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The Estée Lauder Companies, Inc. (EL)

Q2 2021 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good day, everyone, and welcome to The Estée Lauder Companies Fiscal 2021 Second Quarter 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 Senior Vice President of Investor Relations, Ms. Rainey Mancini.

Laraine A. Mancini

Senior Vice President-Investor Relations, The Estée Lauder Companies, Inc.

Hello. 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, the commentary on our financial results and expectations is before restructuring and other charges and adjustments disclosed in our press release. All net sales growth numbers are in constant currency, and all organic results exclude the impact of acquisitions. You can find reconciliations between GAAP and non-GAAP measures in our press release and on the Investors section of our website. As a reminder, references to online sales include sales we make directly to our consumers through our brand dot-com sites, and through third-party platforms. It also includes estimated sales of our products through our retailers' websites.

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

Fabrizio Freda

President, Chief Executive Officer & Director, The Estée Lauder Companies, Inc.

Thank you, Rainey, and hello, everyone. Let me first wish that each of you are in good health and that your families are well. Our hearts continue to be with those impacted by COVID-19, and our focus remains first and foremost on the health and safety of our employees, their families and our consumers.

To our employees, you have lifted us up from caring for the physical and emotional well-being of colleagues to making hand sanitizer, seeking opportunities to support charities around the world, generously contributing to the ELC Cares Employee Relief Fund and so much more. In December, the company made an additional donation to the employees' fund and we continue to make progress on our citizenship and social impact commitments.

Our employees' agility and creativity empowered the company to deliver the exceptional results we announced today. For the second quarter in fiscal year 2021, sales rose 3%, a 12-point positive swing from the decline of 9% in the first quarter. Impressively, 10 brands grew, led by the double-digit growth from Estée Lauder and La Mer, as well as great performance from Jo Malone London. Le Labo and Frédéric Malle also rose double digits. We focused our investment decisions on engines of growth, while employing strict cost discipline in other areas, delivering strong double-digit adjusted diluted earnings per share growth.

In the quarter, we faced increasingly complexity from the pandemic. Yet, still delivered results that exceeded our record second half quarter of fiscal year 2020, when sales grew the strongest in 20 years in our seasonally largest quarter. Our multiple engines of growth strategy continued to prove its value, enabling us to pivot with agility in this challenging moment. We successfully activated efforts behind the growth engines of Skin Care, Fragrance, Asia/Pacific, Travel Retail in Asia, and global online.

Our skin care category performed extraordinarily. Its accelerating growth reflected the strong locally relevant innovations, successful hero strategies, compelling ingredient narratives, and deeper consumer relationships enabled by sophisticated data and analytics. Growth of our high-rated hero products was broad-based across subcategories from cleansers, to watery lotions, serum, eye care and moisturizers. Our Skin Care business has continued to go from strength to strength, bolstered by the peace of mind of the ritual of skin care as an expression of self-care.

From entry prestige to luxury, our brands excelled in skin care. Many brands contributed, demonstrating the breadth of our performance. Dr. Jart+ provided incremental sales from our double-digit organic growth with its appealing derma brand positioning. The Estée Lauder brand once again delivered double-digit growth across several of its hero franchises in Skin Care. Its new Advanced Night Repair serum was a powerful force, thanks to its new formula in a luxurious, more sustainable glass bottle. The serum delivered a healthy fit to Advanced Night Repair Eye. And these two hero products benefited from their synergies in desirable sets. The brand's Revitalizing Supreme+ franchise accelerated significantly, gaining momentum with its hero moisturizer.

La Mer, leadership in luxury skin care, grew as consumer demand for its iconic products with powerful proven efficacy soared. Here too, serum was a vibrant subcategory. Its new The Concentrate was a big contributor to growth, amplifying strength of heroes like Crème de La Mer and The Treatment Lotion. The new Genaissance de La Mer concentrated night balm performed exceptionally well, driving the brand's ultra-luxury franchise to new heights.

Clinique returned to growth, lifted by Skin Care as its hero franchises that are focused on hard to solve skin care problems like acne and dark spots thrived. Even Better Clinical Interrupter is now firmly established as a core performance of the brand, and continues to deliver significant growth. It was complemented by an acceleration in the brand's 3-Step product and acne solution lines.

Our luxury and artisanal fragrances captivated consumer desires. From Tom Ford Beauty, Jo Malone London, Le Labo, Frédéric Malle, and Kilian Paris, innovations and iconic products were both highly sought. These brands all delivered stellar online sales growth along with improving brick-and-mortar sales in certain markets. Jo Malone London and Le Labo home products continued to flourish as consumers craved the sense to elevate the sanctuary of their homes.

Our global online channel delivered outstanding double-digit sales growth, significantly accelerated from the previous quarter and driven by every region. Growth was robust across the board as brand dot-com, third-party platforms, pure players and retailer dot-com doors all contributed meaningfully.

Our go-to-market strategy for each of these were tremendously successful, particularly during Black Friday, Cyber Week, and Tmall 11/11 Global Shopping Festival, driving strong consumer acquisition and retention.

We continue to enhance our brand sites with high-touch services. These strategic investments are elevating the consumer experience from convenience buying to enriched shopping, complete with useful tools, targeted recommendations, and expert advice.

Across our brands, we are uniquely combining technology and data with our talented beauty advisor on a global scale. Virtual Try-On is proving to be incredibly powerful, driving over twice the engagement as well as higher conversion and retention rates. In the quarter, we added Virtual Try-On to more sites around the world. The number of sessions nearly doubled from the previous quarter, reflecting both the expansion to additional sites as well as a big uptick in activity on brand sites that had previously launched it.

