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EL - Q3 2016 Estee Lauder Companies Inc Earnings Call

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OVERVIEW:

Co. reported 3Q16 net sales of \$2.66b and net earnings of \$274.9m or \$0.73 per diluted share. Expects FY16 sales to grow 7-8% in constant currency and diluted EPS to be \$3.09-3.14.



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PRESENTATION

Operator

Good day, everyone, and welcome to The Estee Lauder Companies fiscal 2016 third-quarter conference call. Today's call is being recorded and webcasted.

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 everyone. On today's call are Fabrizio Freda, President and Chief Executive Officer, and Tracey Travis, Executive Vice President and Chief Financial Officer. Fabrizio and Tracey will review our third-quarter results and full-year outlook and then discuss the new initiative we announced this morning called Leading Beauty Forward.

Since many of our remarks today contain forward-looking statements, let me refer you to our press release and our reports filed with the SEC, where you'll find factors that could cause actual results to differ materially from these forward-looking statements.

To facilitate the discussion of our underlying business, our nine-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 expectations are before restructuring and other charges. You can find a reconciliation 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 now I'd like to turn the call over to Fabrizio.

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

Thank you, Dennis, and good morning, everyone. In the third quarter, we delivered a solid performance, with strong gains particularly from our makeup category and international business. In constant currency, sales grew 6% and earning per share rose 5% before charges to \$0.76. Based on our results to date, we are on track to achieve our sales and earning guidance for the full fiscal year, excluding charges.

We continue to benefit from a highly diversified business with multiple engines of growth and the flexibility to move investment quickly to support areas that provide the best returns. We continue to fuel makeup, a vibrant category where we have achieved constant currency double-digit gains every quarter this fiscal year.

Social media is helping to drive makeup sales, with how-to-do videos, tips from consumers and influencers, and beautiful visuals of makeup transformations. Our Company has thousands of talented makeup artists who are a competitive advantage for our brands and help drive consumption through personal lessons in-store as well as online, where they can demonstrate the artistry to a broader audience.

M.A.C Instagram, for example, features photos submitted by its global artists illustrating their creativity and talent style to products and trends. This kind of social media interaction creates an ongoing dialogue between the brand and its consumers and helped drive sales.

We are the largest company in global prestige makeup and all our makeup brands grew this quarter. Each of our three diverse makeup-focused brands has a distinct character and channel profile. For example, our third -- one-third of M.A.C sales came from its freestanding stores. A majority of Bobbi Brown sales came from global department stores, and Smashbox has a strong presence in specialty-multi retailers. And there is further opportunity for growth across all prestige channels.

In addition to its popular fragrance collections, our Tom Ford brand has a fast-growing and much-desired makeup business. Sales of Tom Ford luxury makeup products rose more than 50%.

Estee Lauder and Clinique also achieved global growth in their makeup portfolios. Estee Lauder delivered good momentum in the European region as its Double Wear foundation continued to be a strong seller. In North America, the brand launched the Estee Edit exclusively in Sephora stores and on sephora.com. The Millennial-targeted line generated terrific media attention and there is a full cadence of strong promotional activities planned throughout the fourth quarter.

At Clinique, the brand extended its successful Pop Lip Colour collection with new formulas and attractive young consumers with a digital campaign that included interactive music videos with a rising Swedish popstar.

Growth in fragrance continued to come from our luxury scents. Jo Malone and Tom Ford had terrific results. Both brands generated double-digit growth in every region. The success of these brands supports our strategy to position our fragrance portfolio toward the profitable higher-end tier, an area where we are gaining share.

Our artisanal luxury fragrance brands Le Labo and Frederic Malle contributed higher sales, as did the AERIN collection of fragrances. Recently, we acquired By Kilian, a sophisticated Paris-based brand that we believe further strengthens our leadership in fast-growing luxury fragrances.

Turning to our geographies, our international business was stellar in virtually every market group. During the quarter, I visit several countries to gauge consumer sentiment and visit stores. One trip was in the UK, which had robust sales in the quarter, far exceeding prestige beauty growth.

While there, I spent time in Birmingham and saw how our brands successfully tailor their product to the city's diverse multicultural population. Consumers in the UK have a great passion for beauty, and our brands have responded in ways that appeal to a wide range of demographics, which has helped reinforce our leadership position in this market.

The European region remained robust, with growth in nearly every country and particularly strength in Italy, where all brands contributed to a double-digit increase. The tragic attacks in Paris, Turkey, and Brussels understandably dampened some tourist activities in the quarter, but I'm proud of the tremendous strength and resilience our organization in these countries showed during these very difficult times.

Although fewer tourists contributed to a falloff in retail sales in French airports following the Paris attack, our total net sales in travel retail for the quarter were strong. Enjoying the results of our diversification strategy by region, category, brand, and type of airport. And retail sales in the channel were solid and broad-based. They rose double digits in half of the top 30 travel retail markets in the world.

Currency fluctuations continue to affect travel patterns in our travel business. We continue to see stronger growth in some markets where the currency was weakened, including Japan, Australia, or Canada, due to a greater number of inbound tourists. Weak currencies in Brazil and Russia led to a decline in travel by those population and effected sales in the travel corridors that they frequent. However, local market sales in these two countries grew double digits as more consumer purchased products close to their homes.

