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EL - Q2 2016 Estee Lauder Companies Inc Earnings Call

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OVERVIEW:

Co. reported 2Q16 net sales of \$3.12b, net earnings of \$458.6m and diluted EPS of \$1.22. Expects FY16 constant-currency sales growth to be 7-8% and diluted EPS guidance to be \$3.07-3.12. Expects 3Q16 constant-currency sales growth to be 6-7% and diluted EPS to be \$0.53-0.58.



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PRESENTATION

Operator

Good day, everyone, and welcome to The Estee Lauder Companies fiscal 2016 second-quarter conference call. Today's call is being recorded and webcast. For opening remarks and introductions, I would like to turn the call over to the Vice President of Investor Relations, Mr. Dennis D'Andrea. Please go ahead, sir.

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

Good morning, everybody. On today's call, we have Fabrizio Freda, President and Chief Executive Officer, and Tracey Travis, Executive Vice President and Chief Financial Officer.

Since many of our remarks today contain forward-looking statements, let me refer you to our press release and our reports filed with the SEC, where you 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 six-month and full-year comparisons have been adjusted for the impact of the prior-year implementation of our Strategic Modernization Initiative, and the discussion of our financial results and our expectations are before restructuring and other charges.

You can find reconciliations between GAAP and non-GAAP figures in our press release and on the investor relations section of our website. During the Q&A session, we ask that you please limit yourself to one question so we can respond to all of you within the time scheduled for this call. And I will turn it over to Fabrizio now.

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

Thank you, Dennis, and good morning, everyone.



We delivered strong results in our fiscal 2016 second quarter, with sales growing 8% and earnings per share climbing 18% in constant currency before charges. This performance contributed to stellar first-half results, as constant currency sales also rose 8% and EPS was 17% higher before charges.

Our Company is helping to drive the momentum in global prestige beauty, which is resilient and growing, despite significant economic volatility. We are strengthening our leadership by growing approximately twice as fast as the industry. Our success in this volatile environment has been driven by our broadly diversified business, powered by our multiple engines of growth, coupled with investment agility and strong execution. This was achieved thanks to our talented and experienced leaders and global workforce.

We are not over reliant of any one category, channel, or country, which helps cushion us somewhat from regional slowdowns or political strife. We reacted quickly to unexpected events and volatility during the quarter and reallocated our investment spending, capitalizing on the best opportunities as conditions changed.

To cite some examples, we reduced investment in Hong Kong, which continued to decline, and increased support in Canada, the UK, and other fast-growth markets. As the makeup category surged globally, we invested more in M.A.C.'s terrific momentum and in popular launches from our Estee Lauder and Clinique brands to leverage their accelerating makeup growth. In travel retail, we accelerated our brands' expansion into Europe, which enjoyed stronger tourist traffic. Seeing a growing demand in our direct-to-consumer business, we accelerated development of e-commerce sites and freestanding stores in several markets.

Our strategy is to invest dynamically in our strengths, which added fuel to our momentum and helped us deliver terrific results. Thanks to these strategic resource allocations, we had constant currency gains across the board of our regions and categories. By intentionally accelerating investment in selected winning areas, we generated the strongest results in our makeup and luxury brands, direct-to-consumer channels, and the Europe, Middle East and Africa region, where we gained significant share. Even with formidable competition, we believe we are expanding our leading position in skin care and makeup combined in western Europe and in emerging markets in that region.

Our strong overall results were especially encouraging in light of some difficult macro issues, including a depressed retail climate in Hong Kong and softer market growth in China, as well as worsening currency headwinds, especially in certain emerging markets. Although we expect economic and geopolitical volatility to continue throughout the balance of this fiscal year, we believe we can successfully navigate the instabilities because of our strong positions in the categories, channels, and regions with the strongest sustainable growth.

We anticipated many of the major trends driving global prestige beauty today, so we are able to leverage the increasing growth the industry is experiencing in direct-to-consumer channels, such as online and retail stores, as well as travel retail and specialty stores catering to a growing number of beauty consumers.

We were a pioneer in online beauty, recognizing early on that the channel would be increasing important for marketing, communications, and shopping convenience. Today, we are among the largest and most established players in online prestige beauty and have enjoyed extraordinary growth. This fiscal year, we expect our online sales from our brand sites and retailer sites to top \$1 billion for the first time, representing a doubling of the business in just three years.

Our digital success comes from heading a diverse entrepreneurial team, more than half of whom are millennials, and they quickly adapt the business to a changing landscape. Our websites offer a desirable luxury experience and have become major contributors to brand growth. The holiday quarter was a pivotal time for e-commerce, as more consumers opted for the convenience of shopping online. Online sales accelerated for various product categories, and beauty was no exception.

Our E&M commerce business captured the increased volume and generated nearly 30% growth in the quarter. On Cyber Monday, sales of our North American brand sites were more than 50% higher than last year. On Singles Day in China, sales of our five flagship sites on T mall more than doubled, led by Estee Lauder and Clinique. Many global metrics for our brand sites improved, including the number of orders, which rose 27%. And mobile became an even larger portion of our sales, accounting for 36% of all online transactions.



