%, 3% of progress that we see in the year. Then as I said Estée Lauder and Clinique are on an improvement trends and we expect Estée Lauder and Clinique to continue to improve and M•A•C U.S. is expected to continue to improve in the second part of the year. So all this factor will improve the comp part of the fiscal year.

So a lot of good steps that we believe will, over the year, accelerate. The last thing I want to say on that is that we have proven, just the year fiscal year 2016 that we finished, we grew two of the quarters more than 8% and another quarter is 5%, so we have proven that we have the capability and the potential to grow at 8% plus in the quarters where all the key elements of our building blocks start acting together.

Olivia Tong
Bank of America Merrill Lynch

Q

Thanks, Fabrizio. That's pretty helpful. Two follow ups, first, can you provide how many doors you opened in the quarter? And then just the incremental distribution that you spoke to, obviously it helps grow sales but how do you assess the risk – the potential risk to the prestige of the brand for Clinique going into a more value-tier department store and then just generally how do you view the door expansion potential for Clinique and Lauder brands beyond some of the specialty multi – the incremental doors that you talked about, I think you said 30 doors for Estée. How much more opportunity – the Estée Lauder brand, how much more opportunity do you see there? Thanks.

Fabrizio Freda
President, Chief Executive Officer & Director

A

First of all, we see many opportunities around the world on reaching new consumers. So it's not about diversification of distribution, it's really about reaching new consumers and reaching where the traffic of prestige consumers are. We don't plan to reach consumer which are not interested in the prestige, we don't plan to distribute in any area where prestige and luxury is not well presented and we do not plan to distribute anywhere where the service quality will not be at the level of prestige, so we continue to be completely focused on luxury prestige distribution, that means great environment, the right target consumer, the right service level.

However, the world is evolving, the world is changing, and there are many new opportunities, on line, specialty, travel retail, freestanding stores, and obviously some very promising new activities also in the department store world. And we are focusing on all of them, and wherever there is growth of prestige consumers. That's really the strategy. What you see in the specific examples we are sharing are the immediate next steps, but these are immediate next steps of a long-term strategy. So the answer to your question, there are more and more opportunities over the year to continue reacting in that direction. And then Tracey.

Tracey Thomas Travis
Chief Financial Officer & Executive Vice President

A

Yeah. So, Olivia, I want to make sure that we clearly answer the question. When we have quoted door counts in the past, we're really talking about retail stores. In some cases, our company operated stores and in some cases our total store count, which includes our third-party operated stores as well. So when you ask the question about how many doors we opened in the fourth quarter, we opened 35 of our company operated retail stores in the fourth quarter. We opened a little over 170 of those stores in the full year.

We also opened third-party stores as well in the year. And as Fabrizio indicated, of our total distribution growth, that's about third of the growth of that 2% distribution, is freestanding stores. So they're becoming a bigger part of our overall base of total sales, but still the largest drivers of our growth are comps performance, and certainly the contribution to innovation.

Fabrizio Freda A
President, Chief Executive Officer & Director

And maybe the other number is that the sum of the freestanding store that Tracey just described in fiscal year 2016 grew 11% sales.

Operator: Our next question comes from Bill Schmitz with Deutsche Bank.

Bill Schmitz Q
Deutsche Bank Securities, Inc.

Hi. Good morning, everyone.

Fabrizio Freda A
President, Chief Executive Officer & Director

Good morning.

Bill Schmitz Q
Deutsche Bank Securities, Inc.

Hey. I'm having a tough time understanding the negative mix because it seems like the most profitable brands and the most profitable regions are the ones that are growing the fastest? So why is there negative mix in the P&L?

Tracey Thomas Travis A
Chief Financial Officer & Executive Vice President

So it's a couple of things. And we have a lot of mix impact in the P&L, so it can be a bit challenging. But if you just look at our category margins, makeup is a very high category margin for us as is skin care. Skin care is a little bit higher than makeup, so when you see the disproportionate growth of makeup, which is happening in the industry, and certainly we're both driving and benefiting from. And the slowdown that we've seen in skin care, it does have a mix impact. So that is a piece of it.

