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The Estée Lauder Companies, Inc. (EL)

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MANAGEMENT DISCUSSION SECTION

Operator: Good day, everyone, and welcome to The Estée Lauder Companies' Fiscal 2023 First 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. Please go ahead.

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. Unless otherwise stated, all organic net sales growth excludes the non-comparable 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 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 that 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. It is good to be with you today.

Since we spoke in mid-August, the headwinds of COVID-19 restrictions in China, high inflation globally and a strong US dollar intensified significantly. Amid the increased complexity, we deliver organic sales down 5% in line with our outlook and adjusted diluted EPS higher than expected. Even in these conditions, our multiple engines of growth strategy empower us to seize prevailing growth opportunities. Indeed, we realized outstanding performance in many developed and emerging markets around the world to partially offset the impacts of COVID-19 restrictions in Asia travel retail and domestic China, as well as tighter inventory management by some retailers in the US. To reflect these prolonged and heightened external pressure, we are reducing our outlook for fiscal year 2023, most notably for the second quarter.

While Tracey will discuss our revised outlook in detail, there are three primary drivers. The first is the impact of ongoing COVID-19 restriction in Asia travel retail, particularly Hainan. The restrictions are leading to a slower return of tourism versus what retailers had anticipated, resulting in tightening of inventories. While it is significant, this near-term temporary pause does not diminish our deep conviction in Hainan for the long term as it is among the best brand-building destination for new consumers acquisition. The second driver is the tightening of inventory by some retailers in the US. And the third is the far stronger US dollar.

Encouragingly, beyond these headwinds, consumer demand is robust in markets which are emerging from the pandemic, evidenced in the underlying fundamentals of our first quarter results and retail sales growth. Our optimism in the long-term growth opportunities for our brands and for prestige beauty is intact. During fiscal year 2023, we plan to continue investing in our brands including for innovation, advertising, strategic entry into new countries and expanded consumer reach to grow profitable prestige beauty share.

We expect a gradual sequential improvement to low-double digit organic sales growth and high-teens adjusted EPS growth on a reported basis in the second half of fiscal year 2023. As these pressures begin to abate, the momentum in other areas of our business builds and our ongoing investments drive growth.

Let me now share some insights from our first quarter as while we had headwinds, we also had many bright spots that give us confidence in the second half and beyond. We realized double-digit organic sales growth in many large developed and emerging markets around the world. Japan and the UK grew strongly alongside Brazil, India, the Middle East and Thailand to name just a few. Brick-and-mortar prospered in these markets as we welcomed consumers with high-touch services, engaging activations and newness. Domestic China delivered sequentially

improving organic sales trends [ph] of down (00:05:33) single digits, driven by excellent growth online and better performance in brick-and-mortar.

Our luxury brands, La Mer and Tom Ford Beauty contributed to online growth as did Aveda and Bobbi Brown, among others. We are very encouraged by the terrific results of our expanded consumer reach on JD and Douyin.

From a retail sales perspective in the online channel, we grew nearly twice as fast as prestige beauty in China to gain share. In the US, our freestanding store excelled benefiting from both enhanced omnichannel capabilities and greater demand for our high-touch services, be it artistry at M·A·C or personalization at Jo Malone London and Le Labo. Specialty-multi also performed especially well, powered by traditional store and enhanced by the partnership of Ulta Beauty at Target and Sephora at Kohl's. Clinique, M·A·C and Bobbi Brown led growth. Given excellent results in Ulta Beauty over the last year, M·A·C and Bobbi Brown are further expanding their presence.

We continue to see promise in the US, evidenced in its overall retail sales growth in prestige beauty despite the recession risk and the strong performance our brands delivered in freestanding doors and specialty-multi. We remain committed to investing in innovation, advertising [indiscernible] (00:07:15) consumer acquisition strategies as we aim to best capture the market growth opportunities.

Looking at brands globally, 13 brands rose organically, collectively increasing high-single digit to represent over half of our organic sales. Among the 13, M·A·C excelled in Makeup, La Mer in luxury Skin Care, Jo Malone London in Fragrance and Aveda in Hair Care, while The Ordinary, our newest brand, appealed to consumers with its authenticity and innovative approach to ingredient transparency.

Fragrance sales rose an outstanding 18% organically and expanded in every region. Tom Ford Beauty, Jo Malone London, Le Labo, KILIAN PARIS and Editions de Parfums Frédéric Malle all contributed, driven by sought-after innovation in heroes as our luxury and artisanal portfolio evolves from strength to strength. For example, Jo Malone London's momentum continue with gains balanced across the regions. Innovation served as a catalyst for growth. In China, the new Night Collection resonated beautifully as did the Limited-Edition Brit Collection. Globally, the brand brilliantly leveraged its hero strategy, creatively reimagining the power of English Pear & Freesia in a campaign to recruit new consumers.