During the quarter, we added 69 brand, retailers and third-party sites worldwide. Linking our brand sites to our freestanding stores is key to enabling an omnichannel experience, which is an important evolving trend in retailing. We have launched numerous pilot programs and are building omnichannel capabilities to begin to seamlessly connect consumers across our brand sites and our freestanding stores globally.

We are exploring many different approaches and learning what is successful. For example, we launched online booking for makeup services in the UK and the US and are finding that over half of the appointments at M.A.C.'s new makeup studio in Manhattan have been made online. In the UK, several of our brands offer cross-channel gift cards that can be redeemed online and in our freestanding stores. And in October, Bobbi Brown aired an interactive beauty class that generated more than 1.1 million social media impressions.

Today, we have approximately 1,500 freestanding stores worldwide that are managed directly by our Company or our partners. As we expand our number of high productivity stores, we are testing new concepts. Origins' Discovery retail design, which illustrates the journey from plan to product, is being rolled out globally. M.A.C.'s first makeup studio is a service-based store that we believe will provide an additional revenue stream. M.A.C.'s freestanding stores are a key growth engine and account for approximately one-third of its global sales today.

Leveraging a growing demand for prestige beauty in Brazil, two of our luxury brands are entering the country with stand-alone stores. La Mer recently opened in a luxury shopping mall in Sao Paulo, where it offers spa treatments, and Jo Malone will soon follow, one of 30 stores it plans to add globally this fiscal year. Our M.A.C and Clinique brands have been expanding in freestanding stores in Brazil now for several years.

We also anticipated that specialty multi would be a fast-growing beauty channel. In the quarter, our strongest sales growth in North America was in this channel, which saw robust retail sell through of our brands. Many of our brands are increasing their penetration with the appropriate retailers.

As I mentioned on our last call, one of our exciting initiatives comes from the Estee Lauder brand, which will launch its Estee Edit group of products in 320 North American Sephora stores and on Sephora.com in mid-March. Inspired by today's young consumers, the Estee Edit line delivers instant visible benefits centered on the theme beauty is an attitude. Aimed directly at millennials and promoted on social media, the Estee Edit is part of a strategic effort to modernize the Estee Lauder brand for long-term growth and seed the next generation of consumers, while continuing to appeal to its core consumers.

Additionally, in Sephora Bobbi Brown plans to add more doors in the US this spring and GLAMGLOW reinforced its popularity with the launch of lip treatment products, which have become bestsellers there.

In international markets, La Mer launched in the Mecca specialty chain in Australia, and in Europe, Bumble and bumble and Smashbox had good growth in Boots. Douglas accounts for one-third of our business in Germany and our retail sales there grew double digits in the quarter.

Our brands continued to perform well also in higher-end department stores globally. However, in mid-tier North America department stores, some of our brands are experiencing softness, although they showed solid increases online.

Travel retail is another long-term growth engine and our business improved in the channel as well. Importantly, in the quarter our net sales, retail sales, and traffic growth all grew mid-single digits. With changing traffic patterns shifting where and what consumers buy, we redeployed some of our investment activities to the corridors with the most tourist traffic. Korea returned to growth after concerns about MERS eased and Europe was robust, as the weak euro attracted tourists. Hong Kong remained soft also in the travel retail channel, as did markets in the corridors frequented by Russians and Brazilians.

Overall in travel retail, we had double-digit retail growth in half of our top 30 markets. Mirroring our broader Company strategy, we continue to diversify our travel retail business by expanding our brands in more locations and opening more doors. The preorder business, where travelers order products online and pick them up in airports, had a strong increase.

Healthy passenger traffic growth is projected across all regions this fiscal year.

Touching on some key geographies, the Korean market continued to rebound and our business is posting solid growth and gaining share, driven largely by our makeup brands, which are effectively leveraging important Korean trends and demonstrating our ability to successfully compete with local brands.

In China, nearly all our brands grew double digits. While prestige beauty growth slowed, our business there grew a solid 9%, exceeding growth in prestige. Our results reflect our strategy to diversify our business by expanding our portfolio, channels, cities, and products. Our makeup and fragrance business has been growing rapidly in what has traditionally been a skin care-oriented market, demonstrating our strategy to align our multiple engines of growth with local market dynamics.

The economic environment and beauty market growth in emerging markets overall has slowed. While we are not immune to soft local economic conditions, our business in emerging markets other than China continued to be very robust, rising 27% in the quarter, approximately 3 times the growth of prestige beauty in those countries. We are committed to these markets and plan to invest more in this time of softness to leverage our momentum and increase our market share, resulting in a much stronger position when these economies improve again.

Around the world, makeup proved again to be a strong growth engine, a trend that we had anticipated and prepared for, which is evident in our results. For the quarter, our makeup business grew 13% in constant currency. Our three makeup brands are clearly benefiting, M.A.C and Smashbox especially, up strong double digits. But so are our multi category brands. Estee Lauder and Clinique's makeup sales grew in every region.

Foundation has been very strong across our brands and we had four of the top five foundations in the US in 2015. Among Estee Lauder's best products was Double Wear Stay in Place liquid foundation, a strong seller decades after its launch. This core product was the best-selling foundation in the US, according to NPD, for the quarter and also the 2015 calendar year, with sales up more than 20%.

Clinique launched Beyond Perfecting Foundation + Concealer in Asia, which established a new makeup pillar for the brand and drove strong foundation growth in the region.