Digital is also proving to be very powerful. In North America, conversion of live chat session is nearly four times higher than average conversion in the market. Video chat usage accelerated during the holiday season as our skilled beauty advisors offered useful insights and customized education to consumers, driving much higher basket size than average.

Our brands are increasingly offering other engaging virtual services and experiences. Two examples are found on clinique.com. Clinical Reality, the brand's skin diagnostic tool, instructs the consumer in a highly personalized manner, driving notably strong conversion rates. And Clinique Skin School addresses the growing demand for credible education in an entertaining format with a new focus on real-time interactions. Skin School brilliantly integrates live chat and trend-based programming with the brand expert consultants.

We continue to pursue high-touch innovation online as evidenced by the Estée Lauder brand's new AI-driven product recommendations based on real-time consumer behavior and past preferences that we are piloting in North America. We anticipate that this dynamic merchandising holds great promise and are excited to scale in this year for Estée Lauder as well for other brands.

We are welcoming new consumers on our brand sites by also successfully driving repeat, enabled in part by our loyalty programs. In the first half of fiscal year 2021, the number of loyalty program members who both grow strong double digits, driven by triple-digit growth of international loyalty program members. In so many ways, we are building deeper relationships with our consumers.

Our brands delivered excellent results for Tmall 11/11 Global Shopping Festival, leveraging the latest live streaming technology and capabilities to generate product discovery. For 11/11, the Estée Lauder brand moved into the number one rank in beauty. La Mer notched number one rank in luxury beauty. M.A.C. was the number one prestige makeup brand. And Jo Malone London was the leader in fragrance.

We have long believed in the compelling growth prospects of online and have been investing in it for more than two decades. At the onset of COVID-19, we nearly doubled our rate of online investments, including accelerating our consumer-facing investment, like Virtual Try-On, social selling, omni channel and loyalty programs, while also increasing our investment in our digital infrastructure and fulfillment network to meet the much higher traffic and demand. In addition to these capital investments, we continue to optimize our advertising investment in digital channels as well as invest in our great online talent domestically in our headquarters in New York and in our local markets around the world.

Among the regions, Asia/Pacific delivered the strongest sequential improvement with sales growth accelerating from 7% to 27%. Mainland China prospered, while Korea and several smaller markets contributed organically. In Mainland China, momentum in brick-and-mortar carried into the quarter, with sales again growing double digits. Online accelerated significantly, elevated by a remarkable 11/11 event. Nearly every brand grew, as across the brands we reached more consumers, thanks to locally relevant innovation, hero products, rich storytelling and successful influencer and activations as well as the dedication and creativity of the local team in China.

Travel Retail grew single digits organically, driven by strong results in Asia, particularly in Hainan, as we fulfilled the desires of the traveling Chinese consumers with ideal merchandise. Traffic to Hainan continued to rebound and the duty-free annual [ph] parcel (00:14:41) limit had increased three-fold there in July, providing a favorable benefit in the quarter as consumers sought to spend to the new annual limit before year-end. Conversion was also a strong driver owing to retail, which newly offered live streaming.

Across channels, demand from Chinese consumers accelerated, especially in Skin Care and Fragrance. The long-term growth opportunity we foresee in the dynamic Asia/Pacific region are abundant. Over the last 15 months, despite the challenges of the pandemic, we made three significant investment commitments as we strive to best meet the desires of Chinese and Asian consumers.

In late 2019, we acquired the Korean-based skin care brand Dr. Jart+, while in early 2020 we committed to build an end-to-end innovation center in Shanghai. Today, I'm pleased to confirm we are building a state-of-the-art manufacturing facility near Tokyo. We are on track to open our Shanghai innovation center in spring 2022. This will increase our local capabilities in product design and formulation. We are also strengthening our consumer insight and trend analytics in this vibrant market.

We broke ground on our new manufacturing facility near Tokyo, which is to be operational in late 2022. It will enable us to better meet demand and increase speed to market in the region. The facility will house advanced technologies and engineering equipment with high standards of sustainability and safety, and will be designed to promote flexible and leading-edge working environment. Across our engines, innovation contributed significantly in the second quarter, ahead of our aggressive goals, driven by focus on fewer, bigger and better hero innovations.

We have an enticing pipeline of new product launches for the remainder of our fiscal year. Already out are two in Skin Care. The Estée Lauder brand launched Supreme+ Bright. It addresses the trend of brightening in Asia, and is also highly relevant for consumers of all skin tones around the world with its Even Better skin tone and dark spot benefits, meeting top needs of the mostly ethnic consumers.

Clinique introduced Moisture Surge 100-Hour with an exclusive aloe vera [indiscernible] (00:17:37) that provides hydration that goes 10 layers deep into skin surface, and also lasts 100 hours even after you wash your face. [indiscernible] (00:17:50) Clinique launched Even Better Clinical Serum Foundation, a weightless liquid foundation with 24 hours wear and good-for-skin ingredients to help visibly improving skin instantly and over time.

Our strategic focus and investment in our ESG goals remain of utmost importance for us and our key stakeholders, and we continue to advance our work in the quarter. Let me share a few examples in climate, sustainable ingredients in packaging, and inclusion and diversity for the many areas of our recent progress.

We are pleased to have joined CDP's 2020 Climate A List, having been awarded the highest score of A. In January, Aveda proudly announced that its products are vegan. As a mission-driven brand, this was a natural step for Aveda, a brand that continuously works to reduce its environmental impact, while also responding to the fast-growing consumer trends.

Our brands are employing more sustainable packaging as they launch new products, while also improving the packaging of existing products. The two new Clinique products, which I just described, are two such examples of innovation, launching a more sustainable package.