The other piece is that Hong Kong is a quite profitable area of the world for us from a sales perspective, a sales and profit perspective in that region. And the double-digit declines that we've seen in Hong Kong have also had an impact. So there is a geographic impact. The Middle East would be the same. So there's a geographic impact and then there's a category impact from a mix standpoint that we have experienced. We have, and the team, have done a tremendous job of offsetting that impact with our cost-saving programs and other choices that we've made in order to continue to grow double-digit EPS growth.

Operator: Our next question comes from Lauren Lieberman from Barclays.

Lauren Rae Lieberman Q
Barclays Capital, Inc.

Thanks. Good morning. First is actually just on the point of double-digit growth, and this was the case on last year's fourth-quarter call as well. But Fabrizio, twice you've mentioned for fiscal 2017 an expectation of double-digit local currency earnings growth. But at the same time, twice it's been mentioned that the guidance is 8% to 10% local currency. So I just wanted to clarify which it really is? Understanding there are risks on the table and the M•A•C [indiscernible] (57:40) is 8% to 10% versus double-digits is two different things?

The second thing is around cost savings. I believe for fiscal 2016 you started the year expecting $200 million of SMI-related savings. You lowered that to $175 million for the year, I think, back in May. And then as you look into fiscal 2017, you're talking about $150 million. So it feels like some of those expected savings aren't achievable for some reason, something has changed, because I would have thought maybe it was a delay in timing, but something with SMI, it just feels like perhaps the savings are not quite what had been anticipated even 12 months ago? Thanks.

Fabrizio Freda
President, Chief Executive Officer & Director

A

Yeah, and thank you for your question. I'll answer the first part. Is 8% to 10% has 10% at the top of the range, which is double-digit. So our point is that we are committed to do our best to deliver double-digits, and as usual, if we give you a range, we are committed to do our best to reach the top of the range. But telling you 8% to 10% in this moment in time at the beginning of the fiscal year where there's so many volatility out there and so many social, political situation that we have also explained in our remarks, we are basically acknowledging that there are some risks.

And so that's what 8% to 10% means, but does not take anything away from our commitment to do all what we can to deliver the double-digit, meaning the 10%. And so, that's simply the way we see that.

And then, Tracy, you want to...?

Tracey Thomas Travis
Chief Financial Officer & Executive Vice President

A

Yeah, so on SMI, we're actually pleased with our SMI program. And we did set a target of $200 million for – some programs got off to a bit of a slower start given the volatility that we were managing through in the year. So we ended at $185 million. $150 million – and again, we're talking about year-over-year cost reduction. At some point, as you start to go further and deeper on some of these initiatives, there is going to be less opportunity.

Clearly, when we initiated the second phase of our savings program, we went after the biggest opportunities first, and then, you start to see that weighing down. Hence the reason why we announced Leading Beauty Forward, which certainly will generate more savings in future years as the SMI savings start to narrow a bit.

So I think we're right on track with respect to where we expect to be in terms of SMI savings, and we certainly will always strive – we have a very competitive team, so we always strive to exceed what our targets are.

Operator: Our next question comes from Ali Dibadj from Bernstein Research.

Ali Dibadj
Sanford C. Bernstein & Co. LLC

Q

Hey, guys. I want to ask a short-term question and a long-term one, kind of going back to some of the questions from earlier. One is, still in your 2017 guidance, 6% or 7% constant currency, 8% to 10% on the bottom line, I guess I'm still not convinced that the margins you're projecting are flat because of currencies. And maybe dispel me of that confusion, because it looks like it's less than 1% of an impact on your top-line for the year. You talked about $0.08 on the EPS line, but that's like 2.5% of EPS and that sets a very large multiplier, much bigger than we would've expected.

So trying to get a sense of why that's the case. And even that, by the way, doesn't explain the margin structure being flat given all the cost-cutting that you're doing, the good cost cutting that you're doing. So that's question one.

The other one is, I do want to go back to the question in terms of distribution expansion into Sephora and Sephora into JCPenney, into ULTA, with Estée Lauder, which I think we would have said 10 years ago if ULTA had existed would've been crazy, Jo Malone pushing more. I mean we've seen a lot of, not the same, but analogous issues. I mean just recently Coach, as an example, said look, we're pulling back on department stores, again, slightly different issue, because they were discounting a lot, but we've heard this before from Tommy, Burberry, Ralph Lauren, as Tracey knows very well.