This success in foundation is one of the key factors driving improvement in Estee Lauder and Clinique. We have chosen to reemphasize makeup in these brands to help ignite their businesses. Estee Lauder's progress in modernizing the brand and emphasizing locally relevant products drove its higher sales, particularly in certain Asian and European markets. While skin care is its largest business, especially in Asia, the brand's substantial makeup portfolio is attracting younger consumers. It is creating a vibrant digital strategy with newsworthy updates and enhanced storytelling to communicate with consumers 24/7.

Clinique's greater emphasis on makeup, especially some color products, is creating a stronger emotional connection with millennials, which is helping to stabilize its performance and drive growth. It is enhancing consultant training, distorting key products, and testing a new store formats that is colorful, high energy, modular, and engages consumers. The first pilot of the new freestanding store model opened in Hong Kong two months ago and sales are up sharply in what has recently been a relatively depressed market.

Our strategy of having multiple engines of growth extends to our innovation program, which develops desirable technologies and concepts across our product categories and brands. Our innovation isn't just about creating big blockbusters and our success isn't based solely on the newest product for each brand. Instead, an important impact of our launches is to pull consumers into stores, build traffic, and drive sales. Some shoppers do come to buy the latest lip shade, but many others gravitate on our staples, which account for the vast majority of our sales.

Let me give you examples of some recent and upcoming products by category. In skin care, Estee Lauder's new Advanced Night Repair PowerFoil Mask is a global launch with a focus on Asia, where masks are extremely popular. This offers key ANR technology and extends this important franchise.

Estee Lauder's New Dimension serum was successful in many markets in Europe and Asia, offsetting lower-than-expected results in North America.

La Mer introduced The Renewal Oil, a luxury entry in the popular facial oil subcategory, and it has exceeded expectation in many markets. Clinique built a franchise around its Smart serum by extending it with moisturizers and treatment oils. In the makeup category, since foundations have been



strong sellers, several of our brands, including Estee Lauder and Bobbi Brown, are introducing cushion compacts, which is a growing segment and has been popular with consumers.

The strong growth in our high-end fragrance brands is another important element of our strategy that is working very well. The combination of Tom Ford, Jo Malone, and recent acquisitions are generating sustainable, profitable growth and we continue to expand distribution and roll out exciting new scents. We have had a variety of fragrance launches across prestige price points and many of them, as well as attractive sets, were popular gifts for the holidays.

With an eye towards spring, Jo Malone's Herb Garden Collection will offer five different colognes.

Looking at the balance of our fiscal year, we are confident in our sound strategy and are choosing to increase investment in the strongest areas of our business. These investments will include more advertising, building freestanding stores and e-commerce sites, R&D, and travel retail expansion. We are further fueling our growth momentum by investing in our winners and continuing to build global market share.

There are, of course, many macro factors beyond our control and slower markets to overcome. We believe, however, that our diversification, multiple engines of growth, strong innovation, financial agility, and superb execution, will generate excellent growth. We also continue working to find ways to better leverage this growth in the longer term.

With this confidence, we are raising the lower end of our sales guidance and now expect to deliver 7% to 8% growth in constant currency, as well as continuing to forecast double-digit EPS growth for fiscal 2016, delivering another year of strong results, while continuing to build sustainable, profitable growth engines.

Now, I will turn the call over to Tracy.

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

Thank you, Fabrizio, and good morning, everyone. I will first review our fiscal 2016 second-quarter results and then I will cover our expectations for the third quarter and the full year. My commentary does exclude the impact of restructuring and other charges.

Net sales for the second quarter were \$3.12 billion, up 8% in constant currency compared to the prior year. Acquisitions contributed approximately 70 basis points of this sales growth.

Once again, the strongest geographic performance this quarter came from the Europe, Middle East, and Africa region. Net sales in EMEA rose 13% in constant currency, with double-digit growth in virtually every market. A continuation of strong local demand for our products, increased tourist traffic in certain cities, and our selective brand distribution expansion contributed to double-digit increases in all major Western markets. Sales growth in France was slower than last quarter as the attacks in mid-November understandably curtailed both shopping and tourism in Paris. All emerging markets in the region saw double-digit gains, led by Russia, Turkey, and the Middle East.

Our net sales in the global travel retail channel rose 5% as double-digit gains in many countries and a strong return to growth in Korea were partially offset by continued declines in both Hong Kong and Brazil. Overall, passenger traffic growth is strong and our growth at retail and net reflected this strength in the quarter.

Sales in the Asia-Pacific region grew 6% in constant currency. China rose 9%, with e-commerce sales growing nearly 80%, thanks in part to the success of Singles Day on November 11, when our sales more than doubled versus prior year. Our online sales for the quarter rose to nearly 13% of our total China business. We delivered solid growth in our core markets of Korea and Japan, while some of the smaller emerging markets in the region rose double digits.

Australia also delivered another quarter of strong double-digit sales growth.

These strong results were partially offset by continued weakness in Hong Kong, where sales decreased by high single digits on top of a meaningful decline last year. A sharp continuation of a decline in tourist flows from China that began last year, combined with both the Chinese yuan devaluing this fiscal year and Chinese tourists continuing to travel more to other destinations in Europe and Asia, is creating further weakness in local sales in Hong Kong. Excluding Hong Kong, the region's sales would have grown more than 8%.