Demand for fragrance was even stronger as ongoing supply issues of glass and componentry constrained the still excellent sales growth. Profitability for Fragrance improved despite the significant currency headwinds, further evidence of the benefits derived from our strategic pivot to the higher end of the category.

Hair Care double digit organic sales growth was fueled by increasingly diverse growth engines. We were thrilled to launch Aveda in mainland China, marking our entry in prestige hair care in the market. In the US, Bumble and bumble realized gains from strong results in Ulta Beauty at Target and expansions into Macy's.

In Skin Care, while The Estée Lauder, Dr.Jart+ and Origins brands were most pressured by reduced retail traffic and travel in China, several brands still prospered. La Mer, Bobbi Brown and The Ordinary grew organically driven by coveted heroes and newness to showcase the gains to be had from entry prestige through luxury. Innovation also resonated strongly in Skin Care which bodes well for the future when these transitory pressures abate. In China, Estée Lauder luxury-oriented Re-Nutriv was highly sought after, and the launch of Re-Nutriv Ultimate Diamond Transformative Brilliance Serum boosted overall demand for the franchise.

Clinique Smart Clinical Repair gained momentum in China and also in the US as its new moisturizer complemented the regimens popular serum and eye cream which launched last year. The Clinique Smart

franchise benefit from its 360-degree marketing campaign of these three products featuring powerful scientific credentials and claims.

Makeup renaissance was evident as markets both reopened and evolved in recovery. The category growth in emerging market was especially striking and broad based from Latin America to the Middle East, India and Southeast Asia, while Makeup also grew in most developed markets in Western Europe along with Japan and Korea.

M·A·C had a remarkable quarter, fueling passion for Makeup around the world, growing high-single digits organically. Consumer embraced its unparalleled artistry and the brand innovation proved captivating, especially Powder Kiss Velvet Blur Slim Stick for the lipstick finish and elevated packaging as well as M·A·C Stack mascara.

M·A·C's creative marketing activations further contributed to growth. In Southeast Asia and Latin America, the brand's TikTok challenges realized standout results, driving significant new consumer acquisition on Lazada's Super Brand Day, strong double-digit volume growth across Latin America as over 400 content creators contributed to the campaign.

Before I close, I'm also pleased to share that today we will release our fiscal year 2022 Social Impact and Sustainability Report. It features exciting progress made possible by the extraordinary efforts of our employees around the world across our ESG areas of focus and previously stated goals. The report also details new goals for electric vehicles, water reduction and responsible sourcing. Finally, on the last few earnings calls, I discussed actions we were taking to make more progress in our commitment to racial equity as well as women advancement and gender equality which are also reflected in the report.

In conclusion, the current external pressures are many. However, as we look ahead, we remain confident in our focus on advancing our long-term growth strategy, further balancing and diversifying our multiple engines and fully leveraging the long-term promise of prestige beauty. We aim for fiscal year 2023 to be another year of progress on our strategy despite the headwinds.

In the first quarter alone, we set the stage to expand our luxury portfolio having announced a deal to create BALMAIN BEAUTY with a couture fashion house. We extended our consumer reach in productive distribution in high-growth channels to match success across regions and continue to strategically expand brands into new countries with Aveda launch in domestic China.

We also welcome colleagues into our new China innovation labs in Shanghai, amplifying our ability to best create for the Chinese consumer. And we began limited production for Skin Care in our new manufacturing facility near Tokyo.

I would like to close with my deepest thanks to our employees for their exceptional commitment amid the complexity of the environment. Your creativity, wisdom and passion are beyond compare. Thank you.

And 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 first quarter organic net sales declined 5% and earnings per share was \$1.37. Net sales were in line with our expectations and earnings per share exceeded them even with incremental headwinds in the quarter. While sales overall met expectations, our mix of sales was different than we expected. In August, our outlook anticipated that first quarter sales would be negatively impacted by continued COVID restrictions in China and Hainan with gradual improvement throughout the first half of the fiscal year as the restrictions lifted. However, the impact on our first quarter sales was greater than we anticipated in Hainan as stores were closed for most of the quarter and as they reopened traffic remained quite modest, which resulted in lower shipments due to the anticipation of a slower pace of recovery.

Our outlook also reflected the comparison to the prior year in the US when certain of our retailers secured shipments earlier for holiday due to supply chains and concerns, in stark contrast to the tightening of inventory by retailers this year due to concerns about slower traffic. Our actual results for the quarter reflect even tighter than expected inventory management with certain retailers in the US. These additional headwinds were somewhat offset by a faster pace of recovery in other parts of Asia/Pacific and in EMEA as well as the benefit of strategic pricing actions we took in July and August.