And you look at this a lot, guys, so I want to get a sense of how you're looking at it, right? I mean, I appreciate your thoughts on this, because there is a concern that at some point, you're going to get rid of the scarcity. At some point, you're going to mattify the brands, which drives the brand erosion and you kind of lose a little bit of that prestige. So given some of the analogies, can you explain kind of the long-term, how much longer do you have before you start hurting the brand? Thanks on those two short and long-term.

Tracey Thomas Travis
Chief Financial Officer & Executive Vice President

A

Okay, Ali. So let me start with your questions with respect to margin. So currency is another big impact and we gave you the spot rates that we're using, which again, certainly could change during the course of the year. But rather than us predicting how that will change, we're using current spot rates. And that definitely has at least 30-basis-point impact on our margin for the year.

In addition to that, we did talk about the fact that some of our very high profit margin regions are actually showing either slower growth or declines in the case of Hong Kong, as we mentioned. The Middle East has slowed quite a bit. UK is a bit softer than what we certainly have experienced over the last couple of years.

So those are all impacting. If nothing changed with respect to either our category mix or a geographic mix, then you would be absolutely spot-on. But those are things that we're managing as well. So our cost savings programs not only help us to expand the margin, but they have helped – and fund some of our investments, but they've also helped us, because of the programs that we put in place a few years ago and are continuing to deliver on, are helping us to offset the negative impact of some of the macro situations that we're experiencing right now.

Fabrizio Freda
President, Chief Executive Officer & Director

A

Okay. And on distribution, Ali, my point is we vet every single decision, starting with the consumer point of view. So we are not distributing our brands anywhere where the consumer doesn't demand them and the consumer is the target consumer.

The distribution decision we are taking are always brand building, meaning there are consumer that are on target, particularly millennial that we would not be able to reach without proposing the brand in that areas, and that's what is happening around the world, particularly the millennial consumer are changing their shopping habits.

The brands that do not evolve their shopping habits to reach this consumer will, basically, actually lose traction with the new luxury consumer rather than risk their image. And so, it's an evolution and it's driven mainly by the habits of the millennial consumer. Also, it's very different by category. This is happening very aggressively in makeup, for example, and the way the millennial consumer in makeup is. It's happening also around the world. And a lot of this is about online and the availability of the brands online.

So second thing is it's not the image of the distribution, but is the – we call it consumer reach. So the way we look at it, because again, that's your question, we don't look at it like only the image. We look at it, do we reach the right consumer? So it's an analysis [ph] starts (65:57) from target consumer reach. And in fact, that's why we have used this language in our prepared remarks, coverage, reach, rather than expanded distribution.

Then when you look at internal number of doors, that's actually, there are a lot of closures. There are a lot of stores which are being closed, not only in the U.S., around the world. So in terms of number of stores, this is not necessarily an increased availability. So it's putting the brands where the consumer expects them at a certain moment of the progress.

Last thing I want to say is that you mentioned Estée Lauder and Clinique, which are today within prestige broadly distributed brands. But keep in mind that all the rest of our portfolio is actually an enormous amount of extra distribution opportunity, meaning our brands have not even started being available to the right level of consumer around the world. So a lot of our distribution expansion is not about Lauder and Clinique; it's about bringing the rest of our portfolio available to the right target consumer around the world, and numerically, internal sales and profit, that's where the biggest opportunity is.

Operator: Our next question comes from Jonathan Feeney from Consumer Edge Research.

Jonathan Feeney
Consumer Edge Research LLC

Q

Thanks very much for the question. I wanted to follow up maybe from a different angle on Ali's question. I want to ask about the channel. How do you manage it internally? How do you break the news to your core channel customers, your department stores, that the exclusive availability of not just Estée Lauder, the prestige brand products, but the efforts and alignment of your company have been such a big part of their success historically, that at the margin, yes, you're following the consumer, but this necessarily means less emphasis on those channels and maybe less investment in those channels going forward?

My question would be how do you manage? How do you compensate people to make that switch internally? How do you have those – have you ever gotten pushed back from some of your department store, partners that hey, maybe what you're doing is hurting them a little bit at the margin. And maybe going down the road, are there ways to make the business actually more profitable by maybe investing a little bit less with businesses that have been – retail partners that have been more important to you in the past than they are today? Thank you.

