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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 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 the Senior Vice President of Investor Relations, Ms. Rainey Mancini. Ma'am, you may begin.

Laraine A. Mancini

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

Hello. On today's call are Fabrizio Freda, President and 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 reports filed with the SEC where you will 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 also excludes the noncomparable impacts of acquisitions, divestitures, brand closures and the impact of foreign 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 that we make directly to our consumers through our brand dot-com sites and through third-party platforms. It also includes estimated sales of our products through our retailers' websites. During the Q&A session we ask that you please limit yourself to one question so we can respond to all of you within 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. We appreciate your being with us today to discuss our third quarter results and revised outlook for fiscal year 2023.

In the third quarter, organic sales fell 8% at the high end of our outlook range and the sequential improvements from the decline of 11% in the second quarter. Nearly all developed and emerging markets grew organically, and outperformed our expectations to offset an even lower-than-expected recovery in our Asia travel retail business.

As we discussed in February, Asia travel retail faced two headwinds in the third quarter. The first, elevated inventory in Hainan given retailers' expectation for a more accelerated recovery proved very challenging, as conversion of travelers to consumers in prestige beauty lagged historical trends, as travel initially gravitated to other categories. This led to even lower replenishment orders than we anticipated.

The second headwind, the transition in Korea to post-pandemic regulations as traveling consumers gradually return pressured sales meaningfully. In China and Korea, the resumption of international flights was subdued. Limited visa were granted and group tours were slow to restart. These factors resulted in lower-than-expected traffic in airports to other regions, which combined with the lower-than-expected conversion, further moderated replenishment orders.

With this said, there were bright spots for travel retail in Hong Kong, Macau, Europe and the Americas. All told, global travel retail organic sales declined 45%. This was partially offset by excellent organic sales growth of 10% in the rest of our global business.

Our retail sales growth was even stronger than organic sales growth in many markets around the world, including China and the US. Encouragingly, retail sales performance is significantly ahead of organic sales results in global travel retail, which gives us confidence that the challenges in travel retail are abating with time.

Furthermore, this strength at retail including prestige beauty share gains in many markets demonstrated the benefits of our continuing investment in innovation and building the desirability of our brands around the world. These positive retail trends are expected to continue in the third quarter.

Adjusted diluted EPS in the fiscal third quarter fell 75%, which was also at the high-end of our outlook. We invested to fuel markets in various stage of post-pandemic recovery, launching sought-after innovation, expanding brands into new markets and increasing advertising as a percentage of sales. As the shape of recovery for Asia travel retail comes into a better focus, it is proving to be both far more volatile than we expected and more gradual relative to what we experienced in other markets. We are therefore lowering our organic sales and EPS outlook for fiscal year 2023 as we reduce our implied fourth quarter outlook primarily for Asia travel retail.

For Asia travel retail, there are two factors driving our revised outlook. In Hainan, the pressure from elevated inventory in the trade is proving to be deeper and longer-lasting, driven by this lower-than-expected consumption trend I discussed, compounded by the retailer inventory tightening. Second, the resumption of international travel by Chinese consumers is evolving more slowly than we anticipated.

Having visited Shanghai and Hainan in March, and witnessed first-hand the optimist of consumers, retailers, partners and our local teams, I'm very encouraged for the future of our business with the Chinese consumers. I also had the good fortune to officially open our new China Innovation Labs and met with the amazing scientists and product development specialists in the state-of-art R&D facility, which further bolsters my confidence in the business fundamentals.

Indeed, the opportunity for prestige beauty in our brands with the Chinese consumer in the medium to long term remains vibrant in the domestic market, in Hainan and internationally, which remains our focus through this complex phase of recovery from the pandemic.

For our fourth quarter outlook, the far slower organic sales growth than we anticipated in February is impacting profitability significantly. There are two factors at play beyond the pressure to a big margin accretive area of our business. First, with the rest of the business growing strongly, we will continue to invest to drive the momentum in those areas. Second, strategic and necessary long-term investments in manufacturing, R&D and information technology capabilities are pressuring margin with the slower recovery of sales.

With this said, we are obviously not satisfied by the profitability in our revised outlook for fiscal year 2023. For the future, we are focused on a plan to further accelerate our growth in key markets, return to organic sales growth in our Asia travel retail business, and skin care category, and to progressively rebuild margin across brands, categories and regions.

Let me now share more about our third quarter performance as numerous growth engines excelled. Looking at regions, each of the Americas and Asia-Pacific returned to organic sales growth, which complemented ongoing gains in the domestic markets of EMEA. Developed markets from every region contribute, led by the United States, the UK and Hong Kong, while organic sales in our emerging markets rose an outstanding 17% globally.

Impressively, in the domestic markets of EMEA, we realized broad-based strength as every category grew double-digits organically. The breadth of growth engines by category was matched by the breadth of growth engines by channel, led by specialty multi and online pure-play retailers driven by the successful go-to-market strategy as we focus on high-potential channels.

