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EL - Q1 2016 Estee Lauder Companies Inc Earnings Call

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OVERVIEW:

Co. reported 1Q16 net sales of \$2.83b, net earnings of \$309.3m and diluted EPS of \$0.82. Expects FY16 constant currency sales growth, adjusting for impact of sales shift related to last year's SMI rollout and including 50 BP from acquisitions, to be 6-8% and diluted EPS to be \$3.10-3.17. Expects 2Q16 constant currency sales growth to be 6-7% and diluted EPS to be \$1.04-1.08.



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PRESENTATION

Operator

Good day, everyone, and welcome to The Estee Lauder Companies fiscal 2016 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 Vice President of Investor Relations, Mr. Dennis D'Andrea. Please go ahead, sir.

Dennis D'Andrea - *The Estee Lauder Companies Inc. - VP of IR*

Good morning, everyone. On today's call are Fabrizio Freda, President and Chief Executive Officer; and Tracy 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 will find factors that could cause actual results to differ materially from these forward-looking statements.

To facilitate the discussion of our underlying business, our first-quarter and full-year comparisons have been adjusted for the impact of the prior-year implementation of our strategic modernization initiative. You can find reconciliations between GAAP and non-GAAP figures in our press release and on the investor relations section of our website.

I will turn the call over to Fabrizio now.



Fabrizio Freda - *The Estee Lauder Companies Inc. - President and CEO*

Thank you, Dennis, and good morning, everyone. Our fiscal 2015 year is off to a good start. In the first quarter, we delivered excellent financial results, generating strong adjusted constant currency sales growth of 8%, and earnings per share growth of 16%.

Our winning strategy and business model are at the core of our success. Our strengths came from our broad portfolio of prestige beauty brands, which is diversified by category, geography, and channel. With multiple growth engines across all these areas, we can accelerate the ones that working well, and reallocate resources as market dynamics change. These factors continue to make us more resilient, and position us for long-term sustainable results.

We are pleased to operate in the global prestige beauty industry, which is growing fast, even during volatile times. Within the industry, makeup is today the fastest-growing category, and we are the global leader in prestige makeup. Once again, our luxury and makeup brands, we are the best performers, fueled by their intrinsic brand equity, strong launches, and solid basic business. Worth noting are Jo Malone London, Tom Ford, and La Mer in the luxury tier. M.A.C. and Smashbox were standouts in makeup, the category where consumers are increasingly spending more of their beauty dollars.

We are especially pleased with our results, in light of the softer retail climate in China and Hong Kong, the MERS impact in Korea, a sharp decline of Russian and Brazilian travelers, and significant and higher-than-anticipated currency headwinds.

From a geographic standpoint, we delivered a stellar performance in Europe, the Middle East, and Africa. Growth in the region was helped by an influx of travelers attracted by the weak Euro. Our midsize brands, notably Tom Ford and Smashbox, had the fastest growth, benefiting from strong retail trends, well-received launches, and new doors.

Our growth at retail was robust and we gained share in prestige beauty in several established markets, including the UK, France, Germany, and Italy. We also had double-digit growth at retail in nearly all EMEA emerging markets. The online specialty multichannels were vibrant in the regions. Sales in Boots and Douglas were particularly strong. Freestanding stores are a clear component of our expansion in the region, and we added nine new locations for MAC and three for Bobbi Brown during the quarter.

We continued to expand and improve our business in travel retail. Our sales at retail rose 7%, with most of our brands and markets growing, despite currency headwinds affecting travel from a number of key consumer groups, including Japanese, Russians, and Brazilians. In line with our strategy to introduce more brands and expand our reach in the channel, we launched Darphin and GLAMGLOW, and opened nearly 100 new counters for our other brands. The forecast for international passenger traffic growth is healthy, 7% for the fiscal 2016, which we believe will help improve our business in the coming months.

However, our net sales declined in travel retail, due in part to a tough comparison with the previous year first-quarter. We also experienced a weaker business and significantly lower trade stock in Korea as a result of MERS concerns. Total air travel visitors to Korea dropped about 40% from June through August and continued to be weak in September, even though there were no new cases reported. We expect travel to Korea to improve as fears of MERS subside.

In North America, all of our brands grew sales. Makeup continued to be the strongest contributor to growth, up high-single-digits. Specialty multi remains one of the fastest-growing channels, rising double digits for the quarter. Four of our brands opened new doors in Blue Mercury, and we had strong sales growth in Sephora.

We plan to further broaden our presence in specialty-multi. Clinique continues to selectively expand in Ulta, and Estee Lauder brand is on track to launch its new Estee Edit collection of makeup and skin care products in March in approximately 250 Sephora stores and online.

In Asia Pacific, Australia, and Japan, we are strong, and Korea had another positive quarter. In Australia, a weaker currency drove greater local consumption. Distribution is expanding for prestige beauty, and online is growing strongly. Our sales were solid across all channels, and we gained shares in department stores.

Our sales in Japan rose high-single-digits in the quarter, as the lower yen stimulated greater tourist activity, especially from Chinese. Local demand for prestige beauty was solid.

Our business in Korea continues to improve and strengthen. Our net sales grew mid-single-digits, and our sales growth at retail exceeded prestige beauty growth, as our brands successfully competed with local brands and leveraged the new Korean trends. Korea is a trend-setting beauty market that is known for both rapid innovation and high-quality products. One element of our strategy is to build our presence in the local market to participate in the popularity of Korean brands.

Last week, we announced we are making an investment in the innovative Korean skin care company behind the brands Dr. Jart and Do The Right Thing. This is a strategic opportunity for us to partner with high-growth, distinctive brands that combine Korean innovation with a global sensibility.

The investment give us, our Company, an opportunity to support Dr. Jart's development and continued success around the world. We look forward to working with the company's entrepreneurial founder as he continues to grow the brands. For us, this investment creates another pillar in our long-term growth strategy for Asia.