I just returned from Korea a few days ago and was amazed by the energy and excitement there that beauty produces. Since the fear of MERS has abated, tourists are returning, especially the Chinese. Our business in Korea has turned around very nicely from a year ago, up double digits this quarter. And I was very pleased to see that we are gaining share.

Demand for makeup is accelerating strongly and our brands are successfully competing head-to-head with Korean brands. Four of our brands introduced cushion compacts, which are extremely popular with Korean consumers. Bobbi Brown's cushion compact did so well, it became 15% of its Korea business and contributed to the brand's foundation sales doubling in the country.

During my visit, I met our partners at Dr. Jart+, an impressive brand that is seeing strong demand and gleans insights into consumer desires and opportunities for growth. As I visited stores in Seoul, I couldn't help but notice the sales of artisanal luxury fragrances are booming, including our own Jo Malone brand. I'm excited about the opportunity this trend holds for the newer fragrance brands in our portfolio.

We recently launched GLAMGLOW in Korea and avid consumers are actively using social media to talk about the brand and post photos. Korea is a center of innovation for beauty and there are many new trends and ideas that our brands can leverage and bring to consumers in other areas of the world.

Looking now at our emerging markets, our China business was healthy, as most brands grew solidly and retail sales gained momentum. The online channel had the fastest growth and accounted for nearly 10% of sales.

Sales in makeup and fragrance continue to accelerate, creating greater diversification in our Chinese business. As an example, Jo Malone business more than doubled, with strong momentum in both department stores and freestanding stores.

Our other emerging markets continue to generate excellent growth, rising 20%. Among the best performers were South Africa or Brazil. M.A.C continues to be a trailblazer in sub-Saharan Africa as introduce prestige beauty products and personalized services. It has entered many countries in this area, most recently Zambia.

To fuel our companies' global momentum, we continued investing in fast-growing channels. We opened new freestanding stores and launched several E&M commerce sites for our brands, mostly with retailers. GLAMGLOW, for example, began selling its products on Nordstrom website.

We also increased our presence in specialty-multi. In the US, Clinique continued expanding in Ulta. Estee Lauder launched its Estee Edit product line in Sephora. And several brands added more locations in Bluemercury. Isetan opened a new specialty-multi store concept in Shanghai and several of our brands have presence.

Our creativity and innovation were central to accomplishments in the quarter. Estee Lauder Advanced Night Repair PowerFoil Mask was well received, particularly in Asia, and boosted the brand's important Advanced Night Repair franchise. Clinique Pep-Start Eye Cream, which brightens

and primes the eye area for makeup, debuted exclusively in Sephora in the United States and was the number one eye cream there in February and March.

Beyond products, our brand continued to forge creative collaborations. M.A.C is designing a makeup collection inspired by the singer Selena. And Estee Lauder is teaming up with fashion designer Victoria Beckham for a full cosmetic collection. This collaboration brings great vast to our brand, especially on social media. And we expect them to draw new consumers.

Now, I will turn the call over to Tracey to give more details on the quarter.

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

Thank you, Fabrizio, and good morning, everyone. First, I will briefly review our fiscal 2016 third-quarter results and then I will cover our expectations for the full year. As a reminder, my commentary excludes the impact of restructuring and other charges.

Net sales for the third quarter were \$2.66 billion, up 6% in constant currency compared to the prior year. Our newest brand acquisitions contributed approximately 10 basis points of this sales growth.

As Fabrizio mentioned, our international business remained quite strong as nearly all of our international markets grew this quarter, led by the Europe, Middle East, and Africa region. Net sales in EMEA rose 11% in constant currency, with double-digit growth in most developed and emerging markets. The region continues to benefit in part from the weak euro, making it a more attractive tourist destination, as well as from the benefits of strong execution of its strategic initiatives.

The UK, Nordic, and Italy were the largest contributors to growth among the developed markets in the region, and the Middle East, Russia, South Africa, and Central Europe led double-digit gains in emerging markets in the regions. Our online business was particularly strong across all EMEA markets this quarter.

Our net sales in the global travel retail channel rose 9%, reflecting strong retail trends in most countries in Europe and Asia, which were partially offset by continued net sales declines in Hong Kong, Brazil, and the United States. Overall passenger traffic growth in travel retail across all regions remained solid, despite shifts in consumption patterns between countries due to currency.

Sales in the Asia-Pacific region grew 5% in constant currency. Every market in the region grew except Hong Kong, which was down double digits. Korea was the largest contributor to net sales growth, rising 14% in the quarter, followed closely by Japan, Australia, and Taiwan. China rose 5%, led by 70% growth in E&M commerce sales.

Online sales across all APAC markets rose sharply this quarter. Our net sales in Hong Kong declined more than we had anticipated as tourists from the Chinese mainland continue to decrease. Excluding Hong Kong, the region's sales would've grown nearly 9%.

Net sales in the Americas increased 2% in constant currency. Brazil, Mexico, and Canada all saw strong double-digit growth as currencies in these countries continue to weaken against the dollar. Local market consumption remained strong. Sales in the US rose low-single digits.

Continued strength in our online business, specialty-multi, and high-end department store channels were largely offset by sharp declines in tourist-driven retail doors and continued softness in traffic in the brick-and-mortar business of midtier department stores.

