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The Estée Lauder Companies, Inc. (EL)

Q3 2022 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good day, everyone, and welcome to the Estée Lauder Companies Fiscal 2022 Third 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 Senior Vice President of Investor Relations Ms. Rainey Mancini.

Laraine A. Mancini

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

Hello. 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 the 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. Unless otherwise stated, all net sales growth numbers are in constant currency and all organic net sales growth excludes the noncomparable impacts of acquisitions, divestitures, brand closures, and the impact of currency translation.

You can find reconciliations between GAAP and non-GAAP measures in our press release and on the investor section of our website. As a reminder, references to online sales include sales we make directly to our consumers through our brand.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 to everyone. I want to begin by expressing the great sadness wherefore our colleagues and all the people impacted by the invasion of Ukraine who are experiencing a devastating humanitarian crisis. We continue to focus on our employees safety, and our dearest hope is for peace to prevail.

In the third quarter of fiscal year 2022, we delivered organic sales growth of 9%, in line with our guidance despite the acceleration of temporary COVID-19 restriction in China in March. We exercised cost discipline as volatility increased and our adjusted operating margin expanded, leading to stronger-than-expected adjusted diluted earnings per share growth of 17%.

Our multiple engines of growth strategy enabled to us amplify the engines of the moment amid an intensified macro environment, with sales rising organically across both brick-and-mortar and online. Every category grew organically, led by fragrance's outstanding performance. Eleven brands contributed double-digit organic sales growth and further demonstrated our diversified drivers. Consumer demand remains robust even in this inflationary environment. Our largest brands provided highly sought after M·A·C., Estee Lauder and Clinique each delivered double-digit growth in makeup. Fueling the category, renaissance, while La Mer thrived in skin care.

Four of our scaling brands resonated strongly with consumers as Jo Malone London, Tom Ford Beauty, Aveda and Bobbi Brown each rose double digits. Among our developing brands: Le Labo, KILIAN PARIS and Bumble and bumble each achieved outsized growth and showcased their promise. Our sales rose double digit organically in the Americas and EMEA. We capitalized on reopening to translate improving brick-and-mortar traffic trends into outstanding sales growth, owing to our High-Touch services breakthrough innovation, hero franchises and operational excellence. Our freestanding stores delivered exceptional performance, benefiting from fleet optimization and expanded omni-channel capabilities and complemented strengths in specialty-multi. We are managing the ongoing complexities from the invasion of Ukraine, as well as the temporary COVID travel restrictions in China, which impacted performance in Asia-Pacific in the quarter.

In Mainland China, organic sales fell mid-single-digit, as 25% growth online was offset by a steep decline in brick-and-mortar. After a strong February in Mainland China, traffic slowed more sharply in March to pressure brick-and-mortar sales. Additionally, for us, the distribution centers for our Mainland China business are in Shanghai and operated with limited capacity. Tourism, to Hainan Island, was also curtailed in March, after a vibrant start of the quarter. There is no doubt that these current limitations in China will prove to be transitory, although there will be a far greater impact on our results in the fourth quarter than they were in the third quarter, as Tracey will discuss.

Looking ahead, we are confident in the resilience of the Chinese consumers and the untapped opportunity driving our investments in the market. We expect a reacceleration of growth when this moment of COVID abates.

Let me share the progress we made during the third quarter to drive these strong results and advance our long-term ambitions for our multiple engines growth strategy. Innovation excelled to reach nearly 30% of sales. We continue to elevate our ability to leverage data analytics with our best-in-class creative talent and R&D to successfully anticipate scale and set trends. The breadth of our innovation wins was far-reaching, benefiting every category.

In skin care, La Mer upgraded The Treatment Lotion soared. As the brand doubled down on this coveted east-to-west product, increasing the skin, recharging medical growth, and transitioning to a recyclable, luxurious glass bottle that contains 20% post-consumer recycled content. In Asia-Pacific, consumer gravitated to the new serum strengths and anti-aging benefits, while in the Americas, educating on the benefits of hydration and energy proved impactful with consumers, demonstrating our expertise in serving multiple needs with one product and communicating with the appropriate local relevance.

For Makeup, M·A·C sought to grow its mascara base, especially across Gen Z, younger millennial and multiethnic consumers and created MACStack mascara, with breakthrough technology that stacks and builds the lash look. MACStack went viral on TikTok, having now amassed over 153 million views, and its sales far exceeded our expectations in the quarter. Tom Ford Beauty, [ph] new private blend (00:07:39) rose fragrances, feature locally relevant notes where Rose De Chine feature Chinese golden peony and Rose D'Amalfi includes Italian Bergamot. This launch drove exceptional results globally, including China, where the brand had a very successful Valentine's Day.

Lastly, in health care, Aveda launched botanical repair, strengthening overnight serum, disrupting the category by creating our first overnight serum that builds new hair bones while you sleep. The product [ph] sold key consumer pain points, (00:08:20) with quick-absorbing technology by leveraging a serum-based formula. Encouragingly, the product quickly rose to being the top-selling product in freestanding store and sold out on brand.com.