In China, most of our brands have had higher sales, many rising double-digits, fueled in part by the increasing demand for makeup. We are accelerating expansion of our makeup brands to leverage this market trend. M.A.C. grew 25% at retail in the quarter, and this year is planning to open more doors in more cities. Tom Ford opened its first department store kind counter in China, with expectation to add several more during the fiscal year.

These gains came amid a backdrop and a softer retail environment in China, caused by many factors, including the stock market volatility there. The Company's retail results sales in China were overall flat, with lower traffic in brick-and-mortar stores offset by higher volume online, where our sales nearly doubled.

Our net sales declined 3% due to lower sales of the Estee Lauder brand, which had a tough comparison with the previous year, when its a major new introduction occurred on July 1; and this year, New Dimension launched in mid-September. However, the brand remains the largest prestige beauty brand in China in its distribution.

Although we are seeing Chinese consumers spending less at home, they are traveling more and purchasing abroad, particularly in Japan and large European cities. For example, La Mer and Jo Malone benefited from the huge rise in Chinese tourists in Paris, which helped drive sales growth of more than 50% for these brands in France.

While China's economic expansion is moderating, it remains healthy, and we are bullish on our long-term prospects. We expect to grow high-single-digits this year, in line with the industry. Hong Kong continues to be affected by sharp declines in Chinese travelers and weak local consumption. We are the largest prestige beauty company in Hong Kong, and Estee Lauder is the largest brand. But our sales, at both net and retail, declined in the quarter.

Despite this climate, several of our brands grew, including M.A.C., Tom Ford, Jo Malone. We are pursuing opportunities to strengthen our business with local consumers in Hong Kong. However, we do not anticipate a significant pickup in consumption in the near term.

Another major growth engine is our e-commerce business. Online sales rose 26% with excellent growth from brands, retailers, and third-party sites, with particular strength in EMEA and APAC. Mobile sales were vibrant, and now account for more than one-third of our global online sales, and more than 50% of online sales in the UK. Overall, orders increased, and conversion rose strongly. We continue to expand our online availability and opened 100 new digital brand locations globally, mainly in international markets on both our sites and retailer sites.

For example, in China, Tmall continues to be a strong contributor to our online sales. And Bobbi Brown launched on the platform in September, bringing the number of brands we sell on Tmall to five.



We also progressed on our strategic initiatives. Estee Lauder and Clinique are both launching new products across categories, and making good progress on their turnaround plans. Estee Lauder grew in several regions, and gained shares in EMEA. During the quarter, the brand introduced New Dimension, reinforcing its leadership in serums. It launched in the US and the UK in July, and in the rest of its international markets starting mid-September. The line is performing to expectation, and is proving to be a terrific recruitment tool in Asia.

In makeup, the brand's new Pure Color Envy Liquid Lip Potion has done really well globally. Clinique's Face Forward campaign has strengthened the brand's attraction to younger consumers and generated extensive editorial coverage. The campaign has helped improve sales of its 3-Steps franchise in North America, the UK, and Asia-Pacific. Clinique also launched a digital editorial lifestyle platform, called The Wink, highlighting emerging trends, global influencers, wellness articles, travel, and beauty information; essentially, the people and the ideas that inspire the world of Clinique. This platform is intended to help Clinique strengthen its relationship with current consumers, and recruit new ones.

Our recent and upcoming launch activity is strong across all categories and brands, and we have an excellent selection of gifts for the holiday season. Let me give you a few examples. In skin care, La Mer introduced the Renewal Oil, the first oil formula for the brand; and Genaissance Serum Essence, which builds on La Mer's Miracle Broth technology at an uber-luxury price point. Clinique launched Sculptwear Serum, and Smart Moisturizers, and Origins, new Original Skin Rose Clay Mask strengthened its leadership in prestige masks.

Several brands have developed new foundations, a high loyalty product. Smashbox BB Water, a makeup with very high light texture, is off to a great start. M.A.C. is launching Studio Waterweight SPF 30, a gel serum formula; and also Matchmaster cushion compact, the first of its kind for the brand. Building on the success of Beyond Perfecting Foundation and Concealer, Clinique recently expanded the franchise with a powder foundation.

We have a full slate of exciting new fragrances in time for the holidays, including the Michael Kors Gold Collection, Tory Burch Absolu, Donna Karan Liquid Cashmere White and Black, and Jo Malone's Mimosa & Cardamom. Estee Lauder leveraged the excitement of its Modern Muse Le Rouge launch by live-streaming the event on two popular social media platforms, Snapchat and Periscope.

We're pleased with our strong start this quarter. We remain committed to delivering strong constant currency full-year sales growth ahead of the industry, and double-digit EPS growth; even though, as I explained, we expect continued lower growth in some key markets and channels around the world.

Our performance this quarter demonstrates our many strengths, and is proof that by staying focused on our long-term strategy, we can successfully navigate external challenges and market volatility to deliver sustainable and reliable results.

Now I will turn the call over to Tracey.

Tracey Travis - *The Estee Lauder Companies Inc. - EVP and CFO*

Thank you, Fabrizio, and good morning, everyone. First, I will review our fiscal 2016 first-quarter results, and then I will cover our expectations for the second quarter and for the full year. And to clarify our underlying business performance, my commentary on comparisons to the prior year excludes the first-quarter and full-year impact of the acceleration of retailer orders that shifted sales from the first quarter of fiscal 2015 into the fourth quarter of fiscal 2014, related to our roll-out of SMI. The impact of that shift was \$178 million in sales and \$127 million in operating income, equal to approximately \$0.21 per share. Also excluded for the full year is the impact of restructuring and other charges.