Fabrizio Freda
President, Chief Executive Officer & Director

A

So no, as I said, we start from the consumer, from the consumer demand. And so, that's the way we make distribution decision and we make distribution decision in partnership with our retail partner. And they always know these things before and we have very, very honest discussions about what's needed for the brand.

Sometimes a new distribution decision actually helps sales for the brand in the total country including in the retailers where the brand was previously distributed.

And by the way, our brands very rarely are exclusive to a retailer. They are targeting certain group of consumer that's clear. For example, Macy's, as you know, has announced to close 100 doors. We are collaborating, we will collaborate with Macy's to protect the consumption of our brands in these doors transferred to other Macy's doors consumers. We will do our best to support Macy's in this plan which we believe they are doing the right thing. We will focus a lot to support Macy's in selling more in the remaining doors that they will focus on, as well as we'll continue to support Macy's in building the best we can their online business that we have together.

Also our retailers decide to close doors to other things and we collaborate with them in keeping the sales, continue increasing the sales. So it's not about one or the other. If we focus on the client on the final customer, we get always the right decision made, and there are normally win-win for the brands, for our retail partners, and for the consumers. That's what we are looking, that's our principle.

As far as your question in terms of, if I understood correctly, in term of internal, internal, I think we just have our normal processes. As I said, we're starting from consumer understanding, we make the decision, and then, we discuss those with our partners.

Operator: Our next question comes from Jason Gere from KeyBanc.

Jason M. Gere
KeyBanc Capital Markets, Inc.

Q

Good morning. I guess just one question. I was wondering how you kind of acquire customer data for some of the freestanding stores, so I know there's obviously a lot of data you can get from the department stores. But I was just wondering how you can kind of leverage some of that information in terms of really trying to keep the momentum going with freestanding, especially as a lot of those stores are in some of these malls where you are seeing some, I guess, weakness in traffic with some of the mid-tier department stores. I was just wondering how you think about that.

Tracey Thomas Travis
Chief Financial Officer & Executive Vice President

A

So actually, it's easier for us to acquire consumer data from our freestanding stores given the fact that we have the point-of-sale equipment than it is in the department stores where we don't. In some cases, in department stores, you are right, we do also have some equipment that allows us to capture the consumer, but in all of our stores, our freestanding stores, we do. So it's actually easier for us to capture it in stores as well as online.

We certainly do. Our teams look at that information, our brands look at that information and understand what trends are selling in freestanding stores, and whether or not that mirrors or not what is selling in department stores and put plans together accordingly. And those are all areas that we, as we expand distribution, as consumers continue to shop in multiple points of distribution, we continue to aggregate that information and look at whether or not there are any differential trends that the entire business can benefit from in terms of our strategies and how we allocate resources.

Operator: Our next question comes from Dana Telsey from Telsey Advisory Group.

Dana L. Telsey
Telsey Advisory Group LLC

Q

Hi. Good morning, everyone. As you think about the growth of new products and the impact that they're having, how do you see their influence on the gross margin? And over what period of time should new products essentially reach or exceed the corporate average gross margin? And does it differ by category? Thank you.

Tracey Thomas Travis
Chief Financial Officer & Executive Vice President

A

So Dana, great question. And I probably should have mentioned this as well when Ali asked his question on margin. Depending on our innovation in a particular year, and in some cases, we actually choose to launch some innovation that actually has lower gross margin, because that we've identified a consumer need in that particular space and believe that that product will drive incremental sales and will build to be a large franchise, particularly for franchises like Estée Lauder and Clinique and particularly in skin care. So we have seen in recent years some new innovation that actually is a bit of a lower gross profit margin.

Clearly, as sales continue to build on products that we launch that are new, you're amortizing the tooling and you're getting some more favorability in terms of gross profit margin, but largely, they stay relatively close to where they're at unless there's a significant increase in volume in which case you can get lower cost of goods so.

But we do manage and our team – when you think about the number of brands that we have and the number of new product launches that we have where we have had, to Fabrizio's earlier comment, a steady increase in the amount of innovation, our teams manage that gross margin mix quite tightly in terms of making sure that the new innovation at least over a few years is offset by innovation that also is more margin accretive.