We are [ph] excited (00:08:37) to build upon this momentum when our new innovation center in Shanghai opens later this calendar year. This important investment in China will significantly increase our ability to serve the Chinese and Asians consumers with locally relevant and inspired innovation.

Also, the new center will further enable our east-to-west innovation mindset supporting the creation of more successes like La Mer's The Treatment Lotion.

Looking at our growth engines by category, the strategic decision to pivot our fragrance portfolio to luxury and artisanal is benefit both top line growth and profitability. Fragrances performance in the third quarter was superb with sales increasing 31% organically. Impressively, sales exceeded the pre-pandemic third quarter of fiscal year 2019 by nearly 50% on a reported basis.

Jo Malone London, Tom Ford Beauty, Le Labo, KILIAN PARIS and Editions de Parfums Frédéric Malle each delivered double-digit sales growth and Estée Lauder brand [ph] complemented these strengths (00:09:54) with its well-received new luxury collection.

As consumers around the world increasingly expressed their individuality with scent, these brands are delivering outstanding results with strong double-digit growth fiscal year to-date in every region, driven by demand across channels from brick-and-mortar to online and travel retail.

Their freestanding doors are driving omni-channel experiences while their online businesses had been transformed during the pandemic. And these fragrance brands are also contributing to our sustainability growth with resealable packaging being a compelling element to the value proposition for Le Labo and KILIAN PARIS.

We are also thrilled to announce that during the third quarter, Le Labo became B Corp certified, making it the first major fragrance brand and first within our company to receive this certification indicating a high level of commitment to sustainability and impact.

Turning to Makeup. It was on this call a year ago that we introduced our expectation for makeup renaissance, anticipating it would gradually evolve market by market as social and professional use implications began to resume. We envision that the category would experience a recovery driven by both restocking as well as a renaissance rooted in a renewed passion for the joy and creativity of makeup after a difficult time. Even with the rise of the Delta and Omicron variants, the makeup renaissance has delivered very favorable trends and offers great promise for the future.

As usual location expanded in certain markets upon reopening in the third quarter, Makeup once again delivered double-digit organic sales growth in the Americas and EMEA. M·A·C and Clinique's makeup sales growth accelerated sequentially, while Estée Lauder and La Mer businesses in the category are already ahead of pre-pandemic levels.

What brands have been meticulous in executing their merchandising and innovation strategy for the renaissance? We invested to create the omni artist who is meeting the consumers in novelty ways across brick-and-mortar and online to educate, inspire new looks, and offer the best in personalized high-touch services. M·A·C has been superb in this regard. So too has Bobbi Brown with events like Life Streams from the largest mall in Manchester, England, to expert group classes, to [ph] growing (00:12:45) in China to one-to-one Zoom sessions in the US.

Moving to hair care. Aveda and Bumble and bumble have reignited a growth engine to contribute to the diversified category growth that we expected for fiscal year 2022. Impressively, even as these brands grew sales strong double digits in brick-and-mortar on reopening during the third quarter, they also achieved mid-single-digit online growth.

Lastly, while skin care was pressured by COVID restrictions in the east, the bright spots were still many. In the quarter, we continued to advance our strategies across many long-term growth drivers from luxury to prestige. La Mer performance was extraordinary with sales rising strong double digits. As I discussed, it upgrades The Treatment Lotion soared, creating a [ph] have (00:13:45) effect on the still new, hydrating-infused emulsion while it's heroes were highly sought after.

With desirable innovation and coveted icons, La Mer is welcoming new consumers, earning their trust and trading them up as its ultra-lux Genaissance de la Mer franchise is booming. While our high-end prestige skin care thrives with La Mer and Estée Lauder Re-Nutriv, Bobbi Brown is prospering in the heart of the category thanks to its strategic focus on [ph] treasured heroes (00:14:18) like vitamin-enriched face base.

We are also laser focused on entry level prestige to reach new consumer, notably with DECIEM, The Ordinary, as the brand amplifies its heroes to drive repeat with its ingredient-led regimen-based approach. After the quarter close, DECIEM announced it will be refining its brand portfolio to focus resources on the compelling opportunity we foresee for The Ordinary and NIOD.

During the quarter, we also improved upon the fundamentals of consumer acquisitions, engagement and high-touch services positioning us well to realize even greater success with trial and repeat. Our partnership with TikTok expanded and we are piloting new innovations on the platform to be at the forefront of social commerce innovations.

In the US, several of our brands launched storefronts on TikTok, seamlessly linking to brand.com. Brands also expanded their capabilities with Instagram shopping and launched category powered lenses on Snapchat similarly linked to brands.com.

Clinique realized favorable engagement trends on TikTok, and Instagram and it featured its back-in-stock coveted Black Honey lipstick and strong recruitment growth with new advertising for Moisture Surge 100 hour featuring the made-for-social phase of adventure campaign.

Decentraland entered the metaverse as connecting with our consumer wherever they are is paramount, and we are excited to be testing and learning in this new ecosystem. Estée Lauder was the exclusive beauty brand partner of Decentraland Metaverse Fashion Week, the first-ever live virtual fashion week in an unchained metaverse.