Net sales were \$2.83 billion for the first quarter, which was 8% growth in constant currency. Last year's acquisitions contributed 70 basis points of this sales growth. From a geographic standpoint, Europe, the Middle East, and Africa had a standout quarter. Net sales in the region rose 11% in constant currency, with double-digit performance occurring in both Western developed markets as well as emerging markets. Strong local demand for our products as well as increased tourism in Western Europe fueled double-digit increases in major markets such as the UK, France, Germany, Italy, and Spain. We also continued to achieve strong double-digit sales gains in many emerging markets, including the Middle East, Russia, and Turkey.

Our net sales in the travel retail channel declined 7% as we experienced inventory adjustments among retailers in Hong Kong, China, and Korea, as well as anniversary strong shipments prior to the retail slowdown that occurred in October of 2015.

Sales at retail in the quarter were a strong 7%, as Fabrizio mentioned. Net sales in the Americas increased 9% in constant currency. Strong double-digit growth continued in Latin America, led by Brazil and Mexico. North American sales grew mid-single-digits, which reflected double-digit growth in Canada and solid growth in the United States. Sales were strongest in the specialty multi, online, and department store channels, while tourist-driven doors have been meaningfully negatively impacted by the strong dollar.

Net sales in the Asia-Pacific region were flat in constant currency. Australia delivered another quarter of double-digit sales gains. A sharp increase in Chinese tourists, combined with good local demand, drove stronger growth in Japan. And Korea generated mid-single-digit growth. This sales growth was offset by the less favorable trends in greater China, most notably in Hong Kong.

Net sales by product category were led by the 16% constant currency growth in makeup for the quarter. The biggest contribution came from the continued strength of M.A.C., and makeup sales at Tom Ford and Smashbox rose double-digits on brand expansion, new products, and strong same-store growth. Estee Lauder, again, had growth in makeup, including strong demand for its Double Wear franchise.

Sales of fragrance products grows 12% in constant currency. Luxury fragrances continue to drive sales growth, led by double-digit gains from Jo Malone and Tom Ford, and incremental sales from Le Labo and Frederick Malle. The launch of the Michael Kors Gold fragrance collection also contributed to sales.

Haircare sales rose 6% in constant currency, with growth from both Aveda and Bumble and bumble. Aveda launched Shampure Dry Shampoo, and benefited from other recent launches. The brand also delivered strong salon sales in Western Europe. Bumble and bumble continued to generate good growth in the specialty multi and online channels.

Skin care sales declined 1% in constant currency, reflecting the current global industry trend favoring makeup. La Mer, Origins, and Darphin generated solid growth, and the category benefited from the incremental sales from GLAMGLOW. These increases were more than offset by Asia-driven declines at Estee Lauder, which are a large part of the brand's business there; and US department store weakness at Clinique.

Our gross margin of 79.6% was flat with the prior-year quarter. Operating expenses as a percent of sales rose 90 basis points to 63.6%. The primary drivers reflect our strategic priorities. We incurred higher store operations costs from the increase in free-standing retail store openings over the past year. The strategic acquisitions we made in fiscal 2015 added 30 basis points to operating expenses as a percent of sales. Our investment in innovation and product development continues to rise at a faster rate than sales. And these increases were partially offset by reductions from our cost savings initiatives.

As a result, operating income declined 5% to \$453.2 million, and operating margin decreased 90 basis points to 16%. Also affecting our operating margin were lower sales from our high-margin travel retail business. However, our adjusted constant currency operating income increased 8% in the quarter and resulted in flat constant currency operating margin.

Net earnings were \$309.3 million, or 14% above the prior-year quarter in constant currency, primarily reflecting the higher sales and a 350 basis point improvement in our effective tax rate. Diluted EPS of \$0.82 came in above the top end of our expectations due to higher-than-expected sales, continued expense management, and a lower tax rate.

Earnings per share for the quarter included \$0.11 of unfavorable currency translation and approximately \$0.01 of dilution from acquisitions.

Continued progress in our supply chain initiatives and favorable currency translation helped improve inventory days to sell by 13 days to 180 by the end of September. These improvements were partially offset by the inventory build necessary to meet our future sales growth objectives, and the additional inventory from our new brands.



During the quarter, we generated \$8 million in cash flow from operating activities, which reflected normal seasonal higher working capital requirements and inventory to support the holiday selling period. The comparison of our cash flows versus prior year was also unfavorably impacted by the cash received from the accelerated orders in the prior year.

We invested \$90 million in capital expenditures, primarily to support new retail stores and counters. We utilized \$387 million in cash to repurchase approximately 4.7 million shares of our stock, nearly double the amount purchased during last year's first quarter. We also paid \$90 million in dividends to stockholders. Additionally, this morning we announced another 25% increase in our dividend rate.

Let me now turn to our outlook for the second quarter and for the full fiscal year. For the full year, the sales shift related to last year's SMI rollout will impact comparisons to the prior year. I will discuss our expectations adjusting for the impact of the shift. Our forecasted growth rates, both before and after the shift impact, are available in today's earnings release for your reference.

For the full year, we continue to expect sales to grow 6% to 8% in constant currency, including 50 basis points from acquisitions. Currency has become an even greater headwind than previously anticipated, and we now estimate the translation could negatively impact our full-year sales growth by approximately 4% to 5%. Our estimate assumes current spot exchange rates of around 110 for the euro, 153 for the pound, and 121 for the yen for the remainder of the fiscal year.

However, we are still expecting our diluted EPS to be in the range between \$3.10 and \$3.17, including \$0.05 of dilution from EPS -- or from acquisitions. The increased currency headwinds are projected to affect EPS by about \$0.24, \$0.06 more than we projected when we last gave guidance. Our strong first-quarter performance gave us comfort to raise our expected EPS growth to 10% to 12% in constant currency.