In Western Europe, our brands successfully engaged with consumers to generate trial and repeat. The examples are many. For Estée Lauder, Bobbi Brown and Too Faced driving vital success on TikTok to M·A·C leveraging Paris Fashion Week for its M·A·C Locked Kiss Ink lipstick launch, and La Mer hosting dermatologists for a unique event. These collective initiatives featuring enticing innovation and hero products drove the company accelerating prestige beauty share gains for the quarter in Western Europe.

Looking at Asia-Pacific, it similarly delivered diversified growth. Nearly every market and each category contributed to the region's return to organic sales growth. Fragrance was a standout, rising double-digit, fueled by excellent performance of our luxury and artisanal portfolio led by Jo Malone London, Le Labo, and TOM FORD Beauty. These brands' hero franchises welcomed new consumers into the category while locally inspired innovation and enriching in-store services further contributed to the expansion of this promising category in the region.

Mainland China grew low-single digits organically after four quarters of pressure from COVID-19 restrictions and outbreaks. The beginning of the quarter was impacted by the lingering effects of the COVID cases in November-December. In January, retailers worked through existing inventory, as traffic gradually returned such that organic sales declined steep double-digits. As of the re-opening progress the organic sales grows double-digits in each of February and March.

Even in this complex quarter in Mainland China, consumer desire for high-quality products, elevated experiences and newness was clear, and our brands delivered, led by Estée Lauder and La Mer. For Estée Lauder, skin care fueled its growth. Consumer gravitated to the brand's innovation and [ph] cherished (00:11:24) heroes across franchises, most especially its luxury-oriented Re-Nutriv as well as Supreme.

La Mer further contributed boosted by its expert beauty advisor offering, differentiated services and the launch of the reformulated moisturizing soft cream, which attracted new consumer with its advanced benefits. Encouragingly for the third quarter, our prestige beauty share gains in Mainland China accelerated sequentially, driven by skin care as well as both online and brick and mortar.

In the Americas, the United States returned to organic sales growth, invigorated by strategic go-to-market initiatives and innovation to engage existing as well as new consumers. The Ordinary soared owing to its heroes and [ph] a winning streak (00:12:20) of innovation, with the latest being Multi-Peptide Eye Serum which is bringing in the new consumer demographic.

Estée Lauder introduction of the revamped Nutritious franchise focused on Gen Z with all-new skin care products and launched exclusively with ULTA Beauty, realized strong initial uptake. Looking at Makeup in the United States, M·A·C, Clinique, and Too Faced fueled excellent performance with targeting initiative to serve various consumer demographic across freestanding stores, specialty multi and department stores.

For Clinique, it is a case study in successfully leveraging vital success of a product, in its case, Almost Lipstick In Black Honey, to drive organic sales growth in many sub-categories. Across regions, emerging markets showed their promise as a long-term growth engine, as our in-market team executed with excellence to meet the local needs of consumers. The double-digit organic sales growth in emerging markets this quarter extends our fiscal-year to-date momentum with strong contribution from India and Brazil.

Globally, our diverse portfolio of brands served as a powerful catalyst for growth. M·A·C, TOM FORD Beauty, The Ordinary and Le Labo each contributed strong organic sales growth and demonstrated the gains to be had across our large-scaling and developing brands. M·A·C with its global reach, expert artistry and service-oriented freestanding stores continued to realize the evolution of the Makeup renaissance as markets progress in recovery from the pandemic. Furthermore, the brand leveraged its market-leading EMV ranking with high impact activation and product launches in Makeup.

Consumers also embraced M·A·C new Hyper Real franchise in skin care, which should represent an incremental growth engine for the brand over time. Importantly, Hyper Real is another example in our portfolio of exciting east-to-west innovation, as it was born in Asia-Pacific and launched globally.

TOM FORD Beauty delivered double-digit organic sales growth excelling across Fragrance and Makeup. In Fragrance, the new Private Blend Cherry collection was an instant hit while the brand's extension of TOM FORD Noir Extreme eau de parfum [ph] into parfum (00:14:56) captivated consumers seeking intensity and the highest quality. We are thrilled to have enriched our brand portfolio last week, when we acquired TOM FORD, a power player in luxury with promising growth opportunities ahead. The deal is a wonderful outcome of our successful journey with the brand, which began when we collaborated to create TOM FORD Beauty over 15 years ago.

The Ordinary's ingredient-focused product prospered in its heritage markets as well as in new markets evidenced by the brand's very successfully February launch in the Middle East. While Le Labo continued to evolve from strength-to-strength globally, rising 60% organically.