Fabrizio Freda
President, Chief Executive Officer & Director

A

And I would just like to add one point to this point on gross margin. Again, we are a prestige luxury company. So our main task is to have pricing power. And the moment we do a good job, we can do both, we can give to the consumer this super high-quality packaging experience they want and the price for it so that we protect the right gross margin evolution over time. It's all about pricing power and the power of our brands to sustain it.

Operator: Our next question comes from Linda Bolton Weiser from B Riley & Co.

Linda Bolton Weiser
B. Riley & Co. LLC

Q

Hi. I was curious on the U.S. market given some of the weakness that you are seeing, if you're making any modifications or if you have any initiatives regarding your selling methods in department stores. I know several years ago, you made some changes like more open cell and things like that.

So can you talk about what you're doing to try to help the department stores drive that traffic in beauty? And also, is your investment behind the consultants or the sales force in the stores, is it rising because of the weakness? Do you make more investments there?

And then finally, you mentioned on the Macy's how you're hoping to help them shift consumptions out of stores, but in the near term, is that impacting some of your weakness early in your fiscal year in terms of just the sell-in to fewer doors in Macy's? Thank you.

Fabrizio Freda
President, Chief Executive Officer & Director

A

Let me start answering this question. As you probably know, Macy's has announced their intention to close 100 doors, but they did not give a specific calendar of when this will happen. So the answer is no, in the first quarter, there is no assumptions of the new closing doors, but Macy's closed, I believe, 40 doors or 50 doors so far, and yes, there is obviously the impact of the first 44 doors, 45 doors that were closed before in fiscal year 2016 in the first quarter.

But to your core question for the long-term, we definitely are focused to support our department store partners to continue to improve the experience on our brands and, in general, in the beauty floor of department store. We have many activities in this area, many in the area of improved services, many in the activity of innovation and distortion, many in the area of connecting social media to the activities and activity in the area of sampling.

In other words, we are really focused in working together how to increase traffic in store, which is, in this moment, the key opportunity.

And then, to your second question is what do we see in this moment? Yes, we see a lower traffic than what we would like to see in our counters in mid-tier department stores and that's what you see in our quarter one estimate as well and we are working hard to support our partners to go back to increase this traffic at every level.

Tracey Thomas Travis
Chief Financial Officer & Executive Vice President

A

At the same time, both ourselves and our partners work pretty closely together on making sure that as we see – at the same time of growing volume and all the strategies that we're jointly working on to grow traffic to the beauty counters in the stores, recognizing the reality that there are more options today for women to buy cosmetics and beauty products in many different channels where, historically, it was only more singularly in the U.S. market. We're also making sure that, as you do in a freestanding retail store, looking at staff to sales ratios which any retailer looks at and make sure that those are appropriate for the amount of traffic you see near-term, and then, investing back in those resources when sales increase.

So that too is important, both for our partners as well as ourselves, to make sure that we're managing profit accordingly.

Operator: Our next question comes from Joe Altobello from Raymond James.

Joseph Nicholas Altobello
Raymond James & Associates, Inc.

Q

Hi. Thanks. Good morning. First question, I wanted to go back to Lauder and Clinique brands, and maybe if you could assess for us the progress you guys have made over the past 12 months in turning around those brands? And is the momentum that you're seeing, as we exit fiscal 2016, what you expected to see 12 months ago, given the spending behind those brands, given the expansion in specialty multi, the launch of Estée Edit? How have those kind of contributed to that? And are you connecting with the millennial to the extent that you had hoped 12 months ago?

And then secondly, on Leading Beauty Forward, Tracey, earlier you mentioned that no benefits in fiscal 2017, but is there spending in that program that's going to run through the P&L that's not extraordinary and being excluded? Thanks.

Tracey Thomas Travis
Chief Financial Officer & Executive Vice President
A

So let me start with Leading Beauty Forward. There is a slight amount of spending that's running through the P&L, but it's not meaningful at this point. Most of the program costs right now are running through restructuring because of the nature of the program, which is largely form design oriented.