From a geographic standpoint, organic net sales in the Americas declined 3% reflecting the timing of shipments in the prior year as well as the tightening of inventory this year. The timing of shipments in the US contributed 6 percentage points to the overall region's prior year growth. In Latin America, nearly all markets grew double digits fueled primarily by the strong recovery of Makeup.

In our Europe, the Middle East & Africa region, organic net sales declined 5% primarily due to continued challenges in travel retail in APAC including the negative impact from foreign currency transactions in key international travel retail locations of 2%. Our global travel retail business declined as the ongoing COVID restrictions in China curtailed travel to Hainan. Stores there were closed for most of the quarter and traffic has been slow to return resulting in lower shipments as we support stricter inventory management with certain retailers.

Conversely, travel retail sales in European market and in the Americas rose triple and double digit, respectively, boosted by increasing resumption of professional and personal travel. Net sales in the United Kingdom increased with double-digit growth from The Ordinary. Elsewhere in EMEA, the lifting of COVID restrictions and the return of tourism in the region drove growth in many markets led by India, the Middle East and Turkey and resulted in double-digit growth in brick and mortar.

Organic net sales in our Asia/Pacific region fell 7% due to the ongoing COVID restrictions impacting brick-and-mortar sales in Greater China and travel retail in Korea. In Korea, double-digit growth from nearly all brands was more than offset by the decline from Dr.Jart+'s travel retail business. The rest of the region delivered strong net sales growth led by Thailand, Malaysia and Japan. Many markets in the region continued to recover as restrictions lifted and traffic returned to stores.

From a category perspective, Fragrance led growth with organic net sales rising 18%. Strong consumer demand for our brands and innovation drove growth. Our luxury and artisanal brands continued to thrive led by Tom Ford Beauty, Jo Malone London and Le Labo. Net sales from Clinique rose strong double-digits winning across all regions with the Clinique Happy Product franchise.

Our Hair Care net sales rose 11% organically. Aveda led category growth driven by double-digit growth in Europe, the Middle East & Africa from hero products and strong innovation including the launch of the Color Control product line.

Organic net sales in Makeup declined 6% driven by the COVID restrictions in China as well as a difficult comparison to the prior year period due to the timing of shipments for holiday in the US. Net sales rose strong double-digits in Southeast Asia and in the emerging markets of EMEA due to strong performance from M·A·C, Bobbi Brown and Estée Lauder. M·A·C continues to be an overall top performer driven by the success of both hero products and strong innovation across the foundation, lips and eye subcategories.

Organic net sales in Skin Care declined 11%. This category has been the most impacted by the COVID restrictions in Hainan where Skin Care accounts for majority of our business.

Our gross margin declined 190 basis points compared to the first quarter last year. The positive impacts from strategic pricing were more than offset by higher cost due to promotional items and inflationary pressures in our supply chain. Operating expenses increased 250 basis points as a percent of sales driven by the reduction in sales. Operating income declined 29% to \$668 million, and our operating margin contracted 440 basis points to 17% in the quarter. Diluted EPS of \$1.37 decreased 28% compared to the prior year, slightly better than expected as a result of effective cost management. The impacts from foreign currency transactions in key travel retail locations and the exit of certain designer licenses negatively impacted diluted EPS by 4% and 3%, respectively.

During the quarter, we utilized \$650 million in net cash flows from operating activities reflecting increased working capital primarily due to the timing of payments and higher inventory levels as well as lower net income. We invested \$152 million in capital expenditures for supply chain improvements, online capabilities and distribution expansion. We returned \$325 million in cash to stockholders through both dividends and share repurchases and additionally this morning we announced a 10% increase in our quarterly dividend. So again, we delivered our overall quarter one result as we anticipated.

Now let's turn to our outlook for the remainder of fiscal 2023. While we believe the headwinds that impacted our first quarter results are largely temporary, it is also apparent that both the timing and speed of the stabilization of inflation and recovery from both the pandemic and currency challenges are uncertain. As retailers in Hainan were prepared for a faster recovery of traffic to the island with their inventory levels of our products, we have further modified our shipments to be more in line with the slower retail environment.

And although we expect the adjustment to inventory by certain of our retailers corresponding with potentially lower traffic to continue into the second quarter, particularly in Hainan, we believe this adjustment will subside in the second half, as COVID restrictions ease and consumers begin to travel with less safety restrictions in China. Until that happens, ongoing restrictions are expected to result in lower net sales in these areas. We also anticipate the tighter inventory management in the US to abate in the second half given the still strong demand for our products at retail.