Once again, makeup sales lead product category growth, rising 11% in constant currency. Double-digit growth from M.A.C, Smashbox, and Tom Ford led the increase, while particular strength in the lip and foundation categories drove makeup growth at Bobbi Brown, Clinique, and Estee Lauder this quarter.



Sales of fragrance products rose 7% in constant currency. Double-digit gains from our luxury portfolio -- Jo Malone, Tom Ford, and Le Labo -- contributed the majority of the growth. The Michael Kors Gold collection and Tory Burch stood out among the designer fragrances. This strength at the high end of the fragrance category was partially offset by lower fragrance sales from Estee Lauder and the remaining designer fragrances.

Haircare sales increased 3% in constant currency. Aveda benefited from initial shipments of its new Invati for men products as well as higher sales of more recent launches in existing products. The brand opened new doors in travel retail and added salons and freestanding stores in Europe. Bumble and bumble experienced solid growth in all channels.

Skincare sales were flat in constant currency, reflecting the continued weakness in Hong Kong and the ongoing shift in increased consumer spending from skincare to makeup. Additionally, Estee Lauder skincare business declined slightly in the quarter due to tough comparisons with prior-year launches in the US and in Asia.

There were many bright spots in our portfolio for skincare. La Mer and Origins grew skincare double digits, as did skincare lines of our M.A.C and Bobbi Brown makeup brands.

Our gross margin increased 50 basis points to 81% of sales. The improvement came primarily from supply chain savings and lower promotional expenses, partially offset by channel and category mix. Operating expenses as a percent of sales increased 110 basis points to 66% compared to the prior-year quarter.

Selling and store operations costs to support our retail store growth as well as general administrative costs primarily from employee-related costs, consulting fees, and our prior acquisitions drove most of the increases. These were partially offset by our value creation from our strategic modernization initiative and a deferral of some advertising and promotional expenses to the fourth quarter to support higher expected sales growth in that quarter.

As a result, operating income decreased less than 1% to \$399.2 million and operating margins fell 60 basis points to 15% due entirely to foreign exchange. On a constant currency basis, operating income grew 3%. Net earnings also decreased approximately 1% below the prior-year quarter to \$274.9 million.

Diluted EPS of \$0.73 was 2% above the prior year, reflecting the benefit of a lower share count. Our stronger-than-expected EPS was largely driven by a combination of continued expense management and a delay in some advertising and promotional spending for Estee Lauder and Clinique to the fourth quarter.

Earnings per share for the quarter include \$0.02 of dilution from acquisitions and \$0.03 and unfavorable currency translation. On a constant currency basis, EPS increased 5%.

Let me now turn to our outlook for the full fiscal year. The sales shift related to last year's SMI rollout will impact full-year comparisons to the prior year. I will discuss our expectations adjusting for the impact of the shift as always.

Our forecasted growth rates, both before and after the shift impact, are available in today's earnings release. Also excluded is the impact of restructuring and other charges. For the full year, we expect sales to continue or to grow 7% to 8% in constant currency, including 50 basis points from acquisitions. Currency translation is expected to negatively impact our full-year sales growth by approximately 5 percentage points. Our estimate assumes spot exchange rates as of the end of April of \$1.14 for the euro, \$1.44 for the pound, and \$1.09 for the yen for the remainder of the fiscal year.

Diluted EPS is now expected to range between \$3.09 and \$3.14 or \$0.02 more than our last guidance range, reflecting a slight moderation in the currency impact. Adverse currency translation is now projected to affect EPS by about \$0.27. Excluding the currency impact, we continue to expect EPS growth of 10% to 12%. Our EPS range includes approximately \$0.05 of dilution from acquisitions.



Our strong performance to date gives us the confidence to invest more in the fourth quarter to support traditional advertising and promotion, primarily for Estee Lauder and Clinique. While we continue to pursue value creation from our SMI program, which is now expected to deliver \$175 million of cost savings this year, we also look for ways to further improve our cost leverage in the future.

Fabrizio will now discuss the initiative we announced in our press release today.

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

Thank you, Tracey. The multifaceted initiatives that we call Leading Beauty Forward is designed to provide additional fuel for long-term growth and profitability. It will build on our strong foundation and leverage capabilities we have developed in important areas, driving our business, including digital, retail, and creative.

Leading Beauty Forward will support the continuing success of our strategy in an increasingly fast-paced, complex, and competitive prestige beauty environment. It is designed to sustain our momentum by reducing cost and freeing up more resources to invest in brands, capability, and most profitable opportunities while better leveraging our growth.

As we look toward the future, we believe the best way to capture the growth opportunity of tomorrow is being proactive today. This initiative is a carefully measured next step in our long-term strategy that will allow us to continue to lead in the prestige beauty industry. We expect Leading Beauty Forward to sustain our sales, operating margin, and earning-per-share growth beyond the goals we have set throughout fiscal year 2018.

Clearly, how we do business today and how we must be prepared to do business in the future is very different from what it was just seven years ago when we launched our current strategy. The fast-moving landscape requires a mindset and a way of operating that increases speed and flexibility, is creative, streamlined, cost efficient, and designed to serve global consumers in new ways.