Around the world, our brands are increasing leveraging new campaign management tools to tailor communication and drive repeat. To both reengage with consumers and foster relationship with new consumers, we are realizing increased reactivation and repeat purchase rate from the UK to France, Australia, and beyond.

In closing, we delivered very strong performance amid the accelerating headwinds during the third quarter. We also made excellent progress advancing the long-term drivers of our multiple engine or growth strategy. These results and this progress are due to the tremendous accomplishments of our employees around the world to whom I extend by deepest thanks as they continue to manage complex situation with grace and ingenuity.

Moreover, I'm incredibly inspired by our employees' compassion for each other. Last week marked the two-year anniversary of the anniversary of the ELC Cares Employees Relief Fund. The fund was created in response to employee increasing desire to support one another in times of need. Since inception, over \$10 million has been distributed to employees globally from donations and company matches.

Looking ahead, while we are lowering our expectation for the fourth quarter given the impact of the temporary COVID restrictions in China, we expect to deliver another record year in fiscal year 2022.

We remain incredibly optimistic about the future of our business. This quarter proved the vibrancy of prestige beauty, its resiliency even in a difficult macro environment and the strengths of our trusted brands and product invitations as market sequentially recovered from the prolonged pandemic.

I will now turn the call over to Tracey.

Tracey Thomas Travis

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

Thank you, Fabrizio, and hello, everyone. Our third-quarter net sales grew 9% organically despite the increased complexity and volatility caused by the pandemic and the invasion of Ukraine. Growth was broad based across categories and markets as most regions across the world continued to recover and grow albeit at different rates.

Sales and specialty multi and freestanding retail stores led growth, and online sales rose mid-single digits. The inclusion of sales from the late May 2021 DECIEM investment added approximately two points to reported net sales growth, and currency was a headwind of approximately one point.

From a geographic standpoint, organic net sales in our Europe, the Middle East and Africa region rose 18%. Growth was realized across most markets, channels, and brands. Market growth was led by both the recovery in the largest western markets as well as in key emerging markets like Turkey and India. All brick-and-mortar channels grew, led by double-digit growth in department stores, freestanding stores, and specialty multi-stores. Organic sales online declined when compared to the prior-year quarter where online sales benefited both from the pandemic-driven store closures and reduced store traffic. All product categories in most brands grew in the region led by La Mer, Jo Malone London and M·A·C

Our global travel retail business again grew double digits despite the challenges that arose during the quarter. Asia is the largest region for our travel retail business, and sales in the key markets of China and Korea were very robust at retail for most of the quarter. However, there was a precipitous decline in Chinese travel in March as restrictions to contain COVID were increased in China. We continued to see a sharp increase in travel retail sales outside of Asia as traffic increased throughout Europe and the Americas.

Net sales in the Americas rose 11% organically with all markets contributing to growth. All product categories grew with particular strength in makeup and hair care. The two largest prestige makeup brands in the US, M·A·C and Clinique, outpaced overall category growth to gain share. Bobbi Brown and Tom Ford Beauty also gained share helping to further drive the makeup renaissance as more consumers continued their return to the workplace and resumed more social occasions.

For sales in specialty multi and in freestanding retail stores strongly outperformed this quarter as consumers returned to stores for shopping and services. The inclusion of sales from DECIEM added approximately three points to growth, and favorable currency movement contributed one point to sales growth in the region.

In our Asia Pacific region, organic net sales fell 4% driven entirely by Greater China. For the quarter, net sales in Mainland China declined mid-single digits. Following a strong Lunar New Year in February, sales declined in March as additional COVID restrictions impacted many cities, most notably Shanghai where our distribution center serving the entire country are located. The restriction sharply curtailed productivity at these facilities, affecting our ability to both receive product being shipped into the country and to fulfill demand across all channels of distribution.

However, shipments should begin to normalize as restrictions ease. Net sales in Hong Kong also declined throughout the quarter as the city took increasing measures to contain the virus. Partially offsetting these decreases was strong net sales growth in most other markets including Japan, Malaysia, Thailand and Singapore. Online sales in Asia Pacific grew strong double digits as we continued to expand our brand reach across new platforms.

Our gross margin improved 70 basis points compared to last year. Strategic price increases of approximately 4%, combined with favorable currency and reduced obsolescence, contributed to the increase in gross margin as well as the favorable impact of anniversary-ing last year's under-absorption of manufacturing overhead. This more than offset the impact of increased inflationary pressures in our supply chain, mainly in logistics and materials, and increasing start-up costs for our new plant in Japan.

Operating expenses decreased 40 basis points as a percent of sale. Our leverage of general and administrative expense was partially offset by increased shipping costs related to higher freight rates and more air shipments on increased sales volume. Additionally, as cities throughout China began tightening restrictions and traffic to Hainan slowed, we reduced certain expenses to correspond with slower retail traffic. Operating income rose 15% to \$917 million, and our operating margin expanded 110 basis points to 21.6% in the quarter. Diluted EPS of \$1.90 increased 17% compared to the prior year.

During the quarter, we recorded \$216 million of impairment to goodwill and other intangibles, primarily related to Dr. Jart+, reflecting forecasts for slower-than-expected growth in China and travel retail. We continue to believe in the growth potential of the brand which has been impacted by the temporary COVID disruptions in Asia, given its strong growth prior to the start of the pandemic as well as the growth seen in recovering markets.