In closing, while we are lowering our outlook for fiscal year 2023, to reflect the deeper pressure in Asia travel retail given its extended recovery and related retail inventory tightening, we are encouraged by the strong momentum in the rest of our business. Looking ahead, we are focused on a strong acceleration of balanced organic sales growth across regions, categories and channels and progressively rebuilding margin.

Indeed, consumer demand is robust for our diverse portfolio of brands in developed and emerging markets globally, evidenced in both organic sales growth and retail sales trends. This drives our confidence in the future.

To our employees, I extend my deepest gratitude for your exceptional dedication to our company and each other amid a difficult external environment. You have demonstrated an unwavering passion to exceed consumer desires around the world with our beautiful portfolio of brands.

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 organic net sales declined 8% and earnings per share decreased 75% to $0.47. As Fabrizio mentioned, despite continued challenges in our Asia travel retail business, we experienced accelerated growth across our markets globally, with nearly every market expanding as they progress through various stages of recovery from the pandemic.

From a geographic standpoint, organic net sales in our Asia-Pacific region rose 7% with nearly all markets contributing, led by Hong Kong which doubled in size partially due to the return of Chinese travelers, while Australia grew nearly 50%, and Japan rose double-digits. Mainland China also returned to growth this quarter showing positive signs of recovery in February and March, after the pressure from the increase in COVID cases and slower retail traffic in January.

Throughout the region, markets continued to progress in recovery with fewer COVID restrictions compared to last year, leading to growth in all product categories, with the return of brick-and-mortar traffic. Strong double-digit growth from the regions emerging markets contributed one point to Asia-Pacific's growth.

Organic net sales in the Americas rose 6% lead by the United States. In North America, organic net sales grew mid-single-digits reflecting growth in skin care, Makeup, and fragrance. The Ordinary, M·A·C, and Le Labo excelled each rising double-digits in the quarter. Specialty multi growth including distribution expansion drove the increase in brick-and-mortar along with contributions from freestanding stores and department stores.

In Latin America, organic net sales grew double-digits benefiting from growth in every country and in all product categories, with particular strength in Makeup and fragrance. Organic net sales in our Europe, the Middle East and Africa region fell 24% driven entirely by the travel retail business. Our global travel retail sales continue to be pressured by our Asia travel retail business which Fabrizio described. Outside of Asia, we experienced double-digit sales growth in travel retail as international travel increased throughout Europe and the Americas.

The overall performance in travel retail more than offset the organic net sales growth from the rest of the EMEA region where we drove strong performance in all product categories, and from nearly all channels of distribution. Organic net sales rose across both developed and emerging markets led by the United Kingdom, Germany, France, Italy and Turkey as the progression to recovery continued and tourism resumed.

From a category standpoint, fragrance continued its momentum as organic net sales rose 14%. Strong demand for our products and high-touch services as well as innovation fueled growth across every geographic region. TOM FORD Beauty, Le Labo and Estée Lauder each grew double-digits in the quarter. Organic net sales in Hair Care grew 3% and sales were virtually flat in Makeup.

Makeup growth in the Americas, Asia-Pacific and the markets in EMEA, excluding travel retail, was offset by the pressures in Asia travel retail. M·A·C and Clinique continued to drive makeup recovery and double-digit growth from TOM FORD Beauty and Too Faced also contributed. Nearly every market in Asia-Pacific realized strong growth in the category partially offset by softness in Mainland China.

Organic net sales in skin care fell 17% due to the pressures affecting Asia travel retail. The declines from La Mer and Estée Lauder were partially offset by standout performance from The Ordinary and M·A·C The Ordinary benefited from strong growth in specialty multichannel particularly in the US as well as from geographic expansion into India and the Middle East this year, as well as the success of new product innovation. The launch of M·A·C's Hyper Real product franchise expanded its offerings in the category and contributed to growth.

Our gross margin declined 750 basis points compared to last year, largely due to the slower-than-expected recovery in Asia travel retail. This includes obsolescence charges, higher promotional costs and gift sets to drive increased consumption, excess overhead absorption in our plants due to the pull-down of production throughout the year given higher inventory levels and less favorable brand and category mix.

Operating expenses increased 570 basis points as a percent of sales, driven largely by the reduction in sales. We continued our investments to support recovery markets in areas such as advertising, promotional activities and innovation, which collectively increased 230 basis points compared to last year.

Operating income declined 66% to $316 million and our operating margin contracted 1,320 basis points to 8.4% in the quarter. Despite the volatility that has significantly impacted net sales, we have sustained certain of our strategic investments to support recovery in select markets and the strengthening of our multiple engines of growth.

We've continued to invest in areas imperative to long-term profitable growth, including innovation, advertising, the growth of our emerging markets, the geographic expansion of some of our brands, production capacity and consumer engagement.