We expect the remainder of our first half performance to be pressured as we navigate through these uncertainties. Despite the headwinds to net sales, we remain confident in the strength of our business strategy and expect to sustain our investments to drive long-term profitable growth. We plan to continue to invest in the areas of advertising, innovation, production capacity, consumer engagement, as well as new consumer reach and continued strategic entry into new countries for some of our brands.

For the second half, we anticipate trends to improve sequentially as restrictions are lifted, travel throughout greater China, including Hainan progressively resume and the tightening of inventory subsides in Asia travel retail and in the US. We expect continued recovery in various markets in EMEA and Asia/Pacific for the balance of the year.

Currency is also projected to be a significant drag on our reported results in the second quarter and for the full year as the US dollar has continued to rapidly strengthen against key currencies. As we entered fiscal 2023, we took strategic pricing to mitigate higher-than-normal inflation. Both the magnitude and speed of currency movements experienced thus far combined with inflation have further suppressed our expectations for the balance of the year. Specifically, based on mid-October spot rates of €0.978 for the euro, £1.122 for the pound, RMB 7.29 for the Chinese yuan, and KRW 1,436 for the Korean won, currency translation is anticipated to continue to negatively impact reported sales and diluted EPS growth for the second quarter and for the full year.

We expect organic sales for our second quarter to fall 11% to 9%, primarily reflecting the continued risk of disruption in Hainan leading to further tightening of inventory and continued tightening of inventory by certain retailers in the US. Currency translation is expected to be dilutive to reported net sales by 7 points with an additional 2 points due to the impact of certain foreign currency transactions in key international travel locations. The impact of sales from certain designer license exits are expected to dilute reported growth by approximately 1 point.

We expect second quarter adjusted EPS of \$1.19 to \$1.29 for a decline between 60% to 57%. Currency translation is expected to be dilutive to EPS by \$0.20 such that constant currency adjusted EPS is expected to decline between 54% and 50%. This includes the negative impact from certain foreign currency transactions in key international travel retail locations of approximately 7 percentage points.

For the full year, we expect organic sales growth to range from flat to up 2%. Currency translation is expected to dilute reported sales growth for the full fiscal year by 6 percentage points, and we expect an additional 2 points of dilution from the impact of certain foreign currency transactions in key international travel retail locations. The impacts of returns associated with restructuring and other activities and sales from certain designer license exits are each expected to dilute reported growth by approximately 1 point.

We expect full year operating margin to be approximately 16.1%, a 360-basis-point contraction from the prior year period, primarily due to the geographical mix of sales, foreign currency impacts and the strategic investments I previously mentioned. We now expect our full year effective tax rate to be approximately 25% reflecting the change in our estimated geographical mix of earnings and less benefit from excess tax benefits related to share-based compensation.

Diluted EPS is expected to range between \$5.25 and \$5.40 before restructuring and other charges. This includes approximately \$0.44 of dilution from currency translation. In constant currency, we expect EPS to fall between 21% to 19%, which includes a negative impact from foreign currency transactions in key international travel retail locations of approximately 10 percentage points.

In closing, we remain confident about the long-term prospects for global prestige beauty and in our multiple engines of growth strategy. Despite the temporary external challenges, we plan to continue to invest selectively in strategic priority areas to support the ongoing growth of our amazing brands now and into the future and to gain profitable share globally.

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

QUESTION AND ANSWER SECTION

Operator: Thank you. The floor is now open for questions. [Operator Instructions] And our first question today will come from Dara Mohsenian with Morgan Stanley. Please go ahead.

Dara Mohsenian

Analyst, Morgan Stanley & Co. LLC

Hey. Good morning. So...

Q

Tracey Thomas Travis

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

Good morning, Dara.

A

Dara Mohsenian

Analyst, Morgan Stanley & Co. LLC

How are you? So obviously a large cut to top line expectations in terms of organic sales growth for the fiscal year today, but you still sounded pretty enthusiastic about underlying demand, Fabrizio, in your comments. So can you just give us more detail on how much of the fiscal 2023 top line revision is more related to the temporary issues in terms of COVID or inventory issues you highlighted as primary reasons versus a second bucket in terms of underlying demand related to the greater macro pressure, et cetera? It would be helpful to know how much from each of those buckets is driving the top line revision.

Q

And then, can I just also ask a similar question in regard to 2024 earnings? How much of sort of the 2023 earnings degradation versus your prior guidance might extend longer term? Is your view that it's more temporary? And I just ask that in relation to what you've talked about recently which is greater flexibility in ad spend, more agility to respond to market conditions. Just trying to sort of understand how that plays into the longer term earnings outlook beyond this year and what we're seeing this year. Thanks.

Fabrizio Freda

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

Yeah. It is a complex question, so there's a lot to say. I will start and then Tracey will join me in – particularly in the second part of your question.