For the nine months, we generated \$1.97 billion in net cash flows from operating activities compared to \$2.78 billion last year which reflects investments in working capital to both support growth and mitigate some of the risks of supply chain disruptions as well as higher cash paid for taxes. This was partially offset by higher net income. We significantly increased our capital investment to \$658 million to support the ongoing construction of our new manufacturing facility near Tokyo, investments in our innovation center in Shanghai, as well as investments in online and technology enhancements. And we returned \$2.62 billion in cash to stockholders through a combination of share repurchases and dividends.

Turning now to our outlook, as you have heard and are aware, there have been two significant headwinds that have emerged since we last gave guidance in early February, increased COVID-related restrictions in China, also impacting Hainan, and the invasion of Ukraine. Our current guidance for the balance of this year reflects continued momentum in the Americas and EMEA, excluding travel retail, as well as the continuation of lockdown and corresponding distribution constraints in China through at least the first half of our fourth quarter.

While we expect continued growth at retail in both Mainland China and Hainan, the severity of the distribution constraints we are experiencing are expected to result in a meaningful decline in net sales for these areas for the quarter. We are cautiously optimistic that we will be able to fulfill the majority of our orders in time for our planned 618 activities. The elimination of sales in Russia and Ukraine has reduced expected fourth-quarter sales growth by approximately 120 basis points.

At the same time, we delivered outstanding results for the first nine months of the fiscal year with greater diversification of our growth drivers. Our geographic diversity is a tremendous asset, and we expect our multiple engines of growth to continue including the ongoing recovery of the Americas, Western Europe, and most markets in Asia. We expect to also deliver strong margin improvement for the year. The benefit of our strategic pricing actions this year, along with agility in our cost management, are helping to offset the initial effects of increasing inflation throughout this fiscal year.

We plan to continue to invest in the recovery, support innovation, and assuming current disruptions abate, fuel upcoming key shopping moments in the quarter like 618 in China and Mother's Day. With these assumptions as our backdrop for the full fiscal year, organic net sales are now forecasted to grow 5% to 7%. This range excludes approximately two points from acquisitions, divestitures, and brand closures, primarily the inclusion of DECIEM, and currency is forecasted to be neutral.

Diluted EPS is expected to range between \$7.05 and \$7.15 before restructuring and other charges. This includes approximately \$0.05 of accretion from currency translation and \$0.02 dilution from DECIEM. In constant currency,

we expect EPS to rise by 8% to 10%. These expectations imply margin expansion of approximately 70 basis points including dilution of 40 basis points from DECIEM this year.

In closing, we managed extremely well through an increasingly complex environment in our third quarter, and these complexities are expected to meaningfully impact our fourth quarter. Despite this, we continue to expect to deliver a very strong year with above-average organic top-line growth, excellent margin expansion and solid EPS growth. We are confident that we can continue to manage through the present temporary headwinds and be well-prepared for accelerated momentum when the pandemic effects ease.

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 Lauren Lieberman from Barclays. Your line's now open.

Lauren R. Lieberman

Analyst, Barclays Capital, Inc.

Q

Great. Thanks. Good morning. Tracey, for retail, just hoping to get a little bit more visibility if you will as to the like on-the-ground inventory dynamic in China currently and how you're thinking about that, I guess, for the first half of the quarter. So if I were to go on any of the e-commerce sites or to a store, what do I see now? Am I able to place an order online? Or does it say out of stock? If I go to a store, is there inventory because I'm trying to piece together the comment, Tracey, that you talked about 618, you'd be caught up. But knowing that Shanghai is the way kind of in and out, and you're assuming that quarter, I'm just trying to put those pieces together for that fourth quarter outlook. Thanks.

Tracey Thomas Travis

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

A

Thanks, Lauren. So it depends, really, on the SKU, right? And we've had disruptions now for the last several weeks as it relates to supply chain. We certainly have had inventory in trade, but to your point, we have had some difficulties, certainly, shipping product to consumers. So in some cases, it is taking longer than what it normally would. And in other cases, we haven't been able to ship at all.

We believe that, based on some of the things that we're hearing on the ground, that the market might open up in mid-May, but it's uncertain right now. So we, obviously, had to put our assumptions together as it relates to the fourth quarter, and our assumptions assume that things will start to open up in mid-May. And then, there will be a catch-up.

So we do have the product in and around China for 618. It's a matter of getting it to our distribution center, and then, obviously, getting it out to customers in time.

Operator: Your next question comes from the line of Steve Powers from Deutsche Bank. Your line's now open.

Steve Powers

Analyst, Deutsche Bank Securities, Inc.

Q

Great. Thank you very much. I'm sure there'll be more questions on China, but I actually wanted to talk about the Americas. Growth there was strong, as you called out, but it came in a little bit below our expectations. And on a three-year basis, local currency growth, I believe, is averaging negative 3% versus pre-pandemic levels, which is a deceleration and a reversal from what we saw in the first half of the fiscal year. And that's, obviously, that negative 3% CAGR is with the addition of DECIEM.