To that end, as part of Leading Beauty Forward, we plan to redesign select areas of our go-to-market organizations in the regions, affiliates, and brands to increase agility and strengthen their capabilities. As more of our consumer engagement moves to digital platforms, the markets will need the tools and authority to respond quickly to opportunities and bring our expertise in local relevance closer to consumer.

Stronger skills in innovation, digital, social media, and creative capabilities will allow them to differentiate our unique brands even further by tailoring products and services to specific consumer segments and channels. We also will redesign select corporate functions to increase their efficiencies by making them leaner, scalable, and less costly while continue to deliver excellent services to our brand and businesses.

We are evaluating the creation of a global and regional shared services among certain functions to simplify processes and focus on more strategic activities. We also plan to continue to optimize some of our supply chain operation to create a more efficient structure. These actions are expected to reduce our operating expenses, freeing up resources to invest in our brands, channel, consumer-facing activities, and potential acquisitions.

An important goal of Leading Beauty Forward is to support and grow our brands. To accomplish this, we will invest in activities that will resonate with consumers, including innovation to develop new product and services, unique point-of-sales assets, effective social media dialogues, and compelling advertising. We will also support our newly acquired brands to expand their presence and products and continue to build our small and medium-size brands so they become leaders in the industry.

As employees focus more fully on being creative and strategic, we will enhance our learning and development programs so they have the best skills to lead in critical areas. The redesign will regrettably include reducing position in some areas.

We also expect to add talent in the departments we plan to strengthen and to retain all other employees. In total, we estimate at this time a global net reduction of approximately 900 to 1,200 positions, which is about 2.5% of our current workforce. As the Company continues to grow and invest in new positions in the future, the improved process from these initiative are expected also to better leverage future productivity.



We are launching Leading Beauty Forward from a position of exceptional strength. Since we began our new strategy cycle, our sales have increased by more than 50% and our growth rate has outpaced that of global prestige beauty.

Key to this performance is the much more diversified and balanced business we have created with growth engines across our brands, categories, channels, and geographies. With insights from our ten-year compass, we anticipated many of the trends influencing the industry's rise.

We also modernized our processes and technology infrastructure. Our strategic modernization initiative has been deployed through most of our organization, creating greater visibility to information that let us manage our business in a more cost-efficient manner. We developed a wider spectrum of capabilities strengthening our talents in areas such as R&D, supply chain, information technology, retail, digital, and consumer insights.

Leading Beauty Forward is designed to build on these achievements to further increase our efficiency and effectiveness. Global prestige beauty is thriving. Growing industry, with new channels, emerging geographies, and the influence of younger consumers.

With the convenience of the Internet, the expansion of specialty-multi retailers dedicated to beauty, particularly in the US, how consumers shop is changing rapidly and competition has intensified. Lower barrier to entry resulted in more than 250 new niche brands launching around the world last year. And the sheer number of beauty products vying for consumers attention is vastly increasing.

The design of our new structure should generate greater productivity through better cost leverage of our sales growth. Importantly, Leading Beauty Forward will create ongoing savings and reinvestment to help continue our momentum in this fast-growing and more competitive market, which should mean greater sustainability and less risk in meeting our future growth targets.

As the global leader in prestige beauty, we are poised to take advantage of opportunities that lie ahead by taking charge and leading change. Leading Beauty Forward further positions our Company to continue winning in this rapidly changing arena where the ability to anticipate developments and react cheaply and nimbly is more essential than ever. We expect to sustain our strong growth and lead not only our Company, but all of the prestige beauty forward to greater heights.

Tracey?

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

Thank you. So as Fabrizio just discussed, Leading Beauty Forward is a multiyear initiative designed to help us fuel our growth momentum and create a more efficient cost structure to sustain our margin progression beyond fiscal 2018.

During the course of the initiative, over the next few years, we expect to take charges of approximately \$600 million to \$700 million. We expect to begin realizing initial benefits from the program in fiscal 2018, but will continue to maintain our flexibility to invest in opportunities and mitigate risk.

At this time, we do not expect this to affect the long-range guidance we provided last summer, other than the related restructuring charges. Once fully implemented, we expect to generate annualized benefits -- net benefits of \$200 million to \$300 million, currently anticipated to be fully realized after fiscal 2019. We expect to reinvest a portion of those savings behind the capabilities we need, that Fabrizio just discussed, to continue to succeed in the rapidly changing global prestige beauty environment.

We will, as we usually do update, our three-year strategic outlook and share our goals in August. The update will include the impact of this initiative, any adjustments to our strategy since last year, the addition of recently acquired brands, and changes in currency rate assumptions.

We are pleased with our results so far this year, and we believe Leading Beauty Forward will play an important role in supporting our continued sustained growth momentum for the long term.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Nik Modi, RBC Capital Markets.

Nik Modi - RBC Capital Markets - Analyst

So Fabrizio, I had a question on innovation. If you are to characterize the pipeline going back five years, three years, and then today, how would you explain it to us? And I'm really coming at this from a point of it takes time usually for the pipeline to get filled versus the product actually hitting the marketplace.

So I just wanted to get some context on how you feel about the pipeline today versus maybe five years ago.