Regarding the second quarter, our sales are expected to rise 6% to 7% in constant currency. The translation impact of the stronger dollar could contract growth by approximately 5 to 6 percentage points. Activities behind our key product launches and our holiday programs should help drive sales growth. As we have said before, we manage our business on a full-year basis and for the longer-term; and our spending by quarter can vary, depending on the needs of the business and how the quarter progresses.

At this time, our second-quarter diluted EPS is anticipated to come in between \$1.04 and \$1.08 per share, including approximately \$0.10 per share of adverse currency translation.

As you are aware, the Company has been engaged in a multi-year upgrading and modernization of its systems and processes. In a continuation of these efforts, we are transforming our global technology infrastructure to improve the delivery of internal IT services throughout the organization. We are transitioning from a platform of Company-owned assets to one that is primarily vendor-owned. We will be utilizing a new third-party provider with an enhanced, scalable platform to improve our ability to respond to the demands of the business and leverage more advanced technologies.

We expect to record restructuring and other charges of approximately \$40 million to \$50 million, primarily to write off certain IT assets. Implementation of this initiative will take place throughout calendar years 2016. We expect the transformation to increase operational efficiencies, reduce future IT service and infrastructure costs, and result in additional future savings, freeing up cash that we may reinvest in capabilities and growth opportunities. This initiative will also be return-generating.

We are pleased with our start to the year as we deliver strong sales and earnings growth, and progressed well on many of our growth and efficiency initiatives. And that concludes our prepared remarks.

We will be happy to take your questions at this time.



QUESTIONS AND ANSWERS

Operator

(Operator Instructions). John Faucher, JPMorgan.

John Faucher - JPMorgan - Analyst

Wanted to talk a little bit about the gross margin. And, as you look out over the next couple of years, as you look at your business mix moving to more of a sort of Company-owned store environment, how should we think about the gross margin? Because if you look at this quarter, obviously great top-line growth, but not quite as much leverage there as I think some of us had hoped for. So can you give us a little bit of an outlook in terms of maybe as mix having a bigger impact than what we have currently been modeling? Thanks.

Tracey Travis - The Estee Lauder Companies Inc. - EVP and CFO

Sure. We have different gross margins, depending on the different channels of business. As it relates to our growth in retail, as we grow our retail business or our online business, for that matter, we would expect that gross margin -- that is a benefit to our gross margin from an overall average Company standpoint.

There are other channels and brands that have lower gross margins. So as we have spoken in previous-quarter calls, depending on the mix of our business in any given quarter, you would -- you will see a range of gross profit margin performance and operating margin performance. Which is why we continue to focus on the full year, in terms of the guidance that we give, and you should expect.

Operator

Nik Modi, RBC Capital Markets.

Nik Modi - RBC Capital Markets - Analyst

Actually, two quick questions. Fabrizio, I was wondering if you could give us some thoughts on market share for Estee Lauder and Clinique, just kind of going around some of your largest regions, especially in China.

And then, the second question, just so I can understand this whole IT initiative -- should we be expecting any disruption related to inventory, like we saw with SMI? Or is this completely unrelated? Thanks.

Tracey Travis - The Estee Lauder Companies Inc. - EVP and CFO

Well, I will answer the second question first. Regarding this shift in terms of our IT infrastructure, it is not like the application that we implemented with the SAP initiatives, so -- the SMI initiative. So we will not expect to have an inventory build similar to what you have seen, thankfully, for SMI over the last few years.

Fabrizio Freda - The Estee Lauder Companies Inc. - President and CEO

In terms of market share, as you can imagine, we are growing global market share with net retail sales in the 8% range, and with a market growing at this point from our estimate around 4%. We are really growing strongly global market share. However, in some areas, in Lauder and Clinique, particularly, the market share could be flat or declining.

For example, you asked about Asia. In Asia, Lauder is the clear market leader in Hong Kong and in China, with a softness of these two markets obviously deal with their own market share in Asia of the brand is under pressure. And Clinique, which is the overwhelming market leader in US mid-tier department store, with the lower growth in this channel versus the other channels in the US, also Clinique market share, overall, in that area will be under pressure. But overall, globally, we are doing a very good progress in market share. Again, with the same strategy of a good portfolio by category, and then by channel and by country.

Operator

Caroline Levy, CLSA.

Caroline Levy - CLSA Limited - Analyst

At one point, the Chinese traveler and locals, I think you believe, were about 10% of your business. And with the shifts you have seen in Europe, it sounds like it is attracting more Chinese tourists, but Hong Kong isn't. And I wondered if you could just tell us what you think happened to growth of sales to the Chinese consumer overall. Was it up, or down, or what are your thoughts there?

Fabrizio Freda - The Estee Lauder Companies Inc. - President and CEO

Yes. Our estimate is our sales in China is up, and this continues to be very, very strong, and very solid overall around the world. But, as we explained, where this growth happens is changing. And then, depending of the market share of our brands, in the specific area where the Chinese are going, then it could be a bigger or lower impact. So the fact that there is an issue in Hong Kong at this moment, obviously, that is a negative for our sales to Chinese. Because we are, as a Company, the market leader in Hong Kong.

But, overall, as you said, we are getting great benefits in Europe. And we see good progress in other markets where, like Japan, where the Chinese in this moment are going and buying a lot.

Finally, you see an impact on the US, meaning in the US because of the strong dollars, the amount of purchase is to Chinese consumers has decreased in the last quarters. And, obviously, we have a very high market share in the US, and we have been [penalized] by that trend.

But, all in all, again, we look at the long term. We believe Chinese consumers in mainland and around the world are, and will continue to be, a great source of growth and a great source of business. And we remain completely focused on them, independently from the mix impacts in the short-term. And we have been able to deliver a great growth in the quarter, despite in the quarter a relatively negative mix [in patterns of] Chinese spending.