So I just want a little bit more perspective on how you're viewing the recovery in the Americas, what may have caused that fluctuation in multiyear growth first half versus what we saw in the third quarter, and just how to think about the progression over the balance of the calendar year. Thank you.

Fabrizio Freda

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

A

Yeah. Sure. No. Actually, we believe our North America business is actually accelerating and is in very good trend. Obviously, the sales by quarter may vary for series of things, including presence of holidays or presence of specific brands, innovations, et cetera. But in general, we had a plus 24% in the last 12 months and plus 10% in quarter three. If you think that quarter three Clinique is ranking number one overall brand, M·A·C number one in makeup, Bobbi Brown, Tom Ford, M·A·C, The Ordinary, they're all growing share.

We are executing well the strategy of better covering all US multiethnic consumer groups. We have improved our distribution mix, which now is more focused on high-growth, high-profit areas in general, particularly, we've improved our online penetration during COVID, and we are maintaining it now.

We have reestablished strong brick-and-mortar productivity, which was heavily hit by COVID. Also, closing 40 freestanding store and exiting a number of closing department stores doors, we are rolling out, successfully, the Ulta, Target, the Sephora called new doors, which are proving, by the way, to reach new consumers. We have a stronger M·A·C and Clinique performance business which in North America are frankly the two key brands that are driving the overall size of the growth. We have some strong innovation successes in quarter three, for example MACStack, which we mentioned in the prepared remarks which is so far, an extraordinary success.

And I would underline we are in a market where prestige has been recovering much faster pace than mass, which is exactly proving also that we are back into sourcing from mass new consumers, particularly with our entry prestige pricing brands like M·A·C, like Clinique, like The Ordinary. We also added with DECIEM acquisition The Ordinary brand, which is the fourth, number four, in prestige US brands already in skin care, which is an extraordinary position, and ranking first in units in many of the retail partners where they're sold.

And on top on speaking about distribution, one-third of our North America business now is in direct-to-consumer model with freestanding store brand.com and certain online activity really, including social media direct activities, which give us a lot of more data, consumer data and understanding of the consumer than we ever had in the past. So it's been years of reshaping our North America business in a condition they believed today is strong and is much more stronger platform for continued growth and continued market share development of most of our brands in the future as well. So we are very positive of our North America trend and also very proud of today having a strong and motivated team which is in action, and which is driving the business forward.

Operator: Your next question comes from the line of Nik Modi from RBC Capital. Your line is now open.

Nik Modi

Analyst, RBC Capital Markets LLC

Q

Thank you. Good morning, everyone. For retail, I wanted to get maybe an assessment on M·A·C in the US because, I guess, even prior to the pandemic the brand was under a lot of pressure. It seems like things are looking better now, but I didn't know if that's a function of just improved mobility and a makeup category lift overall, or if there's an improvement in the underlying fundamentals of that brand. If you could just help kind of frame the situation for us, that would be helpful.

Fabrizio Freda

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

A

Yeah. I think M·A·C is really in a strong recovery trend and is first of all the makeup category in general. As I explained during the prepared remarks, is in what we call the renaissance, meaning they used the educations of makeup coming back, basically back to office, back to restaurants, back to parties, back to vacations. All what we have seen gradually coming back with the COVID retreating at least up to a certain extent, this is working. And with the user education coming back, the entire category is flourishing again. Plus, as I mentioned, it's important that makeup is also linked to mood, meaning the joy of interpreting personalities, interpreting yourself. So a most positive sense of recovery from COVID has been developed in the last several months, and this has benefited the category. So M·A·C is the market leader in the prestige in quarter three and so obviously is benefiting of the overall category recovery.

Second, the brand has now a better mix in distribution, has made important distribution choices so it's reaching consumers better, is refocusing well on the multi-ethnic consumers that's always been at the core of this brand, and has extraordinary new creative power and ability to speak the M·A·C values to the consumers in new, fresh ways.

And innovation is back, meaning not only innovation in taste, style, looks that's been always the core of the brand, but also innovation in R&D, new ideas,, and performance like MACStack which is frankly a technical product innovation as well, which builds on an idea which is so close to the core of M·A·C, which is makeup artistry, which is the ability to build mascara on your lashes in different stacks and so allowing a different makeup artist interpretation or how much, how long, in which occasions. So the ultimate customization in mascara. That's a big deal. The consumer is answering fast and already is a leading mascara in North America and any other market where it has been so far launched.

So M·A·C is in a strong recovery trend. And we are very proud of the work of our team there.

Operator: Your next question comes from the line of Dara Mohsenian from Morgan Stanley. Your line's now open.

Dara Mohsenian

Analyst, Morgan Stanley & Co. LLC

Q

Hey, guys. So just returning to China. A, just short-term detail-wise, it sounds like hopefully some of the supply chain restrictions could open up in mid-May. But if that's not the case, can you just discuss contingency plans in a bit more detail that Tracey touched on? Are you comfortable you can meet demand for the June holidays if the Shanghai restrictions continue? Is it more top line risk or more a question of profitability if you have to reconfigure supply chain to get product there?