A

So we are very confident in our retail trend globally and growth of our business even in this very difficult external complex times. So just to give you an example of this, in North America, our retail was growing in the quarter mid-single digit, and I can explain later all the many things which are going well in this direction. But, for example, in the quarter where our M·A·C brand really demonstrated it is back to growth with a 22% growth. And for our North America business, to see M·A·C retail coming back so strongly is great news. Because as you know Clinique and M·A·C are a big part of the growth potential of our North America particularly business. So great news to have M·A·C back into growing and market share growing brands in our top brands portfolio.

Then when you look at China and you look at Chinese consumers combined, what was the retail in travel retail and the retail in mainland in domestic business, we grew mid-single digit, the retail, despite the inventories tightening issues that we had explained in the prepared remarks and in the press release. So there is an underlying strength.

Then when you look, for example, to the China domestic recovery from the difficult moment of the Shanghai closure where we couldn't ship for some time, and we have spoken in the last quarter to the fact that we have been gradually recovering. Now, the brick-and-mortar remained with less traffic but we gradually improved the trend. And the decline has been – still a decline but less – much less than in the previous quarter. And online where there was no issue of restrictions, we have been growing above the market – double than the market, growing again market share in online in China.

Then we spoke about the fact that we are very encouraged in general by the extraordinary progress in the Fragrance business. Now, we've taken the strategic decision to focus on the luxury, artisanal fragrances. And they're growing. They're profitable. And they're growing more than double-digit, as you heard from the numbers, even in presence of a complex supply chain particularly for glass globally, which reduced the ability to get to the maximum potential in this moment to fully fulfill demand. So more to come also because these supply constraints will abate over time gradually.

So we have now our Hair Care business is also in the double-digit growth, which is the other engines that we are activating in our effort to balance the growth across the different engines. And the launch in China of Aveda has been a big step of this, but also there is growth in the west very strongly in our Hair Care business.

The other interesting indication is the Makeup, Makeup globally, except the lockdown situations in China and the travel retail issues that we had described, but wherever there is market reopening, Makeup is doing very well and is continuing the recovery. As I said, with M·A·C performance at the center, which make us very, very happy because that's a very important step forward.

And then we have extraordinary skin care innovation pipeline. Admittedly, the majority of it will come in quarter three and in quarter four, but we will continue on our strong innovation in skin care.

And then when you look at distribution globally, there are many good news of expanded productive distribution. So the Douyin start in China is very, very promising. And this reflects also in the promising start of 11/11. The distribution in North America specialty-multi is becoming more and more productive, and we are expanding the productive part of it. In the next year, we'll continue this expansion.

And there is also the important concept of expanding our brands in new countries which technically is new distribution of our brands to new consumers, and obviously Aveda in China is the big, but it's not the only one. And in quarter three and quarter two – quarter four, sorry, we will continue with these expansions.

So just few examples to give you the sense that we are strong – by category strong in hair care, strong in fragrances, strong in makeup wherever there is reopening and so strong in the future in the market that will reopen in the future. And in skin care, the large majority of the issue that we are encountering is linked to the lockdown, and very strong innovation plan to restart growth there.

So we remain very confident on the long term growth. Proof of that last point is that in the second semester, if you look to our outlook, we are assuming to go back in total in the semester to double-digit growth but obviously, as we explained, gradually in quarter three and then more stronger in quarter four.

Tracey?

Tracey Thomas Travis*Executive Vice President & Chief Financial Officer, The Estée Lauder Companies, Inc.*

A

Yes. And so, Dara, obviously what's impacting us at the beginning of this year are significant unanticipated impacts to the business starting in the third and fourth quarter of last year and continuing into the first quarter with disruptions as it relates to some of the lockdowns and key parts of our business. As we think forward and for the outlook that we've provided today, we are expecting some easing, as Fabrizio said, in the second half of the year. And in the fourth quarter, we're expecting further easing.

As we think about the construct of the business heading forward and assuming more stabilization of some of these matters, our business is intact in terms of the leverage that we can get, the margin expansion that we can get and the growth that we can get as well. As Fabrizio said, consumer demand is strong. It has been disrupted. We are mindful as everyone else of is that there could be recessionary pressures in some of our key markets. And we are taking that into account. But the flexibility that we've created in our cost structure over the last few years remains intact and certainly positions us well in the future once there is more stabilization in the macro environment for continued strong top line growth and also continued strong margin expansion and EPS growth.

Operator: Thank you. And the next question will come from Chris Carey with Wells Fargo. Please go ahead.

Chris Carey*Analyst, Wells Fargo Securities LLC*

Q

Hi. Good morning.

Tracey Thomas Travis*Executive Vice President & Chief Financial Officer, The Estée Lauder Companies, Inc.*

A

Morning.