Net sales in the Americas increased 4% in constant currency. Strong double-digit growth continued across Latin America, led by Brazil and Mexico. North American sales grew low single digits, which reflected double-digit growth in Canada and low single-digit growth in the US.

Sales were strongest in the US in specialty multi, online, and high-end department store channels, while tourist-driven doors in all channels have been adversely affected by the strong dollar. Our sales in mid-tier department stores continue to be soft in brick and mortar, while the related retailer online business was up sharply. Our holiday sales were broadly in line with our expectations, although the environment this year was more promotional than the prior year.

In constant currency, net sales in every product category grew this quarter, with double-digit growth in makeup, fragrance, and hair care. Makeup sales rose 13% in constant currency. M.A.C, Tom Ford, and Smashbox all rose strong double digits due to the success of key recent product launches, further distribution expansion, and solid like-door growth. Tom Ford Lips & Boys collection, which originally launched last holiday season, continued to be particularly strong this year. Bobbi Brown, Clinique, and Estee Lauder rose mid to high single digits in makeup, primarily due to strengthening their product offerings and their support behind the fast-growing lip and foundation categories.

Fragrance category sales rose 12% in constant currency during the important holiday gifting season. Double-digit gains from Jo Malone and Tom Ford and incremental sales from our newer brands, Le Labo and Frederic Malle, drove the majority of the growth. Within other designer fragrances, Michael Kors Gold Collection and Tory Burch also contributed to growth and Estee Lauder's Modern Muse Le Rouge, launched this fall, grew the overall Modern Muse franchise.

Haircare sales increased 14% in constant currency, with growth from both Aveda and Bumble and bumble. Aveda launched Thickening Tonic and Shampure dry shampoo, which also benefited from continued growth in existing products, such as Be Curly. The brand expanded its presence in travel retail and delivered strong salon growth in Western Europe and Bumble and bumble experienced solid growth in the specialty multichannel.

Skincare sales rose 2% in constant currency. Skincare continues to be the dominant beauty category in China and Hong Kong, where there has been more challenging macro trends that have contributed to the category's slower global growth. La Mer rose double digits, Origins and Darphin generated solid growth, and GLAMGLOW represented incremental sales growth in skincare. Estee Lauder achieved modest growth due to recent launches and Clinique declined slightly in the quarter.

Our gross margin for the quarter was comparable to the prior year at 81.2% of sales. Favorabilities in our supply chain were offset by the combination of category mix, with the slower growth in skincare, and some higher promotional expenses over the holidays.

Operating expenses as a percent of sales were in line with the prior-year quarter at 60.4%. Increases were primarily due to higher store operating costs, which reflected over 130 new freestanding retail store openings over the past year, offset by improvements in selling, shipping, and other expenses. As a result, operating income of \$647.9 million was 2% above the prior year and operating margin was unchanged at 20.8%. Our constant-currency operating margin improved 60 basis points, primarily due to expense leverage.

Net earnings were \$458.6 million, or 5% above the prior-year quarter, reflecting a 230 basis-point improvement in our effective tax rate, which was partially driven by a discrete tax credit in the quarter.

Diluted EPS of \$1.22 was 8% above the prior year, including the benefit of a lower share count. Our stronger-than-expected EPS was largely driven by a combination of better sales performance across most of our brands and continued strong expense management as we navigated the volatile macro environment. Earnings per share for the quarter included \$0.01 of dilution from acquisitions and \$0.11 of unfavorable currency translation. On a constant-currency basis, EPS increased 18%.

We recorded \$18.5 million in charges before tax, or \$0.03 per share, for the transition of our global technology infrastructure to a new platform that we announced to you last quarter. As we mentioned previously, for the full fiscal year we expect to record charges for this transition of between \$40 million and \$50 million before tax, or approximately \$0.07 to \$0.09 per share.

Continued progress in our working capital initiatives, along with favorable currency translation, contributed to a seven-day improvement in inventory days to sell through the end of December. 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.

For the six months ended December 31, we generated \$962 million in cash flows from operating activities, 3% less than the comparable period last year. The prior-year cash flow benefited from the SMI sales shift. Excluding the impact of the shift from last year, operating cash flow this year rose 17%.

We invested \$223 million in capital expenditures, primarily to support new retail stores, counters, systems, and office space. We utilized \$628 million in cash to repurchase approximately 7.6 million shares of our stock, \$1.2 million more than the same period last year. We also distributed \$201 million in dividends to stockholders.

So that concludes our results for the second quarter and the half year. Let me now turn to our outlook for the full fiscal year and the third quarter. For the full year, the sales shift related to last year's SMI rollout will impact comparisons to the prior year. I will now 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. Also excluded, again, for the full year is the impact of restructuring and other charges.

So reflecting our strong first-half performance, we have raised the low end of our guidance range and now expect full-year sales growth of between 7% and 8% in constant currency, including 50 basis points from acquisitions. Currency has become an even greater headwind and we now estimate that translation could negatively impact our full-year sales growth by approximately 5 percentage points. Our estimate assumes spot exchange rates as of the end of January of \$1.08 for the euro, \$1.43 for the pound, and 118 for the yen for the remainder of the fiscal year.