And then just, B, longer term, Fabrizio, assuming your supply chain issues do end up being outside versus the peer set, sounds like maybe that's the case based on some of the competitor commentary so far, but, obviously,

it's an issue across the board. Just any implications to your retailer relationships in China or longer-term share and how you think about that. Thanks.

Tracey Thomas Travis

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

A

Yeah, Dara, so I'll start. There are two things going on in the fourth quarter that are impacting us. Given the pandemic management in China right now, there is also a slowdown in traffic to Hainan. And so travel retail is being impacted as well in the fourth quarter, specifically Hainan along with China.

As you saw in the third quarter when traffic slowed in our distribution and online, we pulled back on expenses, and we would be prepared to do the same in the fourth quarter if our assumptions change. The other thing that we are looking to do is have a temporary distribution center outside of the area that is most affected and, hopefully, we'll mitigate some of the pressure on our Shanghai campus.

So those are a couple of the things that we're planning to do as our Plan B, if you will, if the market does not open up in the middle of May. But we are encouraged by some recent signs that we've seen in terms of – or heard in terms of some of the cases coming down, but it's quite volatile, Dara. So this is the best estimate that we have at this time of the situation and what we could deliver in Q4.

Dara Mohsenian

Analyst, Morgan Stanley & Co. LLC

Q

Yeah, and...

Fabrizio Freda

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

A

Yes. And on your question on you ask about retailer relationship. We are in China for the long term and completely dedicated to continue to develop the market and serve our partners there. We are going to open soon our R&D center in China, which is a very big event and a very manifestation of long-term determination to continue to be locally relevant and serving the specific needs of this market. And obviously, we are going to do as soon as the COVID restrictions will allow us to proceed.

So and the other thing I want to clarify, that the China consumer demand underlining this moment of COVID restrictions is strong. And now, it comes really from a multichannel. Online, where it's more than 50% of the mainland sales, we grew double digit in quarter three despite, what Tracey explained, that in the last 15 days of March, we could not ship existing orders. That's the key point. We couldn't ship orders that we had already in our hands, both from retailers and consumers online. And so, obviously, that's temporary. And this happens to us in the past in the United States, in Europe during the pandemic lockdowns. So we know how this works and how this happened, and we know also how to rebound when this finishes because it's not about consumer demand. It's about access to consumers that has changed dramatically in a very short period of time.

But the online was very, very strong, had a very strong February, and despite that, we grew market share in quarter three online which is extraordinary despite the inability in the second half of March to serve consumers. Hainan was strong till mid-March and then Hainan had a very strong decline of traffic. We estimate 60% to 70% in the second part of March and be in April we saw 80% traffic reduction in Hainan. So that's what is reflected in our quarter four.

But also, we have seen historically that also the bounce back can be very strong, because when these restrictions finish people travel domestically very fast and very happily. And so the confidence into Hainan in the future is unchanged, actually increased, given the incredible development of the place. And the confidence in online is very strong also because, together with the continuous success with Tmall, we are also now expanding and having good expansion online with JD, with [ph] Darwin, (00:45:19) digital marketing with TikTok activations. There are so many other things which are in the making.

Brick-and-mortar was the most impacted during the restrictions, and so as of mid-March was real and the entire month of April was really impacted in the areas where there were restrictions. It was not everywhere but it was definitely in Shanghai where we have a lot, as we discussed, of distribution center.

So also, I want to clarify that the long-term fundamental of global prestige beauty in China, and in travel retail in China remains very, very good. Actually, I personally have never been more enthusiastic about the opportunity. When the market rebounds also should be much more profitable, as we have seen in the US because the market will rebound in travel retail, in online, in more productive brick-and-mortar and in more productive fragrance businesses than in any other region of the world because high-end fragrances is much bigger percentage of the total development of the category.

Also, we continue to invest in China, as Tracey has clarified. And obviously, we will tailor the investment to the level of access to consumer that the restriction will permit, but we will invest in the growth, in the innovation center. There will be more brands in China coming soon, additional cities coverage as soon as the restrictions will allow. I spoke already about the strongest plans with our partner Tmall and the further diversification of the coverage in the country. The category growth expansion beyond skin care, Makeup and fragrances are coming up strongly.

The supply chain that needs to be further diversified, as Tracey has alluded to, but we had already plans for fiscal year 2023 and 2024 to have more regional distribution centers that we will deploy. But in the meantime, we'll look for certain temporary activity. Hainan expansion is also a story that our new mega counters are getting expanded in Hainan as we speak, not only for us but also for competition, but it added extraordinary new opportunities, which we are in [ph] the making of temporary. (00:47:49) Obviously, in this moment, as I said, there is little traffic but, for example, in July-September period there will be more [indiscernible] (00:48:00) expanded.

The expectation for 618, assuming that the logistics can be resolved, is pretty strong. And also, I want to underline that we hear that it's very likely there will be more economic stimulus ahead in the country that will further develop consumptions in the next 12 to 18 months. So I just want to underline, I hope it was clear, that we are really trying to be as prudent and objective as possible in reflecting the COVID restrictions, but we remain absolutely determined to continue to build our China and China TR businesses.