Fabrizio Freda
President, Chief Executive Officer & Director
A

And on Lauder and Clinique, a year ago, in this call, Lauder and Clinique were declining. Now, they are flat. And so, there has been a significant improvement of trend. We said they would have started from turnaround in the makeup area of both brands, because it was the area that was better fitting the other goal which was to attract more millennials to the brands. And we have done it in the U.S. Lauder and Clinique makeup is growing double-digits which, frankly, was declining just a year ago, and this is an impressive improvement. And also globally, both brands are growing their makeup in a very strong way.

Now, the skin care also did some progress, as we explained in the prepared remarks. However, on the skin care, the two key issues, which is Hong Kong continues to decline and the mid-tier department store traffic issue that we just discussed in the last half an hour, those two have been a drag to accelerate as well the skin care part, which now we will do our best to do in fiscal year 2017. So good progress on both brands with an excellent start in makeup and some work to do in skin care.

Last point is, to your question, is that what we forecasted, frankly, we have done in line or slightly better than what we expected, but we did not forecast Hong Kong to continue to decline in the way it's declined and we did not anticipate the kind of traffic reduction in mid-tier department store that we have seen in the course of the year. So those two things actually were different than what we anticipated a year ago.

Operator: We have time for one more question. Please go ahead, Steve Powers from UBS.

Stephen R. Powers
UBS Securities LLC
Q

Okay. Thanks. I'm going to try and test your endurance with three quick ones, if I could. The first one is you mentioned Macy's. Across fiscal 2017, does your guidance embed any net inventory de-stocking at the retail level or not? That's the first question.

The second question is, if you could just update us, in aggregate, as you think about your own freestanding doors as well as your own online sites, what percentage of sales is the direct-to-consumer business today? And how do you expect that to trend over the next three years?

And then finally, with respect to makeup versus skin care, not surprisingly, 2017 sounds like another makeup-led growth year, both for yourselves and the industry. But as you think about the makeup ahead of skin care trend, how long do you think that lasts? I don't know if you can take some learnings from past cycles or other consumer insights, but just as you think about your kind of three-year outlook, do you expect makeup to kind of run ahead of skin care for the duration? Or is there a crossover point? Thanks so much.

Tracey Thomas Travis
Chief Financial Officer & Executive Vice President
A

So let me take the first two. As it relates to is there some de-stocking assumed in our forecast and guidance for this year, yes, given some of the retail dynamics that are going on. May not be enough, but we do have some clearly in there given what's happening in the U.S. market in particular.

As it relates to direct-to-consumer which, for us, would be our freestanding stores and, obviously, our e-commerce as well as retailer.com sites, it's about 17% of our total sales is our direct-to-consumer business.

And then, on the makeup and skin care?

Fabrizio Freda
President, Chief Executive Officer & Director

A

Makeup and skin care, I think, first of all, that makeup will definitely continue to grow, and very, very fast. There are two dynamics which are happening which, we believe, are for the long-term. The first one is the Asian consumer is using makeup more and more. So the dynamic of skin care versus makeup, a global level, the strength of skin care was driven by the fact that the fastest growing demand was coming from Asia. In Asia, consumer use much more skin care than makeup.

I think this will continue, so nothing wrong with the skin care trend, but the makeup trend in Asia is dramatically accelerated, because the billions of Asian consumers are using makeup more and more. This is a very strong long-term trend.

The second is the millennial generation. The data shows that the average millennial use more makeup in more occasions during the week than their mothers. So the more the millennial generation grows in percentage of the total population, the more makeup usage will continue to accelerate. So those two trends are long-term.

However, that doesn't mean the skin care needs to continue being growing less. Actually, we see already the first signs that as soon as the millennial will discover also more of the skin care routine, this can impact the skin care. For example, our new brands like GLAMGLOW which are more focused on millennials and they are more based on instant benefit skin cares which are more important for millennials are seeing amazing growth when they do a good product launch.

So I personally believe also skin care will accelerate in the future driven by positive trends.

Operator: That concludes today's question-and-answer session. If you are unable to join for the entire call, a playback will be available at 1:00 p.m. Eastern Time today through September 2. To hear a recording of the call, please dial 855-859-2056. Passcode number 64876241.

That concludes today's Estée Lauder conference call. I would like to thank you all for your participation, and wish you all a good day.