Operator

Chris Ferrara, Wells Fargo.

Chris Ferrara - Wells Fargo Securities, LLC - Analyst

I wanted to ask about EMEA. And I understand that you had an influx of Chinese shoppers in there. I think you cited that as helping. But if you strip out the travel retail decline, it looks like EMEA, ex- that travel retail decline, was up very substantially -- maybe mid-teens, maybe high-teens. I guess -- let me know if that is wrong. And, if it is not, how sustainable is that in the near term? And do you get a bounce in Asia before you get what could be a slowdown in EMEA from those giant growth rates? Thanks.



Fabrizio Freda - *The Estee Lauder Companies Inc. - President and CEO*

We believe this is a strong trend. We are doing very well in EMEA, and growing market share in many, many of these markets, and we believe we have plans to continue this trend. UK is really booming. In the UK market, the market is growing at 7% in prestige more than mass. We are doing great job in attracting consumers for mass and in growing market share across all channels.

The emerging markets in EMEA, which are a big part of this, we are growing outstandingly. Just our total emerging market growth this quarter was 13%; excluding China, was 31%. So in the EMEA market, we are growing basically one-third of our business on top of what we had, and this is supposed to continue. And we have a very clear plan on that.

So EMEA in total, excluding [TR], by the way, is 23% growth. And so really standing, and there are several reasons why this trends -- I am not sure if the same identical trends of the quarter -- but this good, solid trend is expected to continue.

Tracey Travis - *The Estee Lauder Companies Inc. - EVP and CFO*

And the only thing I will add to that is embedded within our guidance for the balance of the year, this was, to Fabrizio's point, a very, very strong quarter for EMEA. And we do expect that to continue, certainly benefiting from both the tourists, as well as strong execution of our brand programs in the region. A bit moderating for the balance of the year, relative to what we experienced in the first quarter, largely benefiting and -- particularly from some of the shifts in the quarter that happened fairly quickly with the MERS situation, as well as the situation that we referred to in China and people changing their travel plans, in addition to benefiting from the lower currency in Europe.

Operator

Jason English, Goldman Sachs.

Jason English - *Goldman Sachs - Analyst*

Actually, two questions, if I may. First, a simple one: travel retail net sales have fallen short of what you reported retail sales to be by double digits for two consecutive quarters. So given that, do you think we're going to see normalization and reversion of net sales matching retail sales on a go-forward? And do you think this can sort of abate some of that margin headwind?

And secondly, Fabrizio, during your prepared remarks, you made numerous mentions to the distribution build -- new counters, new doors, new stores. Any sense of how much that, in aggregate, is contributing to your growth? Thank you.

Fabrizio Freda - *The Estee Lauder Companies Inc. - President and CEO*

I will start with the second question. It is a contribution to our growth is -- or distribution is 2%. So 2 points of growth are distribution increases in the quarter, which is a continuing verse of what happened last fiscal year.

In terms of the travel retail, what you should expect -- first of all, the traffic increase in travel retail today is about 7%. And so it remains very solid. But the mix of it -- meaning there are less Brazilians, less Russians, and Chinese are going in different places than Hong Kong -- this makes a negative impact in the short-term on conversion; meaning, on the number of travelers that really buy, buy in a big way. Because different populations have different conversion rates.

So again, in this global, complex world, you need to keep in mind mix. Mix has a huge impact. So we believe that, in the future, that mix impact should improve. Because, as you know, there is in the base the turmoil of Hong Kong at the start of October, November, MERS should get out of the base as well, and meaning that the MERS impact should not be there anymore in the future.



And then we specifically, as Estee Lauder Companies, as we are doing every other aspect of the business, we are modifying our portfolio and adjusting and diversify also our travel retail sales, meaning we are building stronger business in EMEA, stronger business in the Americas. We are diversifying our brands. We are launching new brands. We are covering more airports, more Tier 2 airports. So we have continued our strategy of diversification also in travel retail. And we expect this will benefit our trend, and will make us less dependent on short-term mix impacts in the travel retail evolution.

Operator

Olivia Tong, Bank of America.

Olivia Tong - *BofA Merrill Lynch - Analyst*

Obviously, some of your Paris-based friends had some pretty negative commentary overall, particularly in travel retail. So can you just give us an update in terms of inter-quarter trends, if you saw any change through the quarter or through October so far? And then, just update us on your assumption in industry growth for this year. Is it still 4% to 5%? Thanks so much.

Fabrizio Freda - *The Estee Lauder Companies Inc. - President and CEO*

In travel retail, the quarter was tough, obviously. And so I think we agree with the negative comment on the quarter. Our point of view on the long-term future of travel retail remain, however, very positive. And we believe travel retail is and will remain a strong channel, a channel of growth, and a great opportunity for us. And then, we believe that in the continuation of this fiscal year, in the next 12 months, we should see gradually an improvement of the trend, as I was explaining. Because many negative impacts on the travel retail will be in the base -- in the base [spirit]. And so that is the difference.

Tracey Travis - *The Estee Lauder Companies Inc. - EVP and CFO*

The market -- yes, we do still expect the market growth to be 4% to 5% this year.

Fabrizio Freda - *The Estee Lauder Companies Inc. - President and CEO*

Yes.

Operator

Javier Escalante, Consumer Edge Research.

Javier Escalante - *Consumer Edge Research - Analyst*

My question has to do with the change -- not call it the change, the emphasis on opening stores that you announced in August. If you could tell us how many stores have been opened this fiscal year, 2016, and what will be your corporate like-for-like growth, excluding M&A and new store openings? So that will be my question.