Operator: Your next question comes from the line of Andrea Teixeira from JPMorgan. Your line's now open.

Andrea Teixeira

Analyst, JPMorgan Chase & Co.



Thank you. Good morning. Fabrizio, you mentioned that you're comfortable to fulfill when you're able to. So I was hoping to see what was the impact in volumes of orders that were made online in China for your organic growth. And also just a clarification on Tracey's comments on the pricing front, with I think a 400 basis points impact of pricing in the quarter, so I was hoping to hear what is the rollover impact on the carryover into the fourth quarter and the mix impact. I'm assuming the mix was a negative given that you're selling less – on a relative basis, you're growing less in skin care. I appreciate all of those. Thank you.

Tracey Thomas Travis

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

A

Yeah. So let me start, Andrea, with the pricing. My 400 basis points really was for the second half of the year. We started the year taking 3.5% of pricing increase, and typically we take most of our pricing increases at the beginning of our fiscal year. We did take a second price increase in January, so the impact year-over-year for our second half is 4% pricing relative to prior year. And we expect to, in our upcoming – the beginning of our upcoming fiscal year in July, take additional pricing, so. And that pricing is strategic between levels within the tiers of our category. So, yes, skin care, higher-priced skin care might take higher priced pricing. Our lower-priced skin care would take lower price increases. It's very much dependent on the market, the currency, the inflation. There's a very sophisticated model that we use to determine what pricing for our various brands. So, yes, we will have lower skin care sales in the fourth quarter, but on average the pricing increases that we've taken will still be around 4%, and we do expect that they would cover the inflation that we are experiencing at the moment.

Fabrizio Freda

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

A

And answering the first part to your question, which is how much we could not ship, frankly, I cannot distinguish the online versus the brick-and-mortar. But I can tell you that as of March 15 when we couldn't for 15 days of the quarter ship the orders we had, the order we had in our hands that we did not ship in that moment were 2.5 points of growth for the entire quarter. So a substantial amount of shipments.

And then the April also and the beginning of May also we had limited capacity of shipments. And also, importantly in the quarter three numbers that you see, the impact of the pandemic was mainly reflected in the Mainland China impact, while TR had a very strong quarter despite there was less traffic in the second part of March, so somehow ended up with higher stocks in our assumptions. And then in the quarter four expectation, there is a bigger proportion of the impact of the reduced traffic in Hainan than there is frankly an impact in China. And so that also maybe give you a bit more light on our assumptions in this very difficult situation, frankly, to interpret in a detailed level given the very high volatility.

Operator: Your next question comes from the line of Bryan Spillane from Bank of America. Your line is now open.

Bryan D. Spillane

Analyst, BofA Securities, Inc.

Q

Hi. Good morning. Thanks, operator, and thanks for taking the question. Fabrizio, you mentioned in the prepared remarks or maybe in the Q&A just maybe an expectation that there could be some stimulus in China. And I guess one of the questions we've got this morning was whether or not any of the softness that you've seen in China is all connected to the consumer feeling the impact of the economy slowing or recession risk. So can you just touch on that a little bit just in terms of whether or not you've seen any sort of impact on demand, or any consumer behavior patterns based on the economy slowing in China?

Fabrizio Freda

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

A

No. So far, we have not seen any impact in this area – not only because – as I said, the demand remained robust, and you can look at the demand in – you need to look at the demand in China in this moment, since when global COVID started mainly, since when Chinese started traveling internationally less. You need to look at it like the brick-and-mortar in China, the online in China and Hainan. The combination of these three has been very, very

strong, even if you look at our quarter three and you put together the results in TR together with the results in Mainland China, online as I said before. We were growing market share and growing double digit and the brick-and-mortar very soft moment. But when you put it all together you see demand growth. When you look only Mainland China or only Hainan in certain moments, you may see different patterns by channel, but the total Chinese consumption has been very, very solid for us, for the industry, for competition in general.

The other important thing to clarify that this is not changing also in the composition. For example, the most important segment in this moment in the China demand is high-end luxury brands, so both in our portfolio brands like La Mer, or Tom Ford, or in our competitive portfolio or within our portfolio within a brand like Lauder, the performance of Re-Nutriv, which is the high-end part of the brand, so everywhere the high-luxury part is doing better in growth than any other part. This doesn't suggest that the consumers are worried by the economy. This suggests the consumers are actually looking for high-performance and strong experiences more and more in this moment.

Said this, there is obviously a lower economic expectation in this moment, but also there is a lot of trust in the possibility of economic stimulus and in the possibilities of restarting stronger economic development, so I believe that the consumer sentiment is still overall solid.

Operator: Your next question comes from the line of Korinne Wolfmeyer from Piper Sandler. Your line's now open.

Korinne Wolfmeyer

Analyst, Piper Sandler & Co.

Q

Hi. Thanks so much for taking the question. Kind of expanding on that last question on consumer sentiment more broadly, how have the recent developments macro-wise assessed or kind of changed your viewpoint or impacted your viewpoint on the resiliency of prestige beauty as a category, more broadly graphically both here in the US and in EMEA and in APAC? We've seen these consumer sentiment numbers start to get a little bit depressed over the past few weeks. So just wondering how you're viewing the resiliency of prestige beauty in these market dynamics.