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

I feel very strong. I think our pipeline versus five years ago, I would say, is almost doubled in term of the power of extra business. We have a very clear internal process where we look for sufficiency of our innovation pipeline versus our next three, five years goals. And I can tell you we consider our innovation pipeline more than sufficient.

Now, the characteristic of the pipeline has changed in some way also. First of all, today, the pipeline is much richer in makeup. Because as you heard, the makeup category is in this moment a fast-growing in the world and also very fast changing.

So there is some outstanding innovation pipeline in makeup, and the makeup pipelines tends to be done by many smaller products versus few very big products, which is more typical of the skincare pipeline. So that is a change and we have adjusted to that change.

Our skincare pipeline is strong. But again within skincare, the pipeline is more focused on what we call instant benefit skincare versus the long-term antiaging. And that has changed.

And third, but probably very, very important, our pipeline in the fragrance business is changed. It is done by much more high-end luxury artisanal fragrances, which will allow us, in my opinion, to continue gaining market share in the high-end profitable fragrance business.

And finally, in hair care, our pipeline, particularly in the styling, more profitable part of hair care, is stronger than ever. So in that, I feel positive about the sufficiency of the pipeline, and also I feel positive by the fit of our pipeline to the future of the markets as identified by our compass.

Operator

Dara Mohsenian, Morgan Stanley.

Dara Mohsenian - Morgan Stanley - Analyst

Obviously you are seeing very strong growth in makeup, as is the category. Can you discuss how long you think the cycle of makeup category strength can continue as you look out over the next few years? And what's driving the category growth?



And then on the e-commerce side, how sustainable do you think the strong growth is that you are seeing on that business? You were kind of earlier than a lot of peers in focusing resources there on that channel. So I guess is there any risk going forward that competitors start to catch up with you? Or do you think you are winding your gap versus peers in terms of the way you manage the business? Thanks.

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

On makeup, first of all, I believe this is a long-term trend. The makeup category is growing, driven by several aspects. The first one is that the Asian consumer, the Asian women, are becoming more avid users of makeup. And so this is an enormous amount of growth, potentially, that will develop -- it is developing now and will continue to develop in the next years.

The second big trend is that the Millennials are on average using more makeup than the previous generation. So there is an increase of consumption per individual in all markets, including developed markets. And this is a long-term trend also because what it is driving, the more usage of makeup, is what historically has been our strength in our business model, which is education and customization. And now the education is available also via online -- exactly our e-commerce activities -- and via social media, which is booming the amount of how-to videos, different trends, etc.

So the combination of this more amount of trends information and how-to information with the Millennial generation point of view is pushing makeup up. I think this will continue for a long period.

In term of our activity in e-commerce, we continue to do very well. I think we gained substantial competitive advantage. But not only in the execution in market, also in the capabilities. We have a very strong e-commerce team that is developing amazing work, which are divided into technology people that can develop sites and develop activity in a very fast pace around the world from our centralized offices in New York in a very -- with investment that now will pay out for the long term that we had done in the previous years.

And we had great quality of execution in the creative silo. So on top of the number of sites, the ability to penetrate the markets, frankly we have the capability and the quality of execution that for the time being set us aside in my opinion from the industry.

Tracey?

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

And we also have a very good partnership with all of our retailers around the world to make sure that our products are displayed and presented well on the retailer dotcom sites as well.

Operator

Olivia Tong, Bank of America.

Olivia Tong - *BofA Merrill Lynch - Analyst*

Fabrizio, I want to go back -- get into advertising a little bit for this particular quarter. Because coming into the quarter, you probably planned to increase A&P support in the businesses. Of course, continue driving sales and support some of the product launches.

But the sales growth did decelerate a little bit, probably a little bit more than people had expected. So can you help with some -- provide a little bit more insight in how you go about making decisions on A&P spend? Because that line does continue to move around a fair bit quarter to quarter.

And then also in terms of the Chinese tourism, do you think you are making up the shortfall in Hong Kong from lack of Chinese tourists in other areas? Thanks.



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

First of all, in term of the sales for the quarter, we continue to believe that we will deliver the fiscal year in the 7% to 8% range, which means if you look at the numbers that we assume actually an acceleration of the sales strength in the fourth quarter.

So the sales by quarter depend a lot by initiatives launches and what happens in specific markets. And the way we take A&P decisions is we base the decision off if we believe there is enough rate of return on that investment in that moment. For example, in quarter three, the things that we saw going less strong than we expected was Hong Kong.

So when we have markets that decrease their growth significantly, we do decrease our spending there. And we keep the spending for better moments where there is better market traction. So what you are seeing in the third quarter, very specifically, is reduced spending Hong Kong from our side.

The second area where we saw less traction was US midtier department store brick-and-mortar, where we clearly saw less traction together with all the tourist doors in the US that particularly influenced by the absence of Brazilians and Russians that was a very dramatic change. So when we see these dramatic changes, we obviously adjust our A&P investment.

The second reason was in this case very specific is some product launch initiatives on Lauder Clinique that we decided to move in supporting them in the fourth quarter, which is the other reason why we are moving A&P investment from one quarter and to another.

Personally I see this as a strength. We have the agility to move our A&P investment by quarter depending on the market situation and the product launch situation. And this make us more efficient and more effective. And we stay consistent on our year ago that we will commit to do our best to deliver. That now changed. But by quarter, actually we see agility and flexibility as strengths.