And a clarification with regards to EMEA, it seems that I understood that -- or at least this is what I gather -- that ex- travel retail, all the other pieces in aggregate of EMEA could do 23%. So how much of that is a -- you mentioned that emerging markets grew 31%, so the Western European piece grew very rapidly as well. Could you tell us what you're doing with Boots and Douglas? It seems that you had mentioned that on the passing. Are you opening more doors? If there is more opportunity to increase distribution in Boots and Douglas? Thank you very much.



Tracey Travis - *The Estee Lauder Companies Inc. - EVP and CFO*

All right. So Javier, let me go ahead and start. In terms of new door openings, for freestanding stores -- now, we referenced both freestanding store and freestanding format openings, as well as some of the openings that we are experiencing in travel retail.

But as it relates to retail, freestanding stores and freestanding store formats, we expect to open about 250 this year. As it relates to -- in our growth algorithm of 6% to 8%, how much we are expecting to come from distribution, it is about 2% to 3% of the 6% to 8%. And as it relates to the acquisitions this year, we are expecting about 50 basis points of our growth, in that 6% to 8%, to come from the new acquisitions that we did last year.

Operator

Steph Wissink, Piper Jaffray.

Steph Wissink - *Piper Jaffray & Co. - Analyst*

Congratulations on a nice quarter. Our question relates to your initiatives, particularly around the Estee Lauder brand, to broaden the reach to the Millennial customer. And maybe you could talk a little bit about your digital content initiative, with respect to the brand portfolio, more broadly. Thank you.

Fabrizio Freda - *The Estee Lauder Companies Inc. - President and CEO*

Thank you for your comment. And, yes, the Estee Lauder brand, as we explained, is doing several plans to complete the turnaround and go back to long-term growth levels. One of these steps is focusing more on that Millennials, and attract new consumers and particularly younger consumers to the brand. The key activity recently has been with the new model, Kendall, and all the activity behind Kendall Jenner, launch of the new fragrance of [new makeup] and the various social media activities behind this new launched. They have been very successful. And so we will plan to continue that.

And, as part of this plan to attract more Millennials -- behind Kendall, behind the social media, behind specific product launches -- we attribute particularly high importance the launch Sephora US of Estee Edit, with 250 doors next March. That will be continuing this progress in attracting to another brand the Millennial generation.

Operator

Dara Mohsenian, Morgan Stanley.

Dara Mohsenian - *Morgan Stanley - Analyst*

Fabrizio and Tracy, given the challenging macros out there, I am surprised you are willing to raise your FX mutual EPS guidance so early in the year here, after the Q1 bead. So I was just hoping to get a sense of what was really driving that. Your FX mutual sales range remains the same, but maybe you are more comfortable where you are landing within that. Or is it more due to margin size and maybe the cost of doing business, just not as high as you expected? And just your level of conviction that you can deliver that earnings growth, with the global volatility out there, would be helpful. Thanks.



Tracey Travis - *The Estee Lauder Companies Inc. - EVP and CFO*

Yes. So I will start, and I will let Fabrizio pick up on the environment and our expectation as it relates to sales. But I think, in terms of our comfort level with raising our guidance, one of the things that we are seeing is better leverage on some of the initiatives that we were expecting for this year. We have talked a lot about our flexibility and agility as it relates to expenses, and the ability that we have created over the last few years to shift resources to fund the initiatives that are driving more momentum.

This -- certainly starting this quarter, there was a tremendous amount of uncertainty. We bet on some strong winners this quarter; hence, we're able to deliver the quarter. And we think we have better insight into what will work for the balance of the year, relative to the initiatives that we started the year with. So that gives us comfort in terms of our ability to leverage our initiatives a bit better than what we had initially anticipated.

Fabrizio Freda - *The Estee Lauder Companies Inc. - President and CEO*

Yes. And then, overall, I think you posed the question that way: is it really overall, is the amount of confidence and the amount of things that progressed well in the quarter, like our cost savings, our activity internally? And also to the mix; because we were anticipating a softer Hong Kong, or softer China. And we had planned to offset, as said, to reallocating resources in EMEA and in other areas, and to accelerate the United States, and North America in general.

Obviously, the softer part was more sure than the good part. And the good part was validated with the activity we had done in the quarter. And so the reassurance that we saw in the fact that our strong offsetting investment were working well gave us more confidence to get the balance of the fiscal year in the direction we just did.

Operator

Mark Astrachan, Stifel Nicolaus.

Mark Astrachan - *Stifel Nicolaus - Analyst*

I just wanted to clarify: so is the expectation still that Clinique and Estee brands get back to growth this year? And sort of more broadly on the same brands, I guess investors -- it seems to us, at least -- lump those two brands together. But I am curious, internally, how you view longer-term growth prospects for each brand? Obviously, they are different brands, different positionings.

And in terms of the Clinique brand, it seems a little harder to sort of get a sense of how it fits in with a consumer that wants either lower end or higher end, with the entry-level prestige brand perhaps becoming more squeezed, from a consumer purchase standpoint, longer-term. I am just curious how you think about that. And could there ever be a scenario where you would look to dispose of that brand in favor of investing other things?

Fabrizio Freda - *The Estee Lauder Companies Inc. - President and CEO*

So let me answer [immediately] the question: there is no scenario in which we dispose of any of these two brands. Those are two core brands of the Company, will continue to be our priority. And, yes, our goal is to bring these brands back to single-digit growth as soon as possible.

Now, the brands are very different, as you state, one from another. So the brands are making progress, as I stated in my prepared remarks -- both brands. But let me take them one by one. The Estee Lauder brand is making progress in makeup. We are already turned around the makeup part, and we will continue to accelerate that. We have a strong holiday plan on fragrances, with the Modern Muse Le Rouge plan. And we expect to continue making progress on the fragrances.

On the skin care part of it, the Lauder brand, frankly, with Lauder being the market leader in Asia, where over 90% of the business is skin care, and we -- in this moment, the global softness happening have been so focused on Hong Kong and China skin care business -- is very difficult to have the skin care turnaround execute externalized in the short period of time in that external condition.