To continue to invest in and advance our diverse talent, we created a sponsorship program for equitable advance and professional development of our Black talent. From [indiscernible] (00:19:33) leadership development program, we'll ensure that our Black employees have the support and advocacy of senior executives and equitable access to leadership training, mentorship and career development opportunities.

In closing, we delivered excellent performance amid the pandemic, leveraging the strength of our multiple engines of growth strategy, hero products, and robust innovation. We did this while leading our values as we increasingly embedded ESG in everything we do, focusing on safety and well-being of our employees, making progress on our environmental goals, and acting on our racial equity commitments.

We also invested in technology and data for new capabilities to support accelerating growth drivers. These accomplishments and actions give us confidence that we are well positioned to continue to drive recovery and return to our long-term growth targets after the period of recovery.

I'm incredibly grateful to our employees whose grace and fortitude are making us a better company throughout this very difficult moment. While the road ahead will still be challenging, together we can be optimistic that brighter days are coming. I wish each one of you good health.

And now, I will turn the call over to Tracey.

Tracey Thomas Travis

Executive Vice President of Finance and Chief Financial Officer, The Estée Lauder Companies, Inc.

Thank you, Fabrizio, and I certainly echo your comments regarding our wonderful employees. As a reminder, my commentary today is adjusted for the items that Rainey mentioned at the beginning of the call, and net sales growth numbers are in constant currency.

Our net sales rose 3% in the second quarter. The COVID-19 pandemic continued to pressure traffic in our brick-and-mortar distribution, but sales declines in stores were entirely offset by strong growth across our online channels and in Travel Retail in Asia. The December 2019 acquisition of Dr. Jart+ added approximately 3 points to net sales growth. Sales performed above our expectations in large part reflecting the outstanding execution during the annual Tmall 11/11 Shopping Festival as well as the many activations our brands deployed during key shopping events like Black Friday and Cyber Week. In addition to the acceleration and growth we saw in Skin Care, Fragrance sales were strong in the quarter, and home fragrance continued to resonate during the pandemic.

Our gross margin increased 10 basis points, compared to last year's second quarter. Favorable channel mix was driven by the growth in our online sales, and also reflects lower cost for testers in our brick-and-mortar distribution. From a category perspective, the acceleration of sales in skin care also benefited gross margin. The positive mix was partially offset by higher obsolescence and a negative currency impact.

Operating expenses improved by 160 basis points as a percent of sales, reflecting both the strength of our sales leverage during key shopping moments, and our cost containment measures. Many of our COVID-related cost containment measures remained in place during the quarter, and contributed to our improved profitability along with the benefits of our Leading Beauty Forward initiative. Lower selling costs and other in-store promotion costs also reflected the mix shift of our business from brick-and-mortar to online as well as some remaining government subsidies in certain countries.

Given the challenged environment, we continued to experience periodic door closures. Partially offsetting the cost favorability was higher investment behind our strategic priorities including China, online and digital technology, as well as the inclusion of Dr. Jart+ expenses this year. As a result, our operating margin rose 170 basis points to 24.3%, a significant accomplishment during this important holiday quarter, considering the record results achieved in the year-ago period.

Our effective tax rate for the quarter came in at 15.9%. The lower tax rate for the quarter was primarily due to the recognition of a one-time retroactive benefit related to recently finalized GILTI US tax regulations. We now expect our effective tax rate for the year to be approximately 20%, reflecting this development.

Diluted EPS of $2.61 increased 24% compared to the prior year. EPS was higher than expected due primarily to the combination of strong performance during the key shopping moments in the quarter, and the lower tax rate, while maintaining strict cost management. This performance is truly a testament to our team's ability to navigate the business through the difficult macro environment.

Our plans under the post-COVID business acceleration program are progressing. Through the past six months, we have taken charges of $46 million primarily to close underperforming free-standing retail stores in our EMEA region, and in employee-related costs as we realign resources to support our online business and our digital capabilities.

As the program continues in the second half, we expect to continue to rationalize our retail footprint, primarily in Western markets. Additionally, we took an $81 million impairment charge for our GLAMGLOW brand, reflecting the COVID-related disruption of the brand's growth plans and lower-than-expected growth from its planned geographic expansion.

During the first half of our fiscal year, we generated $1.98 billion in net cash flows from operating activities, which was substantially above the prior year due primarily to improvements in working capital management. Accounts payable increased, reflecting timing-related items that also support our second half growth plans. And accounts receivable reflected the rapid growth in our direct-to-consumer business and a 5 day improvement in DSO.

We invested $250 million in capital expenditures to support key investment areas like additional production capacity and technology. Conversely, we spent far less on counters and stores due to lower traffic in brick-and-mortar doors. We ended December with $5.5 billion in cash and cash equivalents, just above our total debt.

With the strength of our cash position, our free cash flow generation, and our confidence in our business drivers as we recover, we expect to reinstate share repurchases and maintain our dividend during the second half of our fiscal year.

So, now, let's turn to our outlook. We are obviously encouraged by the sequential improvement we saw in every region as we continue to manage through the effects of the pandemic. While cases of COVID-19 and new variants are surging again in some markets, resulting in renewed door closures, restrictions and lockdowns, we are optimistic that once the vaccines reach enough of the global population, the restrictions on travel and social activities will ease. Nonetheless, we had not assumed a second wave. Therefore, the more accelerated global recovery we originally anticipated in our second half has clearly been delayed.