Chris Carey*Analyst, Wells Fargo Securities LLC*

Q

I'm sure China recovery will get plenty of focus on the call today. So perhaps I'll just actually take a bit more of a medium/longer term angle here. Fabrizio, can you just comment on the willingness of The Estée Lauder organization to take some of your brands beyond historical channels or types of interactions with retailers? I think you called out specialty-multi expansion in the US. Clearly, in China you've expanded with JD and Chinese TikTok. It feels like the organization is certainly becoming more comfortable working with different kinds of channels. And I wonder just in the context of a broader recovery, and certainly there's going to be a big debate on what is the true earnings power of this organization, I wonder if you can just comment on whether this is true, this concept of sort of expanded comfort with new opportunities and whether you see additional opportunities ahead and where those might be.

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

A

Yeah. No, I think we've been very much focused on having the right level of distribution and focus where the consumer preferences are evolving over the last years. We operate in 12 channels now versus basically one channel 15 years ago. And so, discomfort is there and you can see this, first of all, in our online expansion that continues to be strong. We have obviously our brand dot-com that continues to be expanded to more brands, to better sites, to more services in the sites. You have our 3PP, meaning the Tmall model, which is expanding around the world, also Alibaba is present in different countries. And we are collaborating with them in expanding

the model in different countries, Lazada being probably being the most evident example at this point of this expansion. We are playing with pure-play more and more. And we have many examples, particularly in Europe of this. And obviously, our retail dot-com continue to be expanded.

And then in term of our comfort with specialty-multi, I believe this is not new, we are very comfortable and there is – with specialty-multi we are doing well, we are growing. We have increased our market shares in the channels well in North America, but not only in North America, in many other parts of the world, and this is progressing very, very well.

The other important news in this sense is direct-to-consumers, so our freestanding stores, had a tremendous quarter. And we see the model of freestanding store coming back really strongly wherever there is a reopening and wherever the consumers are really enthusiastic to go back to the brick-and-mortar. And today, our freestanding stores are more efficient and more effective for the many efforts of cost management and the expertise in retail we brought in the company in the last years. So the return of traffic to freestanding stores is very promising. Just to give an example, our freestanding stores in the US for fragrance brands were plus 33% in the quarter. So very, very strong sign [ph] already making (00:41:29).

And so we will – the expansion, you said – you spoke about JD, but I spoke also about Douyin, exactly the Chinese TikTok, and this is a more recent expansion. And the interesting thing is not only we are more comfortable with playing in these channels, but we are winning when we play in these channels. Look at what happened in JD where we – when we entered, we entered really, really well with a great partnership and great results. So we are definitely continuing to manage our distribution in line with consumer preference with the evolution of where the consumers we serve go. However, we will keep in mind that our distribution has to be with high-touch services, has to be a distribution which serve the consumer not only with availability of product and pricing but serve the consumer with our education, customization, care services and they're focused on building brand equity or building experiences and they're focusing on building the unique elements of luxury.

We are a pure-play in luxury. So it's not only about distributing wherever there is mass of consumers, it's about distributing with quality, branding and services. And so that focus has not changed. But we have become better in creating these environments in places where there is more and more consumer traffic.

Tracey, do you want to add anything?

Tracey Thomas Travis

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

A

No, thank you. Next question?

Operator: Thank you. The next question will be from Steve Powers with Deutsche Bank. Please go ahead.

Stephen Powers

Analyst, Deutsche Bank Securities, Inc.

Q

Great. Thank you, and good morning. Maybe following up on Dara's question, your comments were helpful, both Fabrizio and Tracey, but is there a rates of overall consumption of retail sales growth that you anticipate across your portfolio on the year just so we can compare it to the flat to 2% positive organic growth that you've assumed in your outlook? That's the kind of follow-up.

And then I guess I'd also if possible like a little bit more context around the retailer destocking that you've called out broadly, but particularly in the US as it's not something I think – I don't think we've heard that from your peers. It's certainly a dynamic we've seen across other categories, but so far beauty hasn't been a focal point for that. So just again a bit more detail on what you've seen, how much do you think may be specific to your portfolio, and what the outlook is through the holidays into the second half. Thank you.

Tracey Thomas Travis

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

A

So let me start on retail. It's hard to do an average retail across all of our markets, as you might well imagine. I would tell you that in all of our markets as we look at the projection for the year, retail is positive. It varies by market, but obviously given some of the disruptions and slowness in certain markets. But it's positive in every market. In some markets, it's actually double-digit positive. And so, again, the gap between retail and net in many of our markets, certainly in our recovery markets, is not very big at all. In markets where we've had more disruption or we have the anticipation of a slowdown, that's where we're seeing more of the disconnect between retail and net.

Operator: Thank you. And the next question will be from Dana Telsey from Telsey Advisory Group. Please go ahead.