Said this, we will continue working on it. We will continue diversifying. And we expect also -- we have the goal also to turn around the skin care part as soon as possible, and as soon as market -- external market conditions also will be a bit more favorable for the skin care part.

On Clinique, same thing: good progress on makeup, which is a very important part of the Clinique business; and good progress on many markets around the world. For example, Clinique in China has been, in the quarter, growing double-digits and is one of our fastest-growing brands there. The Clinique challenge has been in the mid-tier department stores US, in the area of skin care particularly. And that is the area that we are attacking with the next set of initiatives and activity, working with our partners to turn around also this part.

I also want to say in the US, Clinique continued to grow, for example, very well in specialty multi in Sephora, in Ulta, and in overall online. So good progress; and, yes, we are still determined to bring both of these brands, with their very different problematic and strengths, to single-digit growth as soon as possible, external markets permitting.

Operator

Bill Schmitz, Deutsche Bank.

Bill Schmitz - Deutsche Bank - Analyst

Can you guys talk about a few things? First, shipments versus consumption in the quarter -- and I know it is not a great resource, but it looks like NPD continues to pretty dramatically trail some of the numbers you're reporting. So I would love any commentary you have there.

And then, the price harmonization impact in China -- so I know it is fairly early, but I'm just trying to figure out, are the Chinese shoppers -- is it price-driven, or is it experience-driven, when they buy overseas? Are you seeing them by only in travel retail; outlets, because it is cheaper because of the duties; or are they buying it more exponentially, and I think probably the latter is better than the former?

And then, just lastly, very quickly, have you ever thought about a more of an omni-channel approach to Clinique, including maybe going into masks? I know you have done very well in Boots in the UK. I think you have a decent business at Shoppers Drug. So I wonder if you ever explore like CVS or Walgreens with Clinique. I am out of breath. Thanks.

Fabrizio Freda - The Estee Lauder Companies Inc. - President and CEO

Again, [except] from the last part, no, we have no intention to bring Clinique in any other distribution than prestige global distribution. So there will not be expansion of Clinique. To mass, Clinique is a prestige luxury brand that needs service elements attached to the business model to be successful around the world. This will remain the same.

Tracey Travis - The Estee Lauder Companies Inc. - EVP and CFO

Bill, as it relates to NPD information and shipments versus sell-through, I assume you are referring to the US -- the North America NPD numbers. And a couple of things that I would point out: in our first quarter, September is a pretty heavy shipping month for holiday sales. So that would affect shipments, and you wouldn't necessarily see that in the retail sell-throughs and the market share information.

And, also, freestanding stores are not in that information either --



Fabrizio Freda - *The Estee Lauder Companies Inc. - President and CEO*

And online.

Tracey Travis - *The Estee Lauder Companies Inc. - EVP and CFO*

-- and online; so, not our online sites. So those are two elements that are missing that are certainly in our numbers when we report that you don't see in the NPD numbers.

Operator

Lauren Lieberman, Barclays Capital.

Lauren Lieberman - *Barclays Capital - Analyst*

I actually wanted to talk a little bit about holiday, just kind of in general your outlook in terms of the broader retail environment. I know sometimes when there is heavy promotion around other areas of retail, it can impact category growth in beauty. So a little bit on that. Anything you are doing differently in terms of gift sets, or positioning around holiday, would be great.

And then, secondly, within the US, just curious on Estee. Because you have had new dimensions in the market for the better part of the quarter, how skin care for Estee Lauder performed in the US, and just any kind of color on the outlook for New Dimensions and the momentum forward. Thank you.

Fabrizio Freda - *The Estee Lauder Companies Inc. - President and CEO*

Okay. So on holiday, we feel confident we have a good set of activities, particularly strong in our fragrance business, or now in makeup business. And we believe we are well prepared. It will be also our portfolio brands and the growth we see with brands like Jo Malone, Tom Ford, is reinforcing the part of our portfolio which has the possibility of adding great traction during the holiday. So we see improvements not only in our gift sets and in the promotionality of holidays; but we really see improvements also in the kind of portfolio choices that we can offer for gifts during the holiday period, in everywhere in the world.

The other aspect that we are improving is that a lot of the holiday sales are going to be directed online in our retail.com areas and online in general. And we continue to improve our online readiness, therefore having a great gift season.

Now, for the other question, is New Dimension of Estee Lauder was in line with expectations around the world, including in the US. Is particularly successful in the beginning in certainly European markets, but in the UK, also was very successful in July. And in US, I would say more or less in line with expectations. And the input on the overall skin care Lauder is positive.

We see the New Dimension brings new consumers into the game, and so we believe can have a good impact in the long-term. However, last year, during the same period, we had launched Advanced Night Repair Eye product that was a very successful initiative. So in some markets, including the United States, we see that New Dimension launch was not able to completely offset the Advanced Night Repair launch in the previous year; but, again, will continue to grow and attract new consumers to the brand, in our estimate.

Operator

Wendy Nicholson, Citi Investment Research.

Wendy Nicholson - *Citi Investment Research - Analyst*

It is not entirely clear to me, because the first quarter was stronger than we expected, clearly on the top line and the bottom line, and much stronger than your guidance -- why you would it be raising the full-year numbers. I'm just trying to understand, was there more pipeline fill? Was it that shift -- I know, Tracy, you mentioned a shift in some marketing expenses. Or is it that you feel incrementally cautious about the macro environment? Or are you just being wildly conservative with the second quarter and the full-year numbers? Thanks.

Tracey Travis - *The Estee Lauder Companies Inc. - EVP and CFO*

Wendy, we're definitely not being wildly conservative with the numbers. We actually did -- when you think about the fact that we maintained our full-year guidance and we talked about experiencing another \$0.06 -- or expecting to experience another \$0.06 of currency impact, based on the current spot rate. Indeed, we did raise our guidance for the full year. So we did flow some of the beat in the first quarter through to the full year.