So, while we are pleased with our performance in the first half, the prolonged uncertainty with respect to the pace and timing of the recovery makes it still difficult to provide sales and EPS guidance for the full year. We do continue to expect sequential quarterly sales growth improvement as comparisons to the prior year ease, and the global recovery unfolds. The inclusion of six months of incremental sales from the acquisition of Dr. Jart+, which benefited our growth in the first half, adds 2 percentage points to sales growth for the full fiscal year.

As you know, several of our retail customers are liquidating or reducing their store footprints. Notably, Lord & Taylor, Stage Stores, [indiscernible] (00:28:39) are liquidating, and Macy's, Nordstrom and [indiscernible] (00:28:42) have announced door reductions. Additionally, we expect to close certain free-standing stores in North America and EMEA, now that the holidays are behind us. In aggregate, the lost sales represent between 1% and 2% of our total full year sales and we do expect to recapture a portion of those sales in other locations and online.

While we will continue to execute our cost savings programs, it is important to recognize that some of the temporary cost measures we took last year will be returning in the coming months. The principal areas of returning costs include some additional advertising, promotion, and point of sale employee costs, which were all meaningfully reduced during the time that retail doors were closed last year as well as the restoration of certain temporary pay reductions we took. Travel and retail consulting costs are expected to ramp up more slowly.

Costs will also increase as offices reopen and our facilities continue to implement enhanced safety protocols. We will incur incremental spending for our new Asian manufacturing plant and innovation center. And as we continue to see signs of consumers' willingness to resume their normal activities including return to stores, we plan to invest incrementally, as we normally did pre-pandemic in our fourth quarter, to strongly support our launch programs and to begin to reaccelerate our makeup business in the upcoming fiscal year.

Looking at the near-term, for the third quarter, we expect sales to rise between 10% and 11% in constant currency. We have a terrific lineup of product offerings and activations for the Lunar New Year, and we expect continued strong online sales. You may recall that we had an exceptional January last year. We have lapped the purchase of Dr. Jart+ at the beginning of our third quarter and the brand is now part of our organic growth. Currency is expected to be accretive by approximately 3 percentage points.

Third quarter EPS is expected to be between $1.10 and $1.20, reflecting the sales outlook and a careful balance between cost containment measures and investment in key growth areas such as online and technology. And currency is expected to add $0.03 to EPS.

We remain optimistic that the pandemic will be controlled and out of home activities will resume under a new normal. With a solid first half behind us, we have proven we can deliver in the context of a difficult macro environment, while continuing to support our employees, our social and environmental commitments, and invest in the capabilities needed to sustain our growth over the long term. The resiliency of our business during this time, and the passion and dedication of our teams reinforce our confidence in our strategy and the continuation of our ability to deliver long-term sustainable growth.

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

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] And our first question is going to come from the line of Dara Mohsenian with Morgan Stanley.

Dara W. Mohsenian
Analyst, Morgan Stanley & Co. LLC
Q

Hey. Good morning, guys.

Tracey Thomas Travis
Executive Vice President of Finance and Chief Financial Officer, The Estée Lauder Companies, Inc.
A

Hey, Dara.

Fabrizio Freda
President, Chief Executive Officer & Director, The Estée Lauder Companies, Inc.
A

Good morning.

Dara W. Mohsenian
Analyst, Morgan Stanley & Co. LLC
Q

So I just – I wanted to focus on top line. Clearly very strong performance in the Skin Care and e-commerce during COVID, can you just talk about the sustainability of that strength in each of those areas as we move to a post-COVID environment, as well as what some of your key strategies might be to maintain momentum post-COVID?

And then on the makeup side, that's obviously been a laggard area for obvious reasons. How quickly do you think category growth recovers in makeup post-COVID, and what's your outlook there? Thanks.

Fabrizio Freda
President, Chief Executive Officer & Director, The Estée Lauder Companies, Inc.
A

Okay. So first of all, the key drivers for us – let's go one by one – Skin Care, very sustainable. The consumers are always more and more enthusiastic for skin care. We have an amazing pipeline innovation for the future years and the strength of this and particularly in China is derma mix, one of the biggest builders of skin care, because the penetration of skin care, the penetration of beauty for skin care in Asia is very, very high. So we assume the skin care strength will continue after COVID.

The other driver is China and the potential of China as we explained very well in our Investor Day is for the long term. The Chinese consumer – the demographic are right. The potential of the smaller cities, the Tier 3, Tier 4 cities will continue to grow. The power of online and offline distribution will continue to be very strong.

In TR, imagine that the TR growth today, the TR results are mainly driven by Asia and particularly by the domestic travel acceleration within China. So, in the future the domestic travel acceleration within China will continue, but the international travel will be restated, and so this will be a further acceleration in the long-term when COVID will abate. So, all our key drivers are really here for the long term. And most importantly, as you know, our drivers tend to be accretive in profitability, so they will create resource over time.

The laggard is the brick-and-mortar, particularly in the West. Now, this obviously in the short-term is an issue, because there is lack of traffic. And the lack of traffic has created issues of productivity. But also on this one, we are working for rebuilding this for the long term. And so what is a drag today, a big drag on what is about one-third of our business is still in brick-and-mortar in the West.

And so if you imagine that the traffic post-COVID will come back, that there are all the retailer closures that Tracey summarized which are happening, that we'll reduce the amount of stores which will not be sustainable in the long-term and our business acceleration program, which is really putting back – rightsizing, if you want, all the channels for us, rebuilding productivity over time. And so the combination of traffic, closures, and business acceleration program is our answer to in the long term, after COVID, being able to make also brick-and-mortar again an engine of growth, which will be profitable at building the company for the long term.

So yes, we are very positive, in summary, on the continued strength post-COVID of our drivers, new accelerated drivers. And we are working to make also what is a drag in the short term, rebuild as a positive long-term channel, which is the brick-and-mortar in the West.