Dana Lauren Telsey

Analyst, Telsey Advisory Group LLC

Q

Good afternoon – oh, good morning. It feels like afternoon already. Good morning, everyone. As you think about what was embedded in your prior guidance in terms of pricing, is there any change that you're making in any of the categories of pricing that you're looking at?

And then in the US, are you seeing any difference whether it's your freestanding, whether it's specialty-multi, or department stores? Is there a difference in performance and how you're thinking about inventory going forward? Thank you.

Tracey Thomas Travis

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

A

So I'll start with the pricing. We are looking at – so there's no change in terms of the pricing that we took at the beginning of the year. We talked about pricing at about 5.5% on average across our markets, and that was taken in the July/August timeframe. We also anticipated in the prior guidance a secondary price increase, and we are looking at that in light of some of the inflation pressures and looking at taking slightly more pricing in certain markets, not across all markets, and that would be in the January/February timeframe.

As it relates to our channels, channels that have had slower traffic are the ones that we're most focused on in terms of obviously slowing our shipments to those channels so they don't end up overstock, so we can bring down some of the stock level in those channels. So, we talked about if you just think about the first quarter, we called out the channels that performed strongly for us in the first quarter. So our specialty-multi channel performed strongly in our first quarter. Online in China performed strongly in our first quarter. So those are the channels that continue to perform strongly for us.

Other channels, we are a bit more cautious. Freestanding stores performed strongly for us in the first quarter. And we expect in recovery markets that freestanding stores will continue to perform well. So, we will continue obviously to supply our freestanding store network. Where both ourselves as well as our retailers are a little bit

more cautious on some of the traffic trends that are being anticipated, we are being a bit more cautious in terms of how we supply those retailers.

Operator: Thank you. And the next question will be from Bryan Spillane with Bank of America. Please go ahead.

Bryan D. Spillane

Analyst, Bank of America Securities

Q

Hi. Good morning. And thank you, operator. Tracey, maybe just to follow up on the pricing and inflation question. Can you just give us a little bit more detail on some of the sources of inflation and what's been incremental, I guess, since the start of the fiscal year and maybe a little bit of an expectation as you see it today as you continue to see that rising? Is that going to be a factor as we go into fiscal 2024? Just trying to get a sense of how we should be thinking about continued inflation as we go through the balance of the year.

Tracey Thomas Travis

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

A

Yeah. I think we – we certainly have seen quite a bit of inflation in our supply chain particularly as it relates to transport. We do see that continuing in parts of our supply chain. In other parts we actually see it moderating. We've seen wage inflation as well, and again that has been incorporated in some of the pricing that we've anticipated this year. We have seen advertising rates stabilize a bit, and so we're not seeing as much media inflation as we were seeing previously. So those are I would say the biggest areas of inflation that we're watching. But the supply chain area is one that is a particular focus for us going forward. And again, one of the great things about our category, we do have pricing power and so we have certainly exercised that where we see the inflationary impacts.

Fabrizio Freda

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

A

And I just want to add that we continue to remain what we – the same point of view we expressed the last quarter which is we are in a position to offset most of the inflations with pricing, and we are doing that. The other thing, however, which has emerged stronger in this last quarter is the currency. So the dollar has become even stronger. And so now we are also looking with the next consideration of possible price increases in January/February to see if in selected markets where there is also a big pressure of currency and not only of inflation, we can also make some selective adjustments in these areas. But our goals remain to offset most of the inflation with pricing. And then the rest, we are doing things like for example our innovation has been higher price on average and focused well on protecting gross margin, our cost savings and many cost activities are contributing to covering the overall impact of inflations. So we believe we are and we will be in good shape in that sense.

Operator: Thank you. And the next question will be from Rupesh Parikh from Oppenheimer. Please go ahead.

Rupesh Parikh

Analyst, Oppenheimer & Co., Inc.

Q

Good morning. Thanks for taking my question. So in China, I was curious if you can just give some additional color in terms of what you're seeing on the ground today in both the mainland and the Hainan corridor. And as you think about the China recovery, do you essentially assume a return to more normal conditions by Q4? Is that the way to think about it?

Fabrizio Freda

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

A

Yeah. In China, our assumption, as I said before, is that there will be a gradual recovery from the restrictions. And with the gradual recovery with the restriction we will see increased traffic in Hainan and in the brick-and-mortar in domestic China. So those are the two key things that needs to evolve because retail growth overall is positive, and it's interesting that retail growth overall is stronger than the economy, the way the economy is being communicated. So, the phenomenon that is historically proven that beauty prestige industry grows on average more than the economy and then we grow on average more than the beauty industry is that – that trend is what we believe will continue to happen in the future. And it's happening as we speak. However, the traffic movements are very different.