Our effective tax rate for the quarter was 43.1% compared to 21.3% last year. The increase in rate was primarily due to the expected further reduction in earnings related to our travel retail business for fiscal 2023. Diluted EPS of $0.47 decreased 75% compared to last year. This was at the high end of our outlook despite the significantly higher than normal tax rate. The impact from foreign currency translation and foreign currency transactions in key travel retail locations negatively impacted diluted EPS by 1% and 3% respectively.

For the nine months, we generated $1 billion in net cash flows from operating activities compared to $2 billion last year. The decline from last year reflects lower net income, partially offset by lower working capital. We invested

$652 million in capital expenditures and we returned $945 million in cash to stockholders through both dividends and share repurchases.

On April 28, we were pleased to complete the acquisition of the TOM FORD brand. The amounts paid at closing of approximately $2.25 billion were funded through a combination of cash including the proceeds from the issuance of commercial paper, and $250 million received from one of the licensees of the brand Marcolin. An additional aggregate amount of $300 million in deferred payments at 5% interest per annum to the sellers becomes due from the company beginning in July 2025. We estimate an EPS dilution to the full year of approximately $0.03 to $0.04.

And now turning to our outlook for fiscal 2023. Clearly, this fiscal year has proven to be a perfect storm of higher than anticipated volatility from both global, external headwinds and uncertainty surrounding the timing and pace of recovery from the COVID-19 pandemic, primarily in China and Asia travel retail. In August, we expected a gradual improvement throughout the first half of the fiscal year as markets and international travel began to recover from the impacts of COVID restrictions; however, the actual impacts to our business in Asia travel retail and China to a lesser extent have been far greater than we anticipated given the prolonged challenges from the pandemic including a slower-than-expected recovery of traffic and sales conversion in prestige beauty in these markets.

Further compounding this pressure is the tightening of inventory by retailers in Hainan. We now expect that a far more gradual return to normal sales growth in Asia travel retail is likely to persist into the first half of fiscal 2024. In addition, higher inflation and currency volatility as well as promotions in certain markets to alleviate high stock levels more than offset our price increases and further pressured our business margins.

In spite of the volatility in Asia travel retail that delayed the recovery relative to what we had expected as well as the macro pressures from inflation and currency, we have been encouraged by the faster than anticipated improvement across many of our markets globally as they progressed through various stages of recovery from the pandemic. While we are lowering our full year outlook, to reflect continued decline in net sales in Asia travel retail, including the tightening of inventory by certain retailers, we plan to invest in-markets where traffic and consumption are returning and expect to return to overall net sales growth in the fourth quarter.

This reflects double-digit sales growth in the Asia-Pacific region, including Mainland China, as well as in EMEA, excluding Asia travel retail. The Americas is planned to grow single-digits. Currency also continues to pressure margins relative to prior year.

As Fabrizio mentioned, we are certainly not satisfied with our results this fiscal year and will address plans to progressively rebuild the margin accretive areas of our business beyond this fiscal year from the current year's level. When full recovery does occur from the pandemic, we do expect the return to healthy growth of our Asia travel retail business and in our related skin care category supported by a more normalized level of investment in selling, advertising and promotional activities reflective of the increased brick-and-mortar traffic.

With these assumptions as our backdrop, and using March 31 spot rates of 1.09 for the euro, 1.239 for the pound, 6.872 for the Chinese yuan, and 12.97 for the Korean yuan, we now forecast organic net sales for the full year to decline 7% to 5%. Currency translation is expected to dilute reported sales growth for the full fiscal year by four percentage points and we anticipate an additional one point of dilution from the impact of certain foreign currency transactions in key international travel retail locations.

The impact of sales from certain designer license exits are expected to dilute reported growth by approximately one point. Full year operating margin is forecasted to be approximately 11.1%, an 860-basis-point contraction from the prior-year period, primarily due to the disruptions from COVID restrictions that not only impacted sales in Asia travel retail in Mainland China, but also resulted in increased obsolescence charges, discounts and promotional expenses.

Foreign currency impacts and the strategic investments I mentioned previously are also expected to pressure margin. We now expect our full year effective tax rate to be approximately 27%, reflecting the change in our estimated geographical mix of earnings for the balance of the year.

Diluted EPS is expected to range between $3.29 and $3.39 before restructuring and other charges, and includes the expected impact of the TOM FORD acquisition I mentioned previously. This includes approximately $0.26 of dilution from currency translation. In constant currency we expect EPS to decline approximately 51% which includes a negative impact from foreign currency transactions in key international travel retail locations of approximately four percentage points.

While this has been a challenging and disappointing year, navigating through many uncertainties, the strength we are seeing in many of our recovery markets gives us tremendous optimism for the future. Our long-term fundamentals and strategy remain intact as does our confidence in the long-term growth opportunities for global prestige beauty and our brands with the investments we've made to sustain long-term profitable growth.