In terms of makeup, it was the last part of your question, makeup is very much driven by usage occasion. So, usage occasion meaning going to the office, going out for dinner, having a party, et cetera. So clearly the makeup category growth will be associated with the post recovery. And we will be ready for that.

Our point of view is that when the usage occasion they will go back into the life of people, the recovery will be fast and steep, and so we are ready for that. Now, when do we assume this will happen? Frankly, the answer is difficult to answer the same way Tracey explained. It's difficult to answer on when vaccination and the rest will have full impact. But we believe that from what we see in the market, starting the fall of 2021, we could see a beginning of certain usage occasion to be established because of this makeup growth will follow back, in our opinion, starting from the moment particularly.

Dara W. Mohsenian
Analyst, Morgan Stanley & Co. LLC

Q

Great. Thanks. That's helpful.

Fabrizio Freda
President, Chief Executive Officer & Director, The Estée Lauder Companies, Inc.

A

Welcome.

Operator: And our next question is going to come from the line of Lauren Lieberman with Barclays.

Lauren R. Lieberman
Analyst, Barclays Capital, Inc.

Q

Great. Thanks. Good morning. I was curious if we could talk a little bit about e-commerce development in Western Europe in particular, because I think what sort of hidden, if you will, in the numbers and you work through contribution from Travel Retail and so on is that Western Europe, while still down, of course, was down I think a lot less than has been the case thus far through the pandemic. You mentioned the Cyber Week kind of shopping dynamic in Western Europe, but my sense is that is a channel that had been somewhat less developed historically. So, I'd love to hear more about how that built up, and thinking about kind of stickiness of that behavior going ahead, particularly in a quarter or two where there aren't big shopping events that are typical for that market. Thanks.

Fabrizio Freda
President, Chief Executive Officer & Director, The Estée Lauder Companies, Inc.
A

Yeah. So, first of all, the online business has done very well this quarter, plus 60% globally. And it's interesting, we are growing double or triple digits in every brand, every region, every channel. Meaningful channel brand dot-com, retail dot-com, third-party platform, pure plays. And so, Western Europe is the same. Western Europe is growing, depending by market, double-digit or triple-digit in online.

And obviously, the holiday season has been, because of the lockdown, as you know in Western Europe particularly COVID was pretty high, November, December, because of this, the brick-and-mortar were closed. In countries like the UK, as an example, December was a super difficult month, and so there was no regular Christmas holidays in brick-and-mortar, and obviously, UK was not the only place. And so because of this, we were able to pivot to online in an extraordinary way.

I think our teams have done magnificent work in taking care of our consumer online when they were, because of prudent behavior, for COVID not going to the brick-and-mortar. And what we have seen is that this works in many, many cases, meaning at the end the consumers, certain categories were working because of repeat, meaning the consumer didn't do without with their preferred La Mer cream or their preferred Advanced Night Repair, whatever, and so we got a lot of the selling by the online channel. But also, we are able to speak to the gifting habits and we created gifting opportunities and delivery model for gifting, et cetera. So there was a lot of creativity and invention in this area.

Now, this online in general, I believe the online will continue to be very strong also in the long term and this acceleration will continue also post-COVID. And one of the reasons for that, which is particularly true in Western Europe, is that the new online focus created, brought online more than created new consumers, including more mature consumers. Online, particularly in Europe, was really dedicated to millennial and younger consumers, while during COVID, more mature consumers came online and they're liking it and they're becoming loyal. And so, they will also post-COVID have a bigger percentage of the shopping online than before.

On top of this, if you think that we are adding high-touch services online. So, what were the services that in before were available in brick-and-mortar, now gradually but they are also available online. And we've been able to scale these at the speed of light. Just to give you a number to understand our ability to scale new ideas is, today Virtual Try-On is already available in 90% of our brand com sales in terms of coverage. Imagine that. And it was not even close to that six months ago.

And so, the consumer responding to that, and this is driving also in Western Europe a lot of online and probably sustainable and more loyalty online across different group of consumers. So, online had a big role in Western Europe in quarter two, and will continue to have a bigger and growing role over time in the next years.

Operator: And our next question is going to come from the line of Erinn Murphy with Piper Sandler.

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

Great. Thanks. Good morning. I guess my question is around the landscape here in North America. We've seen some pretty unique partnerships inked recently with Kohl's and Sephora and Ulta and Target. Do you expect to participate in these partnerships? I know historically, the math hasn't been that appealing, but maybe with the Ulta Target structure, would some of your brands make sense?

And then, I guess secondly, if you think about the post behavior of consumer – or consumer behavior post-pandemic, how comfortable are you with the entirety of the brand portfolio today? Would divestitures ever make sense? Thank you.

Fabrizio Freda
President, Chief Executive Officer & Director, The Estée Lauder Companies, Inc.
A

Sorry, I didn't understand the second question. How comfortable are we with...

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

Yeah, are there any brands, I'm thinking of the makeup portfolio in particular, that you would ever consider divesting on the other side of the pandemic? I'm just curious on your comfort with the entirety of the portfolio today.

Fabrizio Freda
President, Chief Executive Officer & Director, The Estée Lauder Companies, Inc.
A

Okay. So the first answer is, yes, we are working with our partners and discussing the Ulta, Target, and the Kohl's, Sephora opportunities. As you said, as part of your question, this will depend which brands in our portfolio, these two opportunities may fit different brands in our portfolio. And so we are evaluating this with our partners and we are considering participation by brand to these activities. And this could be a driver of future acceleration of recovery in North America as well. Importantly, to underline, these two opportunities are both brick-and-mortar and online, and so obviously, will be very important also to being able to manage the online part of that opportunity.