On the Chinese consumers, now, we are definitely doing much better with Chinese consumer in other areas where they are going. For example, in Europe, as we have seen, there is a growth of our European business, which is partially driven by tourists. And the tourists are also Chinese. We have seen Korea coming back and Japan being pretty strong.

So yes, we recovered some of the sales. However, not all of them. We have a very high market share in Hong Kong. Very, very high market share. And our market share, for example, in Japan is half of the market share we have in Hong Kong.

So in that situation, we obviously cannot recover the Hong Kong losses completely in other areas. That's what you are seeing in this moment as a phenomenon. But it is a temporary phenomenon, and as soon as Hong Kong will stabilize and other markets where we are now building market share, like Korea, will achieve the levels we believe are achievable, that things will accelerate again.

Operator

Bill Schmitz, Deutsche Bank.

Bill Schmitz - *Deutsche Bank - Analyst*

Can you just talk about some of the US NPD trends? Because it's not just Estee Lauder, but the bigger brands like still continue to lose market share from some of the smaller niche brands. So is there a strategy in place to find a way to kind of outflank them?

And then maybe most -- I don't want to say problematic, but it seems like M.A.C is declining quite a bit in the US -- I shouldn't say quite a bit, but it's declining. So can you just talk about the M.A.C US versus international split and if the international growth can offset some of the softness in the US?

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

Starting from M.A.C, M.A.C is really doing very, very well internationally. M.A.C is growing strong double digits in every single market of the world. And the temporary flattening of the retail trend in the US is being more than offset by a booming international business.

The flattening of the US is -- the temporary flattening of the US trend is driven by two aspects. One, as I said, is the fact that the lower traffic in midtier department store is one of the driver. And the other is tourists. I mean, M.A.C business is driven by tourists of the world that visit the US in a significant way because the brand is very, very popular around the world.

So the important decrease of tourists, particularly Brazilians and Russian, as I said, have temporarily limited the retail of M.A.C also because these stores were very strong in the base period that we are comparing this to. But overall, in total, M.A.C continues to be absolutely one of the strong drivers of our success around the world. And we have programs to ensure that this will continue.

In term of the success of the small size brands in the US, this is a fact that as I explained in my prepared remark that the combination of easier access to consumers and more availability of investment -- you know, money at lower interest rates -- have created a lot of new launches of brands. And the possibility of social media to bring these brands to attention of the consumer is taking down the barriers to entry.

So the way we are reacting is first of all, reinforcing the business in our strong brands. Second, participating to this with our midsize smaller brands, including acquisitions. I mean, Smashbox was one of these brands when we acquired these brands and now in fact is growing at double-digit in the context of this.

And then finally is the diversification of our distribution with freestanding store, more specialty, continued success of online, and our support to midtier department store to accelerate to reinforce the business model, to be able to better attract Millennials, and better activate the floor in order to become even more competitive as to this development of smaller brands and of new channels. This is one of the changes that I was describing before that requires adjustment in capabilities and investments in supporting our brands' growth.

Operator

John Faucher, JPMorgan.

John Faucher - *JPMorgan - Analyst*

You know, if we take a look at your margin performance over the past couple of years, it seems to have moderated a little bit here in terms of the year-over-year increases. And I realize there is FX as well as the acquisition impact in that.

But it really seems to have slowed particularly since the end of the 2010 to 2013 restructuring program. So I guess as we look at your new restructuring program, is that a sign maybe that the incremental margins on organic revenue growth is lower than what it was?

And I guess if that's the case, there's been a discussion and you guys have talked about the cost of growth not having gone higher. But the math would seem to indicate that, again, maybe that incremental margin isn't as high as it had been historically. Any thoughts on that?

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

First of all, yes, I'll let Tracey give more answer. But first I want to say that this fiscal year, we had 50 points. The 0.5 margin point just affected by currency. And 30 basis points just by acquisitions. So 80 basis points are affected by currency and acquisitions.

So yes, that's a new fact in the margin evolution. But then the combination of our business and cost savings is actually producing the power to continue growing margin. Obviously if currency and acquisition will stop affecting it negatively, this would be more visible.

The other thing is there is also a mix change in our business. We have more freestanding stores and we have more makeup versus skincare that also are changing the impact of mix in our business. So we need to continue to deliver our growth. We need to become more efficient and effective and manage our overall cost structure better. That's part of what we are announcing today and we are going to do.

Tracey?

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

I think those are the two differentiators, John, in terms of the time frame that you referred to. Both the restructuring program previously, which allowed us to reinvest back into the business and really drive and support what was a skincare moment, particularly in Asia.

And the period post that corresponded with a slowdown in Asia and Asian consumption, particularly in China and Hong Kong, as Fabrizio spoke about, which certainly slowed our skincare business, particularly with our large brands like Estee Lauder and to a lesser extent Clinique. So that is a margin difference in terms of our business performance relative to the previous time frame.

One of the things that the Lead Beauty Forward program does for us, because we are and certainly our ten-year compass has allowed us to continue to understand that there are very, very significant growth opportunities for us from a total Company standpoint. It allows us the freedom to invest more in those opportunities, irrespective of the margin, and deliver our margin goal well into the future.