On behalf of Fabrizio and the Estée Lauder company's leadership team, we want to extend our immense gratitude to all of our employees around the world. We recognize that this has been an incredibly challenging year for you, and we want to thank you for your extraordinary efforts, your dedication and commitment to the company and your resilience as we continue together on our path to recovery.

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

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] Our first question today comes from Dara Mohsenian from Morgan Stanley. Please go ahead with your question.

Dara Mohsenian
Analyst, Morgan Stanley & Co. LLC

Q

Hey, good morning, guys. So I just wanted to touch on the three areas of weakness versus prior guidance in terms of Hainan, Korea and China. Taking a step back, the magnitude of changes to your guidance stemming from the areas is obviously severe and it also looks more onerous than peers. So just as you take a step back and look at the weakness versus what was expected, how much of that is, do you think, more just the timing of recovery in beauty at the consumer level coming out of COVID or retailer inventory issues which, in theory, are more shorter term, versus the potential for the longer-term recovery in the beauty category is lower in these areas? So really just perspective on lower long-term sales potential versus more short-term issues.

And I know it's hard to speak relative to peer results and guidance but it does look like the issues are more severe for Estée versus peers. So just any perspective on Estée's market share or company performance in these areas would also be helpful. Thanks.

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

A

Okay. Dara, so thank you for the question. In Hainan, as we said in the prepared remarks, we are starting to see, during the quarter, passenger traffic come back in Hainan and that's been very positive. As Fabrizio mentioned in his prepared remarks, we had a group that was in Hainan a few weeks back and saw quite a bit of activity. So we are very encouraged. And, in fact, Hainan actually reflected positive retail sales in the third quarter. So this is the first quarter – the Hainan performance for us has been up and down all year and some of the swings have been quite severe but we did see a progression to positive retail sales.

I think the thing that gives us more comfort now on a more continuous, steady progression of recovery is the fact that the COVID restrictions have been lifted. And so what we were experiencing before with our travel retail business is the volatility related to some of the COVID restrictions and the flow of traffic in travel and people's comfort with travel. So that gives us more comfort that we're going to see a recovery.

In terms of our experience as it relates to the business and why it has been as significant as it is is because when you look back at the beginning of this year, we had very strong momentum coming into the year in travel retail in Hainan in particular. Our July results were up strong double-digit. Then Hainan went into closure, and that extended for longer than we had anticipated. But given the results we had seen in July and actually in some previous months, we had expected that that recovery would happen faster once the lockdown was lifted and that didn't happen, and our retailers also expected that recovery.

We ended up with more inventory in the trade than what was needed, basically, for the level of sales that were being done in Hainan. So our pullback in inventory right now, given the pace of recovery that we're seeing, again, we're very encouraged, but the retail inventory needs to come down, and therefore, we are pulling back on our shipments.

Korea, we talked about in the last call in terms of what happened in Korea. We basically have a change in the rollback of COVID-19-related supportive measures with Korean duty-free operators and that too was pretty sudden in the third quarter. The expectation is that we will see travelers come back to Korea and come back to duty-free shopping in Korea, but that has not happened yet. Korea benefits from having a lot of organized tour business from Chinese traveling consumers, and that has been slower to come back, so that certainly is pressuring our fourth quarter as well. And again, it's been difficult to predict the timing of all of this recovery, but we do know the recovery is happening.

So we don't believe there is an issue at all with prestige beauty, when we look at the recovery we're seeing in the Americas, in other Asia-Pac regions, in EMEA, we see very strong recovery of prestige beauty and actually are seeing an acceleration of Fragrance, Makeup, and Skin Care. So it really is based on what we're seeing in other regions given they're further along in the recovery relative to some of the regions that you asked about.

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

And, Dara, I just want to add that so as Tracey explained in TR, it's really an issue of inventories versus pace of recovery. Another proof of that is that our retail in travel retail is so much stronger than our net, so you have a minus 45% in quarter three versus a single-digit decline in retail. So there is a lot of inventory absorption, which is going on with the recovery, and a lot of the speed of this absorption will depend on the speed of the recovery that we have in front of us. We are estimating that given the trend in this period, in the quarter four, retail will go positive, and then the absorption will continue to improve over time and definitely continue in Q1 of next fiscal year.

On other encouraging point, I want to touch briefly on China that you asked also about. So in China we returned to organic growth which is excellent news, and we expect double-digit growth in quarter four in China mainland. We accelerated market share gains for the second quarter in a row and I want to underline when – the problem with the volatility in China started in the period where Shanghai got closed and we were particularly affected by the close of Shanghai, at that moment during these three months of closure we lost significant market share.

Now, the good news, we're now essentially made up for the lost market share from the lockdowns. We are back in-line with the total market share, we expect in Q4 because also the low base to get into a positive market share growth versus also the pre-lockdown period which is extraordinary. We said we would have tried to recover this in one year and we will do that and better than that.