Diluted EPS is expected to range between \$3.07 and \$3.12, including \$0.04 of dilution from acquisitions. The increased currency headwinds are now projected to affect EPS by about \$0.29, which is \$0.05 more than we projected when we last gave guidance. Our strong first-half performance gave us comfort to increase our investments in the second half of the fiscal year to support new innovation, additional freestanding store acceleration, omnichannel pilots, travel retail, and the Estee Edit, which should allow us to continue to fuel profitable growth.

And while we remain on track to deliver \$200 million of cost savings this year, we will also continue to look for ways to further improve our leverage in the future. We continue to expect EPS growth of 10% to 12% in constant currency. In the third quarter, our sales are expected to rise 6% to 7% in constant currency, including 70 basis points from acquisitions, as we anniversary our strongest sales growth quarter from last year.

The impact of foreign currency is anticipated to reduce growth by approximately 4 percentage points. Our third-quarter diluted EPS is expected to be between \$0.53 and \$0.58, including approximately \$0.03 per share of adverse currency translation and approximately \$0.02 dilution from acquisitions. This estimate reflects our highest quarter of planned advertising and promotional spending as a percent of sales in the third quarter and is deployed behind key activities, such as the global launch of Estee Lauder's new Advanced Night Repair PowerFoil Mask, the US introduction of the Estee Edit collection in Sephora, as well as a variety of activities in the makeup category across multiple brands.

We delivered strong sales and earnings growth and showed solid progress on our strategic initiatives in the first half of the fiscal year, while managing through a volatile global macro environment. We are encouraged by our results thus far and the scope of activities we have planned throughout the remainder of the fiscal year, which should support our continued growth momentum for this fiscal year and beyond.

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



QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Steve Powers, UBS.

Steve Powers - UBS - Analyst

I wanted to pick up on the theme of agility, which was at the center of the discussion we had a couple of months ago, and you began by calling it out again today. So really two questions, if I could, related to it. First, Fabrizio, can you maybe talk about some of the structural steps you have taken to enable that flexibility? Because I think there is some debate out there as to how much of what we are seeing is innate skill and a function of institutionalized discipline versus simply you benefiting from a spate of good luck that might eventually run out. That will be my first question.

And then, second, Tracey, can you talk about how the theme of agility relates to your ability to protect margins and profit? Because I am struck by the fact that, here we are, you just beat the top end of your Q2 guidance by \$0.14. And none of that is being passed through to your full-year guidance to insulate the P&L from incremental FX pressure. And maybe that is prudent on your part. I am inclined to think that it is, but at the same time I just thought that with the topline strength, all the pricing levers you have, some of your productivity efforts, that there would be more ability to be nimble and agile on that front as well and avoid the guide down. So I would just love your thoughts there, too. Thanks.

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

Okay. Now on agility, as we discussed, so first of all, we monitor the changes around the world. So the first institutional model is it continues monitoring all the changes. Example, travel in corridor and tourist full. Markets growth in different levels. We have now a new level of analytics and follow-up of how the business evolves. So, understanding.

The second institution is then we tailor launches, product launches, assortment, and things based on what we learn regularly.

Third is when markets overdeliver their financial trends, they get more opportunity to spend. And when the market tend to underdeliver, they tend to cover at least part of what did they cover for the profit pressure that they are under. So this automatic mechanisms are any way generating flows or resources automatically to the winning part of our business.

Third, the way people collaborate is completely different today. We collaborate, we make decisions together, and so the ability to flow in an agile way both resources and money and make fast decisions on our locations is taken at the top of the Company in a collaborative way.

Those are institutional ways which are here to stay. And actually, they are the way we work across every quarter. So, assume that once we decide a plan, we constantly work to improve it, quarter by quarter, month by month, and the Company does this in a structural way.

Second point before Tracey answer the second part of your question, I would like to say that in reality, what we are doing is focusing even more on growth, even in the second semester. We have so many winning opportunities and our location methodologies are working. And our ability to build the topline in a sustainable way for the long term is definitely the most important priority for sustainable double-digit EPS growth in the long term.

So, our point of view is that moving the lower end of our topline sales trend from the 6% to 8% -- we have the 6% to 8%, some moving from closer to the 6% to closer to the 8% in a sustainable way has much more value for our shareholders in the long term than just covering currencies in the short term.

So, our approach is to focus on long-term topline growth acceleration. And in a moment, where the environment out there is volatile and we have proven that in volatile environments we have a competitive advantage in being able to operate, we want to leverage that momentum and get this

competitive advantage through. That is what we are doing. That is why we have decided not to cover currency. We trimming investment in the short term that we didn't feel was the long-term priority.

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

And so I think Fabrizio answered it well, Steve, but I will just add on that while Estee Lauder and Clinique are ahead some good signs in terms of the first quarter, they have some great programs lined up for the second quarter that we think are worthwhile investing in.

If we didn't have good opportunities to invest in in the second half, we would certainly drop the upside to the bottom line, but as Fabrizio said, we have tremendous momentum in many of our brands. We have good programs in Estee Lauder and Clinique that we think will deliver good results in the second half of the year and beyond. So it is important for us to invest not only for this fiscal year, but obviously to continue the growth momentum beyond this fiscal year.