In terms of the portfolio of brands, we continuously look at our portfolio. We look at our portfolio for efficiency and we are opened, and we've done this already in the past, to rationalization decisions in our portfolio, meaning closing brands that for a good reason do not – cannot sustain the long-term investments. And we continue looking into acquisitions and opportunity for reinforcing our portfolio in areas, where we have strategic opportunities or strategic access. So this is a continuous process. And during COVID, this is continuing.

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

Great. Thank you.

Operator: And our next question is going to come from the line of Rupesh Parikh with Oppenheimer.

Rupesh Parikh
Analyst, Oppenheimer & Co., Inc.
Q

Good morning. Thanks for taking my question, and congrats on a nice quarter.

Fabrizio Freda
President, Chief Executive Officer & Director, The Estée Lauder Companies, Inc.
A

[indiscernible] (00:45:01).

Rupesh Parikh
Analyst, Oppenheimer & Co., Inc.
Q

So, Fabrizio, I had a question just on your China business. I was curious what you're seeing right now in the makeup category in China.

Fabrizio Freda
President, Chief Executive Officer & Director, The Estée Lauder Companies, Inc.

A

Yeah, the makeup category in China is stronger than makeup in the other regions, because, as I say, responded to broader in social occasions and usage occasion, but it's still declining. So it's not different than the rest of the world, China, meaning skin care is very, very strong, fragrance is accelerating, and makeup is the laggard, even in China, however, on a completely different proportion, because when you think of the explanation I just gave before, that makeup is completely correlated to the occasion of usage.

In China, because of the good control of COVID and because of the occasions like business offices are open, people are shopping more regularly, brick-and-mortar shopping is more present in most of the cities. Because of these more occasions, makeup is in better shape, but still is the laggard between the categories. And mostly in China, I would say, from our consumer understanding is because of mask wearing, meaning China is better controlling COVID, but also better controlling COVID because there is very disciplined mask wearing, and mask wearing also is a reason for less usage of makeup. So stronger than the rest of the world, but still not as strong as it will be after COVID and post COVID, where we assume there will be – or expect there will be a strong recovery on makeup also in China.

Rupesh Parikh
Analyst, Oppenheimer & Co., Inc.

Q

Great. Thank you.

Operator: Our next question is going to come from the line of Nik Modi with RBC.

Nik Modi
Analyst, RBC Capital Markets LLC

Q

Yeah, good morning, everyone. Fabrizio, I wanted to go back on the online discussions. You guys have done such a great job with analytics and understanding kind of consumer behavior. And given how much migration has occurred on them, I'm just curious what your data and research and analytics is saying about the stickiness? For instance, you talk about these very mature consumers in the developed markets migrating online. How sticky do you think that behavior will be? I think that will be an important kind of discussion going forward, given the margin differential between online and some of the other channels. Thank you.

Fabrizio Freda
President, Chief Executive Officer & Director, The Estée Lauder Companies, Inc.

A

Yeah, no, it is a very good question. And again, our point of view, this will be very sticky, because the people are shopping online and obviously some of them are shopping online, because the brick-and-mortar were closed for sure in the case of luxury. But they're liking it. And we see all the statistics, all the data telling us that they are enjoying the experience. For example, our loyalty programs are working better and better. And we have more loyalty program as we discussed, and they're getting expanded and the level of loyalty is going up and the repurchase rate, meaning they're coming back, is going up.

Then, we see conversions very strong and traffic increasing. And there are ways where the conversion will be driven, it will be maintained after. The most important of the investment we are doing in order to maintain conversion also after COVID is the high-touch services transfer online. So, the chat with the consultants, the

Virtual Try-On, the live streaming opportunities, the use of our – particularly the brand dot-com in this case, also has a media platform, because we see that the time that a consumer is spending online is increasing dramatically, because when they have the Virtual Try-On service, the possibility to talk to a consultant, they spend more time.

This time is time of exposure to all of our equity messages, so this is media value. This is really media value. Meaning, we have more than 0.5 billion consumers coming on our site every year, more in this moment, and then imagine that they stay nine minutes. If we had to buy media to speak to half a billion consumers for nine minutes, this would be a huge cost, while this [indiscernible] (00:49:32) is an added benefit of our selling operation.

So, there is a lot of value in this high-touch services. What they will do is they will increase differentiation of our sites from us. They will increase traffic because people are coming upon it to buy product, for services, and we'll maintain or possibly further increase conversion after COVID. And then, finally, we'll increase the value of our online as media value.

And so, this is a very positive view for the long term. Obviously, we believe that there is a lot of consumers that will continue to shop also in brick-and-mortar after COVID. There is no one consumer that is only online or only brick-and-mortar. I believe the consumer will love the omni-channel experience. By the way, after COVID, they will be anxious to get again the brick-and-mortar experience, so they will come back. And that's why we are building around this reality, this expectation, a much better omni-channel platform, where the consumer will be able to choose the percentage of purchase of time or experience online, and how much they want in brick-and-mortar and they will navigate among the two channels in new ways. I believe that companies that will have brands, that will have a good omni-channel model in the future will have a competitive advantage.

Nik Modi
Analyst, RBC Capital Markets LLC

Q

Excellent. Thank you.

Fabrizio Freda
President, Chief Executive Officer & Director, The Estée Lauder Companies, Inc.

A

You're welcome.

Operator: Our next question will come from the line of Olivia Tong with Bank of America.

Olivia Tong
Analyst, BofA Securities, Inc.

Q

Great. Thanks. Good morning. First is just a clarification. Tracey, I believe you said that you were adding additional production capacity, so just curious what categories, what regions you're looking at for that?