The other important thing to underline that linked to this TR issue there is the skin care issue, obviously, because there is a high percentage of skin care which is a very profitable category for us and I want to also underline that ex-TR skin care is growing globally plus 6%, so we are growing skin care. We will grow skin care. We are growing skin care in China mainland, and retail is growing ahead of the market, we are building market share in quarter three, we expect to do even more in quarter four and Estée Lauder, La Mer are driving this growth, with La Mer growing double-digit at retail in the quarter in China, and Lauder single-digit.

So the last part of your question is our different situation versus peers. I would say that if you look at the business overall, the answer of the difference is in the level of stocks, in the TR and the volatility and the fact that we are bigger and historically more exposed to this strong accretive channel that in a moment of crisis obviously resulted into a bigger negative.

Operator: And our next question comes from Chris Carey from Wells Fargo. Please go ahead with your question.

Chris Carey
Analyst, Wells Fargo Securities LLC

Q

Hi. Good morning, everyone.

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

A

Good morning.

Chris Carey
Analyst, Wells Fargo Securities LLC

Q

So I guess just digesting these results and taking Dara's question in consideration, I guess it's like APAC and Americas actually exceeded expectations, which in a way probably helps combat this dynamic of it's a category or a brand or a structural issue. I think it's also probably not fully understood that L'Oréal and others have much smaller travel retail businesses or maybe it is understood but I guess the question is clearly, you have created a unique business where you're much bigger in travel retail than many of your peers and this has been something that's been growing over the last several years and obviously that created a lot of great tailwinds during the up move but it's just created an enormous amount of volatility and I think also, a lack of visibility as we've come into this kind of down trend. Right?

And I hear you on rebuilding demand building activities and leaning into the market but I just wonder does this market need to reset lower before you can really talk about stabilization or are we really just, we have one more quarter or two of issues and we're really rebuilding from there, right? And I appreciate Korea and China all have different dynamics but I think the overall context here is certainly that the travel retail business is creating a ton of volatility for your business.

And then just related to that, and I apologize, but the fiscal Q4 guidance range is quite wide and I think that maybe speaks to visibility. Can you maybe just talk about how you might be approaching the concept of guidance given the lack of visibility so that perhaps we can maybe avoid some of these resets, so thank you so much for any of that perspective. Very much appreciated.

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

A

Okay. Let me start. Thank you for the question, and our point of view is that, as you said, this is kind of a reset, but then after this reset, travel retail will remain a large, very important channel because it is an important channel also for consumer acquisition and is a growing channel, and so to grow global market share, to be strong in travel retail, will remain important, also in the case of Asia travel retail and China travel retail is very important for coverage, because in many emerging markets, for sure in China the coverage of small cities is possible only by online and via the people traveling, because the brick-and-mortars are not there, are only in a part of the city which is the reason of high productivity in China. So travel retail is also a great opportunity for discovering product, for the physical experience, for interacting with our product, so and is a very luxury channel, meaning the experience of luxury is very high.

So the issue with travel retail has been really that during the pandemic, the volatility of travel and the interest and the possibility of travel is so much impacted by regulation change, the pandemic up and downs, et cetera, obviously in a moment of a pandemic moment, travel retail has been more difficult to predict and has been more volatile to anticipate, but in term of the positives of the channel in the long term, for brand-building, for trial building, for being an accretive and positive profitable channel in the long term, remains intact.

And so we believe that out of the pandemic, this will remain important channel. Now, will this be more balanced growth? Absolutely. We have a plan and an interest in balancing our growth and balancing the proportion between all our business segments, and we will continue to do that.

The other thing I want to underline that the high inventory, as Tracey explained what was the sequencing of event and the reason why our retailers and us went for higher inventories at the beginning of the fiscal year and then we encountered this issue of this lower recovery than anticipated, and remember the important thing, and in a slower recovery, also the retailers want less stock, and so the replenishment get affected, as Tracey explained.

So this situation is also impacted by our relatively long supply chain where you need to order and then after months you receive it. The relatively long supply chain has an impact on the fact that the retailers, when they decide their stock for us, which is not true for every one of our peers, they need to make a bet several months before when they receive the products and that issue obviously in a middle of the worst volatility we ever experienced has been difficult for our retailers and for us to estimate with such an anticipation.

So we are acting on this. All the investment we have done which [ph] in part are (00:46:13) visible in our short-term profitability pressure like the manufacturing that we call Sakura in Japan, that will have the new distribution center in Mainland China and in the near future in Hainan, [ph] and so it's all (00:46:29) designed this investment to shorten the lead time.

Now the shortening of the lead time will also reduce the risk of being wrong in the choices in volatile moments and so assuming that a certain amount of volatility will continue, even after the pandemic, we have done investment to reduce our risk and to our ability to manage better in a volatile period.