Operator

Dana Telsey, Telsey Advisory Group.

Dana Telsey - *Telsey Advisory Group (TAG) - Analyst*

Congratulations and wanted to get a better understanding of channel penetration, given that specialty multi is growing so fast. What does it mean for distribution of the business? What percentage could it account for over time? And how does that impact margins go forward? Thank you.

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

Okay. So specialty multi is growing well globally and what it means for our distribution that we are increasing distribution globally with our brand portfolio in specialty multi where appropriate. So, you can expect a global increase of distribution gradually in this channel.

However, we are also learning how to win in this channel. So it is not only a distribution game, it is also a marketing game. These channels require different marketing and selling techniques than the traditional department store core business that we have around the world. And so, over time, I believe our organization is becoming better and better in partnering with specialty retailers around the world and learning how to grow our business in this channel better and better.

The first thing is so you can expect that the percentage of our business in which [chara] will grow, but this is very different by country around the world, depending on the penetration of this channel. So I will not give, frankly, detail on percentages, also because they would be very much the results of mix by geographies, rather than on specific advancement in a given brand or in a given country. Tracey, (inaudible)

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

No. I think you answered it well.

Operator

Wendy Nicholson, Citi Investment Research.



Wendy Nicholson - *Citi Investment Research - Analyst*

Could you give us a little bit more color on the Estee Edit? So it is going into 320 doors. How many SKUs is that? Can you give us some sense for how large a contribution to the revenue growth in the third quarter that will be? Is it 50 bps or whatever? Is it skincare and color or just color? And are there plans to expand it either to more Sephora doors or Ulta doors or any of the department doors as we go forward?

And then, just following up on that, second of all, can you remind us -- or tell us; I don't think I heard it -- Clinique and Estee Lauder, are you still expecting them as big brands to be up for fiscal 2016? Thanks.

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

Yes. Lots of questions in there. So on Estee Edit, so first of all, Estee Edit is exclusive to Sephora and will be launching Sephora brick and mortar and Sephora.com. And it is being developed also in strict collaboration with the Sephora teams.

The Estee Edit is focused on makeup, but includes also some, how we call it, eastern skincare benefit products, plus some core SKUs of Estee Lauder business. This brand will be supported by a very strong social media and very strong digital activities, really focused on the millennials, and incorporation also in magazines that support the magazine and social media activities. So it will be a strong launch.

In terms of impact, for the long term obviously it will depend from the success. We have a very strong belief that this will be a strong success. And in case of success, we assume it will be a standard to more Sephora doors over time, obviously. But we will need first to test and see the success level that we get.

Now in terms of the quarter, remember, this is launching March 15, mid-March, so the impact on third quarter is relatively limited. But we hope that the impact on fiscal-year 2017 and 2018 will be obviously much stronger when success will happen.

The other important aspect of Estee Edit is that it is not alone going to be hopefully a success in sales, but it is also a very important way to attract millennials to the Estee Lauder brand and is one of the steps to modernize the Estee Lauder brand as a whole, in our opinion.

On Lauder and Clinique, the Lauder and Clinique combined grew about 1% in the Quarter 2, which is a turnaround. This was, in Quarter 2 specifically, was driven by Estee Lauder growth, as Tracy explained in her remarks, but the important point is that both Lauder and Clinique are growing again on their makeup business, which is, in the case of the Clinique, a very big percent, and in the case of Lauder, a smaller percentage of total business because of the big Asia penetration of skincare, but still in many countries is the bigger part of the business of these two brands.

So, that is the important reality. We said that we would have started turning around to grow these two brands for -- starting from makeup and then fall into skincare. Our skincare, it's frankly difficult to imagine that skincare will also start growing again within this fiscal year with Hong Kong in the situation in which it is and with the China market growth in skincare being so soft. As I said before, China market growth is mainly driven by makeup at this point, and the skincare is not growing very aggressively. But as soon as the Asia skincare dynamic will find back a normalized growth, we will complete the turnaround also in the skincare front of these two brands. That is our assumption for the fiscal year.

Operator

Mark Astrachan, Stifel Nicolaus.

Mark Astrachan - *Stifel Nicolaus - Analyst*

I wanted to ask about gross margins, so flat sequentially for the second straight quarter. Just curious, you talked about promotional activity in China and the press release talked about just general levels of promotional activity around the holiday period. How much did that impact gross margins in the quarter? Were there other drivers as well? As you sort of think longer term, is modest expansion still reasonable? And then, sort of related to

all that, I guess just back to the previous question, so there is clearly going to be some mix effect, I would assume, from skincare. So, how does that factor in as well? Thank you.

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

No, great question. So, promotion affected the margins slightly in the quarter. The bigger impact in terms of it being flat year over year was the category mix, as you indicated. So, tremendously strong growth in makeup and much softer growth in skincare. And fragrance as well, so strong growth in fragrance. Those two factors do affect our category -- or our gross profit margin mix.

In terms of the future, yes, we do expect to see some modest improvement in gross profit margin over the next few years, not to the extent that we saw four or five years ago, but certainly a continuation of modest improvement over the next few years.

Operator

Lauren Lieberman, Barclays Capital.