So it's a very exciting program. But certainly, it is proactive on our part looking forward in terms of where the growth opportunities are and making sure that we can support them with capabilities. We can support them with other investments and still drive the business and the profit expectations.

Operator

Lauren Wolff, Piper Jaffray.

Lauren Wolff - *Piper Jaffray & Co. - Analyst*

Thanks for taking our questions. We have a couple for you this morning. And I'm calling on behalf of Steph Wissink.

The first question we have I guess we have seen an [ads sudden] shift into Q4 related to Estee and Clinique. Is that tied to specific product line introductions or in response to other channel plans? And then secondarily, just examples of speed and agility. Is that largely in the product development and marketing pipeline?

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

So I think on the A&P, Fabrizio did speak with that -- speak to that a bit earlier, Lauren. It is tied somewhat to some of the launches that we are expecting from particularly Estee Lauder and Clinique in the fourth quarter. It's also tied a bit to some stores that slipped in terms of store openings from Q3 into Q4, primarily related to M.A.C. So those are the primary drivers.

And as Fabrizio mentioned also previously, the slowdown in Hong Kong and a couple of other market slowdown North America, we've seen the last few years post-holiday, traffic has been quite slow. And it has taken longer to start to see traffic flow back into particularly the department store channel and particularly the midtier department store channel. So those factors are what caused us to think that the A&P spend that we had initially planned for Q3 would be better spent in Q4.



Operator

Javier Escalante, Consumer Edge Research.

Javier Escalante - *Consumer Edge Research - Analyst*

My question has to do with your expansion of freestanding stores in the third quarter. My understanding is that you had opened 90 out of the 250 target that you set up for the year by the second quarter. 90 by the second quarter.

So if you can tell us how many stores you opened in the third quarter, in what regions, what was the contribution to growth, and whether -- what is slotted for Q4 is what it is going to drive the re-acceleration of the top-line growth. Thank you.

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

So Javier, we opened net 25 stores in the third quarter; a little bit less than what we had expected. And as I just mentioned, more of those will shift to the fourth quarter. We don't comment on the incremental sales by channels related to growth from our different channel activity outside of travel retail and online.

But certainly, the incremental stores will contribute some to the growth in the fourth quarter. A pickup in performance in the US is also expected to drive more of the fourth quarter growth as well, and in particular, our bigger brands Estee Lauder and Clinique in addition to M.A.C.

Operator

Caroline Levy, CLSA.

Caroline Levy - *CLSA Limited - Analyst*

Two questions I have to ask on China, of course. If you could talk a little bit about the shift in channels. And obviously, online is doing really well, but could you talk about your strategy within department stores?

How many freestanding stores you are opening beyond the Tier 1 cities and whether over time, you think freestanding stores will be throughout the country or online? How big could online get there?

My second question is simply on innovation in skin. I'm just wondering if you are changing the way you look at that innovation, given the challenges to the growth in the category now?

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

Yes. So on, China, as we have been growing 5% our net sales this quarter and 8% our retail sales. So retail sales 8% in China is good, is strong. And the profile of our growth, first of all, by brand is that all brands are growing double digit, with the exception of our Estee Lauder brand, which is the biggest brand in the profile.

So we are, first of all, even before distribution, we are diversifying our brand portfolio that goes with the distribution. Because different brands are in different distribution. And we are diversifying geographically, because as I explained, our timing was through also this quarter. We are opening new cities and new geographical area of China. We opened one new city; we opened 13 new doors just in the quarter three.



In term of the channels, online is doing well and will continue to do well. Today, we have now 10% of our business by now in online in China versus 12% in the US. So China is catching up with the US at a speed of light.

We are opening more freestanding store. In this moment, it is mainly on M.A.C and Jo Malone. But in the future, we may decide as we see the opportunity to have add also other brands, increasing the number of freestanding stores, particularly in the cities where this is appropriate and there are no alternative distribution solutions.

I personally believe that the future of freestanding store in China will go directly to omnichannel. Meaning, the stores will be connected to the online brand dotcom activities and will be one basically only channel opportunity that will bring the brands in many more cities with pretty efficient freestanding store models, which are not the traditional big freestanding stores in cities like in the developed markets.

And finally, we believe the specialty channel over time will also develop in China. And today, we are much more penetrated and developed in the specialty channel in China that we were in the US at the beginning of the specialty channel development. So well diversified by region of China, well diversified by brand -- or better diversified by brand in our strategy, and well diversified by channel is our goal for the development of the China market.

Now, in the innovation on skincare, as I explained before, yes, we are looking at skincare in a different way: reflecting the new consumer trends and reality. As I said, when you take skincare as a whole, there is a bigger and faster growth in what I call skincare for immediate benefit or skincare as a base of makeup.

And there is less growth in this moment in the intense antiaging skincare part. For the same reason of makeup: a lot of the growth is driven by Millennials, which are more interested in this part of the skincare. So yes, big part of our innovation pipeline is also driven in the skincare benefits, which are more modern and more Millennial.

Take an example, the new Dimension launch of Estee Lauder is not about antiaging. It's about really the shaping of the face depending how a consumer want. Or think of our fastest-growing skincare segment, which are masks. Masks -- or even we have a brand, GLAMGLOW, which is completely focused on masks.