But it is a very uncertain macro environment. And, as Fabrizio mentioned, there are many markets that are volatile right now, and currency still remains volatile right now. So we were not comfortable flowing 100% of the beat through -- in the first quarter to the full year. But we certainly flowed a portion of it through.

Operator

Ali Dibadj, Bernstein Research.

Ali Dibadj - *Sanford C. Bernstein & Company, Inc. - Analyst*

I have a couple of things. One is on the SG&A beat, based on lower spending. Given the commentary that we have heard for a while now about agility and nimbleness, is there any way to help us think about how much less volatile you may be today, given some of these kind of organizational capabilities you have built about reacting more quickly and stuff? Because -- or if you could be specific about what you have actually done.

Because it has always been a concern, I think, among investors -- among us, as well -- that you are not really a staple company; you are much more discretionary, so macro has to be much more concerning for you guys.

Can you give us a sense of how your organizational capabilities have changed? And if you can tell us how much less volatile you might be, so we can be less concerned about macro, that might be helpful. Tough question, but would love some context there.

And then, second thing is around the dividend increase of 25% -- good; again, I think that was 20% last year, so now 25% this time. How should we think about where you are funding that from? I mean, clearly, the payout ratio seems to be going up because the EPS growth, ex-currency, is 10% to 12%. Should we expect some more debt load? Lower stock buybacks? Or is it just kind of the payout ratio going up, working capital improvements? How should we think about that from a signaling perspective, given your dividend is going up so much? Thanks, guys.

Fabrizio Freda - *The Estee Lauder Companies Inc. - President and CEO*

I will take the first one, and Tracy probably the second one. In terms of volatility, the market is -- has increased volatility, and that is why we have prepared ourselves to deal with this volatility better. And so the strategy that I keep repeating, the multiple engine of growth, is actually a clear strategy; and, internally, we are executing since several years. Now, this has reached to a point where we believe we have much less volatile than we used to be, and more reliable and more sustainable than ever.

This comes from the fact that, by channel, we have today more diversified. For example, we have now 8% of our business online. In some of our key markets, like US and UK, this is 12%. And in China, as I disclosed, that is double-digit, is 10%. We have more business in our free-standing stores,

particularly in certain brands, and particularly in emerging markets. Meaning that we have better the ability to build business in the emerging markets which are growing fast, even if, in some cases, there is not available luxury distribution in those markets. And some of our brands have been designed to drive this accordingly. We are better diversified because now we are winning around the world much better in specialty multi.

We mentioned our strong growth in the US in Sephora, or our strong growth in Europe in Douglas, or in Boots in the UK. And there are several example in Asia, as well. So, channel diversification is one example.

Second, category diversification: we have now demonstrated that we are the market leader in global makeup. And so even in a moment where the macro factor makes skin care grow less aggressively, particularly because skin care in Asia is growing less, we can definitely accelerate makeup. And within makeup, there are very profitable segments, so makeup that can be accelerated that are equally profitable to skin care.

We have demonstrated that in the fragrance business, creating these high-end fragrance part to the portfolio -- which is profitable and growing fast, like Jo Malone as a brand -- that we can continue tapping into the growth of the fragrance strategy, but with a strategy which is more in tune with the Estee Lauder Company capability and long-term vision.

And, finally, diversification by brands -- we are not [less] dependent only from Lauder and Clinique. First of all, M.A.C. today is a brand which is as big as Lauder and Clinique; and then, the rest of our portfolio of [the more] brands, now in midsized brands. Altogether, as I explained at times, had actually bigger than our biggest brands. So we have now really multiple origins of growth, more diversified.

So the first reason why we are less volatile is because there is not any more one thing that can happen, macro, that can have a very big impact of our business. Because there will be others that we can accelerate to compensate this one.

Second part of the answer is, then, what do we do? What we have changed in terms of resource allocation? We have created internal system where we are much more capable of reallocating resources when we discover these trends, or these changes in trends; and to make sure, for example, that we do not overspend if there are situations where the market doesn't deserve it, because the market is under pressure. And so we can cap standing very fast where the market doesn't deserve to be pushed in a certain moment, or cap spending where initiative and new launch is not delivering what we were expecting to avoid burning [man] is they will not return.

On the other side, we are also capable to increase spending in areas where there is strength and where there is growth, or where the market often an opportunity was not forecasted before. And we can do this in the range of months. And so our ability to reallocate resources with internal systems in just a few months has increased dramatically versus the past.

So in summary, we are more reliable, more sustainable, more long-term, less exposed to external trends than ever, because of our portfolio and because of our ability to reallocate resources in a pretty fast way.

Tracy?

Tracey Travis - *The Estee Lauder Companies Inc. - EVP and CFO*

And so to continue with what Fabrizio said, one of the benefits of being able to execute well against our strategy, inclusive of the agility -- the diversity and the agility that we have created from executing in our strategy -- is that our free cash flow, as you all know, has increased quite dramatically over the last few years. We have seen a big acceleration in our free cash flow. Which has allowed us to take up the dividend, as well as repurchase more shares every year as we, on an annual basis, review and get approval from the Board to -- in terms of how much of our free cash flow we'll redistribute to shareholders. Much of that cash is generated overseas. And so we have taken on small amounts of debt as we have committed to that strategy. And we have also taken on debt; and, as I have shared with you previously, will continue to take on debt for acquisitions as we need to in the future.



Operator

That concludes today's question-and-answer session. If you were unable to join for the entire call, a playback will be available at 1 p.m. Eastern Time today through November 16. To hear a recording of the call, please dial 855-859-2056, passcode 64698005.

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

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