Lauren Lieberman - *Barclays Capital - Analyst*

Great. Thanks. I was curious about the travel retail stepping up investments there because I feel like from an external perspective and some of your competitors, if anything, there is more concern about travel retail being a soft spot and I think even questions around whether we will see a resurgence when and if some of those wealthier emerging-market travelers start shopping again. And yet, you talked about increasing your investment in travel retail distribution.

So, can you talk a little bit about that decision? Is it new airports? Is it new brands in some of your existing corridors? Just any color there would be great. Thank you.

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

Absolutely. So, first of all is we are applying to travel retail the same multiple engine of growth, diversification, and investment agility philosophy that we are applying to the entire Company.

So as you said, travel retail has been having some outstanding momentum for years, based on the Asian travelers' acceleration. And in this moment, the Asian dynamic, particularly the Hong Kong and Macau one, which is the worrying one and it's been soft, very soft in Quarter 2, and we predict the softness to stay in the [past]. But in reality, it's not the traffic which is declining. It is where consumers are going and how much they are shopping.

So, we are reacting to that. We are increasing brand distribution, yes. We are increasing penetration of airports where the traffic is going now, meaning more Europe and more other areas of Asia, for example. We are adjusting assortments to the new corridor, to the new traveling corridor.

So I'll give you an example. At the moment, Brazilians don't travel anymore as much as they used to. And when they travel, they shop less. We adjust assortments. And in these places, like Miami, now there are more different kinds of travelers to which we adjust. And maybe there are other brands that today are not there that are better suited to the different group of travelers that's to the previous brands that we had before that we are maybe more suited to Brazilians, as an example.

This is happening all over the world. So it is adjustment in assortment, is increase our number of brands, is penetration of more airports, and, most importantly, is a dynamic adjustment to the corridor traveling, to the corridor travelers. So that is the first thing, which is about traffic management.



The second thing is about commercial. What is changing is that all these currency changes in travel retail, the currency changes, are changing the dynamic of the duty-free aspect, the discounts that consumers found around the world [best] of their home market. And that is why, for example, makeup is growing much better in travel retail. Makeup is much more purchased because of the commercial marketing from travelers to buyers, rather than for big discounts. Also, they get discounts for these in absolute terms, much smaller.

So we are learning to increase some categories in travel retail where we were not as penetrated as we were in skincare, like some makeup. We are learning that our high-end fragrances, like Jo Malone, are extremely successful in travel retail, so we are expanding the high end, the sophisticated artisanal fragrances, including our new acquisition will be part of that. That is a very big opportunity, also because, as you know, fragrance is a very big market in travel retail.

And we are learning more marketing techniques to convert traveler into purchaser based, for example, if M.A.C is adding a makeup artist. Jo Malone is adding gifts methodologies in travel retail. So making sure there are more reasons to buy in travel retail than just lower prices than in the home markets.

So that is the entire strategy. It is a pretty sophisticated strategy and, as everything we are doing, it is about the long-term sustained growth of this very important and profitable channel.

Operator

Joe Altobello, Raymond James.

Joe Altobello - *Raymond James & Associates, Inc. - Analyst*

Since we are talking about travel retail, I guess I will start there. Obviously, a big turnaround this quarter for your sales, although retail sales have been pretty good for the last few quarters. Is this an indication that the inventory adjustments we have seen in the past are now behind us or was this sort of a one-time blip in the quarter?

And then secondly, on skincare, up 2% constant currency. Obviously, the market conditions of Hong Kong and China are not helping you, but how does that 2% compare to category growth overall? Thanks.

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

So I will answer the first part of the question, which is basically yes. We believe in this moment, as we said, the net sell-in and sell-out at retail seems to be aligned. Remember that the -- part of this alignment was caused by the MERS event in Korea, so we cannot eliminate the risk that more events like this will happen or flus or things in other parts that will disrupt the relationship between that and retailing in the future. But for the moment, I believe we are in a situation where they are realigned, and in absence of new disrupting events, hopefully they will stay aligned. Tracey, you want to try some of that?

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

The skincare -- I think the second question was skincare versus -- the skincare growth in travel retail versus the category. And as you might well know, our skincare travel retail business is heavily driven by Asia and Asian markets and Asian traveling consumers. So we did see softness in the Hong Kong and China part of our travel retail business that was largely related to skincare. We also saw some softness in Brazil that was more related to makeup. But for skincare, definitely the Hong Kong, China softness impacted the category in travel retail.

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

But I want to again stress what I said before, that makeup is growing. The M.A.C brand travel retail trend is outstanding and the Jo Malone, for example, or the Tom Ford, so our high-end fragrances are really, really doing well.

Operator

Kevin Grundy, Jefferies.

Kevin Grundy - *Jefferies LLC - Analyst*

My question is on emerging markets, specifically, where you guys have delivered outstanding growth. What is your outlook for the year, broadly? And I am curious how that may have changed or may not have changed over the past three to six months, given the difficult macro? And specifically, do you still think you can deliver this mid to high 20% growth that we have been accustomed to, just the fact the comparisons become more difficult in the third quarter? So any commentary there would be helpful. Thank you.

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

So, sorry. The question was the other markets, the other emerging (multiple speakers)

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

(multiple speakers) other emerging markets.