And then, my question is really around the margin progression, especially given this quarter, I think it's the highest quarterly operating margin you've achieved as a public company. So realizing of course there's a lot of normal expenditures that aren't happening right now, but as you think about second half, long term, are there things you learned over the courses of the almost 12 months now on areas you can cut back on spend more permanently? Are there areas where you have to just push even harder?

And as you think about specifically for Q3, what's planned in Q3 to – because, while you're looking for margin expansion, it looks like it would only imply about similar to what you achieved in fiscal Q2, despite COVID obviously now entering [indiscernible] (00:52:10). Thank you.

Tracey Thomas Travis
Executive Vice President of Finance and Chief Financial Officer, The Estée Lauder Companies, Inc.

A

Okay. Olivia, thanks for the question. So, regarding our production capacity, as you've seen from our results over the last couple of quarters, clearly, where we are in – have been in need and have been investing in terms of production capacity is in skin care. And we have invested in North America. We've invested in Europe. And as you heard us announce this morning in our prepared remarks, we are also investing in a new facility in Asia to support primarily skin care and there will be some makeup, primarily foundation, as we're thinking right now in Asia. So very much having capacity closer to where our strongest demand growth is will be a real benefit to us, and we're looking – we're certainly looking forward to that.

As it relates to the margin, I mean, I would – as I said in my prepared remarks, Olivia, we had done an excellent job of controlling costs last year, once the pandemic hit. Many of those cost controls were temporary controls. When you think about the management salary reductions, some of the rent abatements that we got, given the fact that our stores were closed, some of the furlough and benefits and [indiscernible] (00:53:34), we controlled head count, T&E, et cetera.

So, in terms of the learning going forward, clearly, there are some areas of, I would say, more discretionary costs as we emerge out of the pandemic that we will continue to control. But the long-term sustainable cost controls really come from our cost saving programs. That's where the permanent, more sustainable cost take-out comes from.

So, that's the reason why you're seeing, if you think about what we said last year, in terms of our cost programs and the significant amount of management that we did in the third and the fourth quarter to control costs, given the fact that all of our brick-and-mortar doors over the course of the first half ended up closing, that some of those costs certainly will be back in the second half, in the third and the fourth quarter. But we will continue to manage costs in a disciplined way as we have up to this point.

Olivia Tong
Analyst, BofA Securities, Inc.

Q

Thank you.

Operator: Our next question is going to come from the line of Chris Carey with Wells Fargo Securities.

Christopher M. Carey
Analyst, Wells Fargo Securities

Q

Hi. Good morning.

Fabrizio Freda
President, Chief Executive Officer & Director, The Estée Lauder Companies, Inc.

A

Good morning.

Christopher M. Carey
Analyst, Wells Fargo Securities

Q

So, I just wanted to follow up on the operating margin question. I think it's important. EMEA, strongest margin we've seen. Fragrances, I think strongest margin we've seen. And if I'm just hearing the answer to that question, it sounds like there's been a lot of efforts around cost savings, but certainly there's a channel dynamic as well with

EMEA online doubling, and certainly you've seen strength in Skin Care and Asia. And so I'm just wondering how much the margin improvement actually might be more sustainable over time from a product or channel mix standpoint. Thanks.

Tracey Thomas Travis
Executive Vice President of Finance and Chief Financial Officer, The Estée Lauder Companies, Inc.
A

Well, yeah, I mean, absolutely, we have tailwinds as it relates to margin, given both our category mix growth as well as our channel mix growth. We do have obviously a fairly large footprint of brick-and-mortar that right now, given where traffic is, is a bit of a drag on our margin performance. And obviously, we're addressing that. And we will see, once the pandemic is behind us and traffic returns, how fast it returns. And in the meantime, obviously, we're taking some actions. But we are very comfortable that we have margin progression ahead of us once the pandemic is behind us in a more sustainable way, especially given the tailwinds that we have to your point, Chris.

Christopher M. Carey
Analyst, Wells Fargo Securities
Q

Okay. Thank you.

Operator: Our next question will come from the line of Michael Binetti with Credit Suisse.

Michael Binetti
Analyst, Credit Suisse Securities (USA) LLC
Q

Hey, guys. Thanks for taking our questions here. I do want to follow that, Tracey. At the Analyst Day, you walked us to a margin that was well into the high teens with what you knew on the business there. As we look around at some of the businesses that I would say are probably the closest in comparison to yours, we see some with that start with a 2 on the operating margin. Obviously, you've made the structural changes that a few of the other analysts have run through, but you're going to end in a bigger travel business, a bigger digital business, a bigger China business, closing some stores that were a drag. I mean, do you see over the very long term, 5 to 10 years, can this business move into the 20s on margin?

Tracey Thomas Travis
Executive Vice President of Finance and Chief Financial Officer, The Estée Lauder Companies, Inc.
A

It's – again, you said over the very long term. So, look, I would say that certainly that is something that we are targeting, given all of our – again, given the tailwinds in terms of channel growth and category growth might change. Obviously, makeup might – we believe makeup will recover, and we're certainly going to support it to recover. And the margins will improve on makeup as well. Makeup actually is the category that has the biggest penetration of free-standing stores and brick-and-mortar. So, it is a category that is particularly challenged from a margin standpoint in this particular environment. But certainly, Michael, everything that we are doing from a business management standpoint and from a cost management standpoint would get us in that North Star of 20%.