Fabrizio Freda

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

A

Yeah. No. I have to say that we see the consumer sentiment, obviously, a different level of development by region. So first of all, the US, the consumer sentiment is solid. And in the US is very interesting. You can also read the results by channel, and you see that prestige continues to grow and to accelerate in the post-COVID environment, at least from a consumer-sentiment standpoint. Sorry. Prestige accelerates much faster than mass. They both are growing, but Prestige is growing much more. And this is a sign. Again, this is a sign that consumers feel the confidence to go for quality, for performance, for experience and for what they feel connected to and the more and more and to go back to the pleasure, to the joy, to the self-pampering feelings which are overall a positive consumer sentiment.

But positive doesn't mean necessarily trust in the long-term economy. Positive in what move beauty is a positive consumer sentiment also in the sense of the interest in dedicating to yourself, the interest in pampering yourself, is actually the consumer sentiment that is better explained by the coming out of very difficult periods rather than by necessarily on the economic trend. And so that consumer sentiment is the one that push prestige beauty in general around the world. And this consumer sentiment is sometimes even stronger in moment of high stress because there is more pampering needs. So strong in the US I believe still solid in China, better in many other

markets like Japan, like UK, like markets – sorry, UK, I'll mention in a second – like Japan, like other markets in Asia, Korea, Singapore, which are all recovering from a tough COVID period.

The only area where the consumer sentiment, as you know, is going down is Europe, and it's not because of economical reasons because also in Europe there is the pleasure of getting out of the pandemic pressure as a sentiment. But the war in Ukraine is obviously creating a very bad feeling among people, and so people are sad and there is this element of the sentiment that create a mixed consumer sentiment this moment in Europe. But that's the only area where the numbers are just this, by the way the numbers, not the business. The business in prestige beauty remain very, very solid, suggesting what I was explaining which is the consumer sentiment is a mix of economic external pressure like the horrible war, but also how they feel in terms of how much they need to take care of themselves, to pamper themselves in this very difficult environment. So in that sense prestige beauty is more resilient to this kind of situations than many other markets.

Tracey Thomas Travis

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

A

And the only thing I would add to that is even as we've commented the fragrance category during this time has picked up, so to Fabrizio's point in terms of self-pampering and prestige hair care. So we're actually seeing an acceleration in some categories of prestige during this time particularly in the markets that are in recovery. So this really is a temporary situation that we're experiencing now and into the fourth quarter.

Our team on the ground in China has been working diligently to try to get product to consumers respecting obviously the restrictions that are in place and staying healthy. And we are incredibly thankful to them for all of the things that they're doing to make sure that they can, as best they can under these circumstances, meet the demand of our consumers in China who really are looking for our products, and will get them as soon as we can get them to them, so.

Operator: We have time for one more question. Your last question comes from the line of Dana Telsey from Telsey Advisory Group. Your line is now open.

Dana Lauren Telsey

Analyst, Telsey Advisory Group LLC

Q

Good morning, everyone. As you think about the categories of makeup and skin care, what are you looking at for skin care going forward as makeup is recovering so strongly in terms of new product releases? And then any expansion of what you're seeing at the new Ulta and Target relationships and your product expansion there? Thank you.

Fabrizio Freda

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

A

Yeah, sure. Skin care will continue to develop. Actually, one of the key thing is happening, is the skinification of many categories including makeup, hair care. The skin care key trends are increasing. And what's happening in a very broad sense on top of anti-aging that remain very important, particularly with the growth of the more mature consumers, growth in numbers and in interest in the category, what's happening is that skin care is entering category of instant benefits than in the past where basically online makeup area. Today's skin care is about anti-aging, is about also instant benefit. For instant benefit, I mean, I don't know, luminosity, even skin tone, brightness, and there are so many different benefits that today are linked to how the skin looks in the day. You use it rather than just all the time. And so the category is bigger. There are more usage occasions, and there are

more usage reasons, basically more benefits. And the industry's providing some amazing technology and some great progress in this area.

On top of that, the penetration of skin care and on different target groups and also younger target groups linked to the better penetration of instant benefits is increasing around the world. So frankly, we have a very positive view in skin care in the long term. Obviously, skin care is very strong in Asia and particularly in China. And so in a moment of restrictions like in China now, you will see less strong growth in skin care, but this again is temporary, as we explained of the entire situation. But the long-term skin care trend remains strong.

In terms of the situation of Target, Kohl's – Target and Kohl's, yes, Target, Ulta and Kohl's, Sephora stores, we are pretty happy of the initial results there. These accounted for the moment only three points of growth in total for the quarter of North America, but the most important news is that it's bringing new consumers. So a lot of this is extra and give us the possibility to access new consumers, and our brands are doing very well in those spaces with these consumers.

So this also is a good trend in the right direction, but it's only the beginning of the journey.

Operator: That concludes today's conference and questions question-and-answer session. If you were unable to join for the entire call, a playback will be available at 1:00 PM Eastern Time today through May 17. To hear a recording of the call, please dial 855-859-2056 passcode number 9349743. 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.

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