The other thing is, let's not under evaluate the investment in the R&D center in Shanghai that will increase the speed of innovation, reduce the timelines of innovation as well, and will have another [ph] impact (00:47:08) of better ability to make the right decision [indiscernible] (00:47:10) volatility because faster reactivity, in other words, we built agility, and agility is one of the things that will make our future ability to forecast TR in the correct way.

So in summary, we count on continue having a strong TR business in the future. There is a reset that our retailers in the market are doing for us but after that we will continue to grow in a more balanced way, and with better agility to make the right forecasting.

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

A

So as Fabrizio said, we have made some structural changes to the business that going forward should allow us to manage volatility. Hopefully, we won't see the level of volatility that we've seen certainly over the past year, but we will have more agility in our operations.

To your question on the fourth quarter and what's in our implied guidance as it relates to travel retail, coming off of the trends that we're seeing in March, the progressive trends that we've seen through the third quarter, we're expecting that our retail sales in travel retail will be up double-digit and our net sales are down double-digit, down double-digit more than our retails are up. So, again, this is another quarter of trying to whittle down the inventory that's in the trade, hence the impact that you see in the fourth quarter, and as Fabrizio said, much of that being our very strong skin care business, so we do expect as I said in my prepared remarks that some of this will bleed into the first quarter, and perhaps a little bit into the second quarter but get progressively better until we get to the inventory levels that both we and our customers want in the trade.

We are working with and partnering with our customers on programs, also now that traffic is back in airports, we are investing in advertising in airports. We are reemploying some of the sales staff that was not there when the airports were empty, and we are working with our brands on great programs and promotions for our customers as they return to airports, so our travel retail team has been quite busy working with our retailers to recapture the growth that we're now seeing in particular in Hainan and hopefully soon in Korea as well.

Operator: Our next question comes from Rupesh Parikh from Oppenheimer. Please go ahead with your question.

Rupesh Parikh
Analyst, Oppenheimer & Co., Inc.

Q

Good morning and thanks for taking my question. So obviously, this year you had to step back in your earnings power. I'm trying to get a sense in terms of how you guys think about the achievability of getting back to the 20% operating margins and earnings north of 7%. So I'm just trying to better understand just how you guys are thinking about the profit recovery.

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

A

So thank you for the question. As I said in the prepared remarks, we expect off of this year, which obviously has been a big setback year for the reasons that we've spoken about, our highest margin category in a very high-margin channel being pressured. We do expect a progressive recovery in margin, but that does mean not back to 19% in fiscal 2024, and so we are taking cost actions as we always do. We certainly have cost control measures in place as it relates to areas like head count, consulting expenses, other expenses as well, and we are in the process now of finalizing our budgets for fiscal 2024 and certainly will have better information for you in terms of what that margin progression looks like for fiscal 2024 in our August call. But it certainly will be more than 50 basis points of margin expansion off of this level but certainly not to the 19% level.

Operator: And our next question comes from Oliver Chen from TD Cowen. Please go ahead with your question.

Oliver Chen
Analyst, TD Cowen

Q

Hi, thanks, Fabrizio and Tracey. I was curious about what you're most concerned about for ongoing risk related to your guidance as we've seen, and you called out promos and volatility as well as there are uncontrollable factors about – regarding the inventory and the channel. And as we think more broadly, you called out previously losing share in independent brands and opportunities in loyalty as well as customer data programs. Love your take on how that may be an opportunity going forward as well. Thank you.

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

A

Yeah, in terms of in the prepared remarks, Oliver, we talked about areas that we are gaining share. and so I think we are seeing strong momentum in some of the recovery markets that are gaining share, inclusive of China. And China is a real indicator for what we can expect when some of the areas that have been suppressed this year, like travel retail, Hainan and Korea, when Chinese traveling consumers return to Korea, so I think those things are quite positive. We have strong innovation programs as well to support our growth for certainly next year as well.

And the fact – again, the biggest volatility that we've seen this year has been in some of the COVID restrictions in certain markets that have been lifted, and so now it's a matter of the timing and pace of that recovery. We feel a bit better but I'm a bit cautious, obviously given what we've experienced this year, but recognizing that that trigger is one that really has created as much volatility for the reasons that we have already spoken about. We are feeling a bit better.

There will be still volatility certainly in the fourth quarter and there will be volatility next year, but we have always been a company that's been relatively good at managing volatility this year, given the severity of it and the severity in the channel of operation that [ph] it happened in (00:54:06) has caused us to have these results. But rest assured, myself, Fabrizio and the entire management team are diligently working on recovering our profitability and certainly recovering growth. And our brands continue to be very strong with consumers.