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

So the other emerging markets, the China that grew 30% in the first quarter grew 27% for us in the second quarter. And, anyway, this is three times the growth of these markets.

So we are growing market share by design in the emerging markets around the world, from Mexico to Brazil to Turkey to South Africa to India to the Middle East, and in all these markets we are growing double digits. As we said, China is not in this group, but when we say we think China, which is growing 9%, and the rest of emerging markets 27%.

I think we will continue. Actually, as I said in my remarks, we plan to continue to invest for growth and beat market share in these markets, even if in some of them the currency issues is creating some economical issues in these markets. We will take the opportunity to further increase our market share in this moment because also it can be done in a very efficient way and hopefully get the benefits of this when this market will go back to more normal economic growth.

So it is a good momentum. Our brands are loved and the opportunities in front of us are enormous, so if the question was can this kind of growth be sustained, I believe, yes, this kind of growth can be sustained for the long time.

Operator

Ali Dibadj, Bernstein Research.

Ali Dibadj - *Bernstein - Analyst*

I'm sorry. I have three questions, but they are relatively straightforward. One is, just going back to the agility, I want to better understand how you are organizationally structured to do that. So who is actually responsible for the dynamic resource allocation? Is it centralized? Is it decentralized? So some more color there would be interesting because it seems to really be helpful to you guys.

Number two is -- and it may relate to the first question. It may not. Your SG&A, ex advertising spend, still seems relatively high here. So I'm trying to get a sense of how much opportunity you think there is there, especially perhaps as you become more nimble. Typically, that is fewer layers, fewer heads, et cetera, so some ideas there.

And then, the third piece is something completely different, just about the fragrances. I guess two of the 12 fragrances that remain with P&G, Dolce & Gabbana and, I guess to a lesser extent, Christina Aguilera, and your interest in those, given what you are seeing trend wise in fragrances recently. Thanks. Sorry for the three.

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

So, I will answer the first and the third and let Tracy answer the second. So how our methodology works, first of all, it is about how we are structured.

But the short answer is centralized. This decision is pretty centralized. We have a monthly meeting where the finance team, with Tracey at the head, and the group presidents, which are -- we have two group presidents take care of the regions or the go to market and two group presidents that take care of the combination of the brands. These four people, plus Tracey and me, centrally have basically a complete control of the business and the resource allocation. And we review the opportunity and make decisions centrally in the same room on a very agile way. And that is, I think, the key topic.

Then how technically it is work, frankly, will be more time than eight minutes on a call. But that is the key idea. It is centralized by six people.

Second question -- actually, your third question, on fragrances, again I want to insist. We declared that in this moment our priority are high-end fragrances on brand assets that we own, like Jo Malone, and that is why the acquisition of Le Labo, I think. That is our priority; that stays our priority. This part of high-end, brand-owned artisanal fragrances model are very profitable, are growing at a smaller but fast-growing part of the business, which is very well suited to the Estee Lauder company portfolio.

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

And Ali, regarding your second question on costs outside of advertising, yes, we do believe we have further opportunity in those areas.

Most of our cost-saving programs this year, some of them were targeted at A&P effectiveness, many were targeted outside of that with selling productivity and other cost-saving initiatives. And we think there is further opportunity, as I mentioned in my prepared remarks, to leverage expenses going forward with some of the process improvement initiatives that we have put in place this year that should yield some benefits in the future.

Operator

Caroline Levy, CLSA.

Caroline Levy - *CLSA Limited - Analyst*

I was interested in just digging a little deeper into China, if I might. It used to be that prices were -- I mean, I think at least 50% above, say, the United States. And I just wondered with some of the price changes that had gone into place, how much the price premium is in China today, on an average?

And if you could just maybe walk around differentiating between Tier 1 cities, other cities, and obviously your online is doing very well, but where are the real pockets of weakness in China and what are the opportunities to change that even in the face of a soft consumer?

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

First of all, on pricing, in China we have decreased pricing, as you probably know, some time ago. And after the price decreased, the currency in China continues to devalue. So the reality, the price differentials are much diminished on our brands.

And I cannot tell you an average because -- but they are 10%, 15%, in some cases, or 30%, 35% in other cases by SKU, depending on many different dynamics. But they are much more reduced than they used to be in the past.

The second part is where are the strength/the weakness of China. Our strategy in China, like the one I explained for travel retail, is about diversification. So China is softer in this moment in the biggest skincare segment, is softer in the biggest cities -- Shanghai, Beijing, while China growth is very strong in Tier 2, Tier 3 cities, is very strong online, is very strong in smaller brands, which are entering in areas in makeup and fragrances, which are fast-growing categories for this population.

So, again, it is about diversification. If you have multiple engines of growth, you can operate in new cities. You can operate online. You can operate in new growing segments, like some makeup and some fragrance -- high-end fragrant segments. There is an enormous amount of growth opportunity in China. And that is the diversification, multiple engine growth work that we are doing also there and which are driving our results.

Just to give you a number, our online business grew 80% in total in China during Quarter 2, 80%, eight zero. So it is very strong acceleration. And that is what is the focus of our activity of creating the right engines of growth also in China for the long term.

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 PM Eastern time today through February 19. To hear a recording of the call, please dial 855-859-2056, passcode 35830757.

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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