And, again, to clarify what I think the prepared remarks should have clarified in detail, but take the Hainan situation, Hainan traffic – the last time Hainan traffic was, if you want, regular was January/February – last January/February where it was full normal traffic. Then after the first lockdown, went down 80%. And then in July, recovered and went to minus 30%. And there was the assumption that this traffic over time would continue to go well. But then on the contrary, now in October it was still minus 70% again. So basically is the expectation of future traffic that make the inventories presence too high for that level of traffic and need to be readjusted.

And the second factor is that traffic in minus 70% is obviously much less than what originally was expected and also in terms of consumption. But on the other side, there is more consumption online. There is more growth online. There is people going through channels. So in total, we have seen, as I said before, a mid-single digit growth even in this tough situation with reduced traffic levels.

So when the traffic will recover in brick-and-mortar, both in travel and in domestic, when this will happen, the retail should further improve and further increase and be pretty positive. And we do assume that this phenomenon will be more visible in our quarter four, so in the April/June period is when we assume there will be a rebuild of traffic and that between now and then, as we explain, we don't see a lot of improvements in quarter two but we then see a start of gradual improvement also in quarter three. That's the dynamic we are seeing.

Operator: Thank you. The next question will be from Jason English from Goldman Sachs. Please go ahead.

Jason English

Analyst, Goldman Sachs & Co. LLC

Q

Hey. Good morning, folks. Thanks for slotting me in. I'm going to rapid-fire a couple of questions. First, to put a fine point on the answer to that last question, is the exit rate for the year are you assuming at Hainan is like back to bright, running at normal traffic or down 30%, down 50%, if you can clarify that – I guess, sequential improvement, but to what level is still uncertain.

Second question. Is Europe the next shoe to drop, like for – in terms of destocking?

And then lastly, I'm sure you have multiyear plans. I'm not asking for multiyear guidance. But as you think about like what you thought your earnings power may be in fiscal 2024 or fiscal 2025, how has that changed in light of all the dynamics that you're discussing today? Thank you.

Tracey Thomas Travis

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

A

So let me start, Jason. In terms of Hainan, no, we don't anticipate that Hainan will be fully back to normal in Q4. Much improved, but not fully back to normal. And so we are now looking at fiscal 2024 for traffic to recover. And again, it's a guesstimate at this point in time. So the recovery obviously has been slower than I think all of us have anticipated, but we do know that there is a commitment by the retailers in Hainan and certainly the area in general to get back to fantastic growth. They just opened a new mall, so it is still an exciting travel destination, and we look forward to the recovery. But it is not fully recovered in our Q4 thoughts right now, more fiscal 2024.

In terms of Europe, Europe, as we said in our prepared remarks, is recovering. And so we have seen strong growth in Europe particularly in emerging markets in Europe. We are seeing Makeup recover. We're seeing strong Fragrance growth, and the one category that has been a bit slower really in all of our markets has been Skin Care. But we've got strong innovation in the second half of the year, and certainly into fiscal 2024 that we believe will accelerate our Skin Care growth. But right now we do not believe that there are any reasons to be concerned about Europe. Obviously, everyone has been talking about a European recession, but I think as many have talked about, and we would say the same, we're not seeing it yet. So that's Europe.

As it relates to fiscal 2024, when you think about this year, really the biggest – one of the biggest impacts we've had outside of the disruptions in terms of travel retail, has been currency. And so, our fiscal 2024 is dependent on in terms of what we thought before will be impacted by what happens with currency. And one of the things that we talked about as well in the prepared remarks, some of our currency impact is adjusted out in our constant currency results and guidance, and some of it is not as it relates to travel retail, in particular. And that's a big amount. So as you're looking at our margins and the significant impact on our margins, currency is an impact on our margins. So depending on what happens with currency rates, that influences our outlook for fiscal 2024.

But most importantly, Jason, as it relates to the fundamental health of our business, once these disruptions are behind us, we still feel very strong about, obviously, the strategies that we executed throughout the last couple of years, this temporary impact, and how we have prepared the business for future growth. We're opening a new production and R&D facility in Asia that will reduce some of the transport issues – oh, by the way, it will reduce some of the currency issues as well. And so, there are many things that we've done over the last few years that have really strengthened our business once we emerge from the disruption that has been extended, unfortunately, this year. And our teams are managing through with fantastic resiliency. And we are, as Fabrizio indicated, incredibly proud of all of them and what they've been doing to support the business.

Operator: Thank you very much, ladies and gentlemen. This concludes our question-and-answer session. If you were unable to join the entire call, a playback will be available at 1:00 PM Eastern Time today through November 16. To hear a recording of the call, please dial 877-344-7529, pass code number 9985405. 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. Take care.

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