A mask is a product that you use to get immediately after 10 minutes the benefit that you are looking for, be it luminosity, moisturization, irritation, or brightening, etc. So skincare for immediate benefit, which is closer to makeup in reality in term of better for the consumer, is the fastest-growing trend. And our pipeline in these areas are the strongest they've ever been.

Operator

Joe Altobello, Raymond James.

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

First question on Hong Kong. Fabrizio, you mentioned earlier that you think that's going to be a temporary phenomenon, but it's been going on now for five or six quarters. Is there anything that you are seeing that leads you to believe that that should get better anytime soon or is that going to be with us well into fiscal 2017?

And then shifting gears to skincare a little bit. You just mentioned the new reality in that category. Is there anything that can be done to re-accelerate the category? Or is that going to be demographically challenged for some time? Thanks.

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

Which category?



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

Skincare.

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

Yes, okay. On Hong Kong, so I don't know what I don't know. I'm saying it's temporary because Hong Kong is a gray market with an enormous internal demand of local consumers. And is a very attractive market for Chinese in general.

So it has been declining substantially in the last period. I believe at a certain moment, it will stabilize. I personally don't have the expectation that will go back to big growth fast. But I do have the expectation that this trend will stabilize.

It will stabilize also because the local consumption has actually continued to increase. And so is the mix between local consumption and tourists, particularly Chinese tourists, that at a certain moment will stabilize. And I just came from Hong Kong. As I said in my prepared remark, I was in Asia last week. I visited Hong Kong and Korea.

And the other thing that gave me confidence is the strength of our team there, which is managing this very difficult time in its fantastic way, increasing their activities on local consumers to help our business to stabilize without waiting for tourists. But just increasing our market share with locals, which I think is the right strategy. And I have great confidence in our team to be able to stabilize the trend as soon as the market will allow.

On your skincare question, I think I've answered already several times: the skincare obviously is and remains the most important categories overall and will continue to grow. As I said, the fastest-growing part of skincare is the skincare which is more relating to immediate benefits, which is the skincare which is of higher interest for Millennial.

We had to adjust our innovation, our technology, our activities, and planning for the future to the balance between more drastic antiaging benefits and more immediate benefits. We are doing that via our portfolio of brands. Some of our brands are much stronger in antiaging, like Estee Lauder.

Some other of our brands, like GLAMGLOW, are completely focused on immediate results skincare. And some of our brands, like Bobbi Brown, have a strong skincare business, which is actually the skincare as a base of makeup. It is to support the makeup habits of women.

So we are attacking skincare on multiple fronts: antiaging, base of makeup, instant benefit. Thanks to our portfolio of brands and thanks to our innovation pipeline, I feel very strong about our long-term skincare trend. But it's a fact that makeup in this moment is a much faster-growing category. And we are, again, I see as a strength that we have the agility to adjust and refocus our investment resources depending on the biggest trends we see.

Operator

Lauren Lieberman, Barclays.

Lauren Lieberman - *Barclays Capital - Analyst*

Great, thank you. I just had one clarifying question on the door openings and second on the investment spending. So first on the doors, just I wanted to confirm that 250 is still the right number for this year. So there would be 135 doors opening roughly in the fourth quarter.

And then secondly, if that's the case, that would actually suggest that a lot of the step-up in spending budgeted for this year is really affiliated with those doors more so than necessarily a specific step-up in advertising. So if you'd comment on that, it's great.



And within the AMS line, I know it's not reported quarterly, but on a full-year basis, if you could talk about how that mix has maybe shifted over time. If there is some reduction in some buckets, like sampling or merchandising, with less reliance on department stores, but an increase in the kind of core advertising dollars, that would be really helpful. Thank you.

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

Lauren, I'll start and then I'll let Fabrizio add. In terms of the door openings, you are right: approximately 130 in the fourth quarter, possibly a little bit less. And yes, we do see and expect to see a step-up in our store -- our related expenses. So selling expenses, store ops expenses related to many of those store openings.

We also do, though, however, expect to see a step-up in A&P expense related to some of the programs that we are supporting in the fourth quarter. And it runs the gamut in terms of the spend. Certainly, there is some sampling that's involved in that A&P spend.

So we did talk about the fact that promotion was down in the third quarter. We do expect it to be up more in the fourth quarter related to some of the programs that we are supporting.

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

Yes. And in term of advertising, we are -- there is an increase of sampling, to be very clear. Sampling more and more important, given the dynamic of the consumer and given also the channels that we are going in.

The recent increase in loyalty programs and in the ability to link consumers to loyalty activities, particularly that goes along with freestanding store and online and e-commerce. There is an increase of this and a decrease of all other kind of promotion which are more typical of brick-and-mortar.

And in term of swing, I would say you need to look at what's happening for us is like our magazine print advertising is more or less stabilizing. But our TV advertising is decreasing and is increasing of equivalent or more the digital social media advertising. So summarizing, it's a stabilization of the magazine advertising, a decrease of the television, and an increase of the digital social media. That's the trends we see now.

Now obviously, this mix is very different by country in the world and by brand. But in general, this is the big trend we are seeing. So more sampling and more digital social media.

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 May 17. To hear a recording of the call, please dial 855-859-2056, passcode number 91609680.

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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