Michael Binetti
Analyst, Credit Suisse Securities (USA) LLC
Q

Thanks. And, Fabrizio, if I could follow that, you've seen some really strong growth, and Hainan has come up a bit in the last two calls. We've seen some new regulations even as recently as this week, government is going to allow consumers to ship goods home versus physical pick-up in the past. So it seems like there's more and more friction coming out of that process and a lot more square footage is going to be added there. Does Hainan Island change your Travel Retail business even after global economies reopen? Does it change your outlook on travel and the Chinese domestic consumer?

Fabrizio Freda
President, Chief Executive Officer & Director, The Estée Lauder Companies, Inc.

A

Yes. As I said before, our Travel Retail business in the short term is really driven by Asia in general and China domestic in particular. Within China domestic, Hainan is the star. And it's driven by the new traffic and by the increased conversion and by the quantities purchased because of the regulations that you just explained and by the development of retail. So those are all very important long-term strengths of the channel which is developing.

Now, when the normal travel – maybe it will never be normal, exactly, but the new normal travel will be reinstated after COVID, and you add to this progress of the domestic travel in China, the international travel in America and Europe within the rest of Asia and the Chinese consumer will go back traveling the world, and that's obviously their desire, one of the biggest aspirations, if you talk to the consumer and look to the consumer opinions and research for the long term.

So, [indiscernible] (01:00:14) will be a combination of restated international travel with stronger domestic travel model that has been developed during this period, this will make TR still one of the most important long-term channels of opportunity, full of opportunities. And again, the biggest opportunity remains technically driving conversion, so the conversion of travelers into buyers and retail, so the possibility of buying also without queuing in a store for a long time where you need to take a plane and things like that. Those two elements are big drivers of the future of Travel Retail, independently from the short-term management of the crisis.

And in terms of the China overall business, we do monitor Chinese consumers. We spoke to it last time. This time, our Chinese business between quarter one and quarter two is basically double the level of growth, our China mainland business. Our TR business is also accelerated, but not as strong as the China Mainland business, which was driven by amazing online events like 11/11, during the November period.

And so the combination of the development of online within China [indiscernible] (01:01:38) the brick-and-mortar in China is still double-digit. In quarter two, it was growing double-digit, showing the potential of brick-and-mortar when COVID is more managed or will be more manageable. And then Travel Retail continues to do very well. And so, when we look also to our total Chinese consumer consumption, bringing all together what is domestic Travel Retail and Mainland China, we still see an acceleration in total from quarter one to quarter two.

And so, we believe this is a very, very strong potential. We are working to manage it in a way which is still building equity of our brands, still protecting every single one of our customers, being able to do good business with us for the long term. That's our goal and we are working on it.

Michael Binetti
Analyst, Credit Suisse Securities (USA) LLC

Q

Thank you so much.

Operator: And we have time for one final question. And our last question is going to come from the line of Mark Astrachan with Stifel.

Mark Stiefel Astrachan
Analyst, Stifel, Nicolaus & Co., Inc.

Q

Yeah, thanks, and good morning, everybody. Maybe just one follow-up and one other question. So just on online, where does that settle as a percentage of the category sales post-pandemic? And how do you think about retention of those incremental consumers on retailer dot-com versus your own brand dot-com, I assume, higher for you all?

And then just quickly, holistically, and thinking about your guidance on a go-forward basis, are big events like 6/18 and 11/11 becoming more important in driving your business, meaning that the June quarter might be a little bigger than historical levels, same thing for the December quarter? And does that partly explain kind of why we saw somewhat weaker September forward guidance than I think maybe people had expected kind of the same for the March quarter today? Thank you.

Tracey Thomas Travis
Executive Vice President of Finance and Chief Financial Officer, The Estée Lauder Companies, Inc.

A

So I'll – go ahead, Fabrizio.

Fabrizio Freda
President, Chief Executive Officer & Director, The Estée Lauder Companies, Inc.

A

Tracey, you can go. I'll take the...

Tracey Thomas Travis
Executive Vice President of Finance and Chief Financial Officer, The Estée Lauder Companies, Inc.

A

So, yeah, let me talk about the key shopping moments, absolutely, particularly in the holiday period. As you recall, last year in the second quarter, we had a 16% growth in constant currency, very much driven by key events that are in the second quarter. The fourth quarter, 6/18 is a little bit – quite a bit, actually, less meaningful to the quarter than certainly 11/11. But we are seeing concentration in some of those events. And certainly that beat in terms of our expectation on sales really flowed through to the bottom line in the second quarter.

Fabrizio Freda
President, Chief Executive Officer & Director, The Estée Lauder Companies, Inc.

A

On the brand dot-com, I mean, the different – online has different channels. There are brand dot-com, retail dot-com, pure play and third-party platform which we define that is the Tmall model. And so, these channels have different level of developments by countries, and is a result of consumer preferences and historical development of the channel. So, it's not we are driving – we are driving all of them and particularly we work with our retail partners very closely to drive their retail dot-com, which is most of the times doing very well, particularly in this period, but also for the long term.

So, for example, in China, retail dot-com is very limited, and while brand dot-com and most importantly third-party platform model is the most developed, while in the US, retail dot-com is very, very strong and we see a lot of great development recently in the retail dot-com of our key partners. And this also serves in this moment as a mitigating factor to the brick-and-mortar issues of productivity that we have discussed before. So, we will continue to develop each one of these channels and it's the consumer deciding where to go. And, obviously, we partner with each one of our retail partners to do the best possible job in every channel.

Operator: Thank you. If you were unable to join for the entire call, a playback will be available at 1:00 PM Eastern Time today through February 19. To hear a recording of the call, please dial 855-859-2056. Passcode ID number is 1484229.

That concludes the Estée Lauder Conference Call. I would like to thank you all for your participation, and I wish you all a good day. Thank you.