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

Yeah. And just to add just for clarity, because Tracey explained everything, but I want to clarify. Our retail global is growing, and there are very – in our key markets, we're also growing market share. I already said it but want to repeat it, the market share growth in China mainland is really encouraging because we already made up what was lost in the Shanghai closure period. The market share growth in EMEA is very strong. The market share growth in many emerging markets and emerging markets in total is very strong. I said it before, our emerging markets are growing 17%. The market is growing by less than 17% in some of emerging markets. In North America we are growing again although not in the US, not yet market share, but we are growing market shares in Latin America and many other places of the world, so our demand is very strong.

And the other thing that I mentioned already the several brands which are doing well and are very encouraging but I believe, in this quarter, the key attention is on skin care. And on skin care, we have La Mer growing, Estée Lauder doing well also in China. We have double-digit Skin Care growth in Europe and Latin America. We have single-digit skin care growth in US but again back to growth. We have an exciting innovation plan, as Tracey said, but let me give you a few examples.

We just launched Clinique Moisture Surge 100H [ph] SPC (00:55:59) , so new sun protection thing, and then The Ordinary Multi-Peptide Eye Serum. We had launched The Ordinary in India and the Middle East with extraordinary results. M·A·C Hyper Real, mainly the skin care M·A·C and the skin care Bobbi Brown are very strong, so all the skin care makeup brands is a new trends that we are leveraging very well with good success and importantly, we have our hero upgrades in the high luxury area, so La Mer Soft Cream, Re-Nutriv Ultimate Diamond which are going out, they are very important for the Asia trends where luxury skin care is growing more than skin care in general on average, so a lot of signs of strength in the fundamentals of consumption, of demand, of desirability of our brands are very evident.

We are going through a inventory issue. And with the profit pressure created by this high inventory issue, and we are going to focus on sell-out, retail acceleration and profit rebuilding as the next steps.

Operator: And we have time for one additional question. This question comes from Lauren Lieberman from Barclays. Please go ahead with your question.

Lauren R. Lieberman
Analyst, Barclays Capital, Inc.
Q

Great. Thanks. Good morning. So one thing that hasn't come up is just visibility into what's in "inventory but outside of traditional retail". And we know that Fabrizio has spoken many times over the years about travel corridors shifting and particularly now when we think about the further development of Asia travel retail broadly. But there's also shoppers that move around and buy in bulk. And there's been a lot of conversation in the industry about visibility and controls around that practice, and the degree to which that was a huge driver of Korea travel retail during these lighter regulations, let's call it, and supportive measures.

So I heard your comments on encouraging progression on share and retail sales turning positive in Hainan and so on, but I was curious about what you're doing, I guess, A visibility into kind of untracked retail if you will, B anything that you were thinking about changing controls-wise to sort of have a better read on the quality of sales going out the door from some of your travel retail channels. And then finally, kind of putting a cherry on all of it is do you expect the inventory drawdown dynamic to be completed in the fourth quarter? Or should we think about there still being a mismatch between sell-in being down and sell-through into the first quarter of 2024? Thanks.

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

So, Lauren, let me take that last one. Yes, we do expect that our sales will be down again in the first quarter and pickup in the second quarter and so that's the cadence that we're seeing right now. Again, much depends on retail sales and again, as we said, we're encouraged by how retail sales have picked up in Hainan, not as much in Korea at the moment, but we remain encouraged that that will happen as well. So the pace of retail which has been slower, again, than we expected this year, will determine how quickly we resume shipments.

We do have some very exciting new products that we do hope that we can actually ship them in the first and second quarter but again, with the activities that we have going on with our travel retail partners I believe that we'll see a continued acceleration of retail like we started to see in this quarter.

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

Yeah, and Lauren, to answer the first part of your question, we sell to our authorized retail customer. We do not sell directly to [indiscernible] (01:00:14); however, as you alluded to, during COVID, there have been some temporary government policies, for example, in Korea, were put in place to support the travel businesses and the travel retailers in these very tough moments where they risk to go bankrupt because everything was closed, So now, you are right, there is no complete visibility on that part. There was no complete visibility on that part, what they were doing in the moment when the policies were allowing this.

Now these policies are changing. There is an interest of the industry in general and our retailers which is the most important factors in this. There is an interest in going back to regular travelers as regular travelers go because, by the way, this is a more profitable and more interesting business for them as well. So now that airport traffic is gradually recovering, we expect a re-balancing of the total market and because of this we expect an increased visibility on all of these areas and we are also putting extra focus as Tracey explained before on retail sell-out to regular travellers. With new investment, we are rebuilding the people, the staff in the airports, we are rebuilding the advertising there, all what Tracey already established, that with our interest is to support our retailers in this transition, and we are really pushing at building this transition at the maximum speed, and so there's been during COVID less visibility. There will be more visibility in the future and more control.

Operator: And ladies and gentlemen, that will conclude today's question-and-answer session as well as today's presentation. 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 877-344-7529 and use passcode 8161271. That concludes today's Estée Lauder conference call. I'd like to thank you for your participation and wish you all a good day.