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Estee Lauder Cos., Inc. (EL)

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MANAGEMENT DISCUSSION SECTION

Operator: Good day, everyone, and welcome to the Estée Lauder Companies Fiscal 2018 Third Quarter Conference Call. Today's call is being recorded and webcast. For opening remarks and introductions, I would like to turn the call over to the Vice President of Investor Relations, Mr. Dennis D'Andrea. Please go ahead, sir.

Dennis D'Andrea

Vice President, Investor Relations, Estee Lauder Cos., Inc.

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

To facilitate the discussion of our underlying business, the commentary on our financial results and expectations is before restructuring and other charges, provisional one-time impacts of the recently enacted U.S. tax law, and other adjustments disclosed in our press release. You can find reconciliations between GAAP and non-GAAP figures in our press release and on the Investors 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'll turn it over to Fabrizio now.

Fabrizio Freda

President, Chief Executive Officer & Director, Estee Lauder Cos., Inc.

Yeah. Thank you, Dennis, and good morning, everyone. Our excellent performance continued in our fiscal third quarter, building on the momentum we generated in the first half of the year. Our strong growth was broad-based across all regions and product categories, which produced double-digit increases in both the top and the bottom lines. Sales rose 13% in constant currency, about double the robust pace of global prestige beauty, and we gained share.

We leveraged our higher sales into even greater profit growth, aided by further cost savings, efficiencies and lower tax rates. Our adjusted diluted earning per share increased 17% in constant currency. With these better-than-expected results and confidence in the fourth quarter outlook, we are again raising our sales and EPS guidance for the fiscal year, which should make our performance one of our best in the last decade even in the midst of high competitive environment.

Our global success came from bringing our brands into high growth markets, channels and retailers, and attracting consumers with compelling innovations, high quality products and social media activities. We have been able to devote increased investments to our digital activities as a result of our Leading Beauty Forward initiative, which has freed up resources from other areas. Today, all our brands are amplifying their digital communications and aligning with inspiring influencers.

We have reengineered our financial structure to make this happen, and our results this quarter are proof of our ability to capitalize on positive industry trends. Our winning strategy is centered on activating and accelerating multiple engines of growth. As our business flourished around the globe, we continue to support the momentum of

our fastest growing brands, countries and channels. They are gaining greater traction, as we develop more growth engines in each area.

We opened new doors in consumer preferred channels and retailers, and closed less successful ones. Our results reflect skilled execution, improved analytics and our increasing agility to take advantage of opportunities quickly, effectively and respond to trends faster. Consumer interest in beauty and access to products is expanding in established and emerging markets. This trend is evident in our third quarter results, where virtually all our brands grew on a global basis.

Many rose by double-digits led by our luxury tier, skin care focused brands and the Estée Lauder brand. Many of our mid-sized brands have grown so strongly in recent years that they are now leaders in their respective categories in prestige beauty. Jo Malone London for example is a top brand in high-end fragrances. La Mer is number one in luxury skin care. Tom Ford is a leader in luxury makeup and Aveda is highly ranked in natural prestige hair care. All these brands improved in the third quarter, further solidifying their positions.

Sales at each of our largest brands, Estée Lauder, Clinique and M·A·C grew globally. Our established brands are winning because they are changing, innovating and appealing to new and younger consumers. The most brilliant example of this transformation is our Estée Lauder brand, and we intend to apply its playbook to other brands. Like many of our mid-sized brands, our big brands are also prestige beauty front-runners. Estée Lauder is a global leader in prestige skin care. Clinique is number one in prestige beauty in the U.S., and M·A·C is top ranked in prestige makeup worldwide.

Estée Lauder was again a standout in our portfolio. Sales climbed strong double-digits, reflecting the brand's strengths across skin care and makeup, as well as in many markets and channels, illustrating its increasing global appeal. The brand's success stems from the high quality of its product customization to consumer needs by region, strong repurchase rates especially amongst its hero products, and a focus on engaging consumers through digital and social media.

Clinique growth improved, led by gains in skin care, which rose in every region. The brand's makeup and fragrance business also increased with particular strength in European region. M·A·C global sales increase reflected strengths in Asia and travel retail. Several of M·A·C top global doors were in travel retail location in Asia, boosted in part by visitors to Korea for the Winter's Olympics (sic) [Winter Olympics] (07:01).

Several factors drove our skin care acceleration. Asians are large users of skin care, and our business in that region was robust. In addition, more millennials are purchasing skin care products, and our innovation in hero products were well received, including newer ones like masks. This is a trend we had anticipated, and therefore, we are well positioned. Many of our brands' hero products continue driving our strong performance.

Clinique new Moisture Surge 72-Hours Auto-Replenish Hydrator was first introduced in North America in December, and the franchise nearly doubled there this quarter. In the past two months, the new moisturizer has been rolling out internationally and it's helped lift Clinique Moisture Surge franchise by over 50% fiscal year-to-date. In Asia/Pacific, Clinique hero products comprise about one-third of its sales, driven in part by strong Moisture Surge growth.

Clinique is gaining share in moisturizers in many large markets, including the U.S., UK, France and Spain. Estée Lauder launch last July of Advanced Night Repair Eye Concentrate Matrix has helped solidify the brand leadership in the eye treatment subcategory, which is a critical [ph] recruitment (08:30) area in skin care.

Our makeup sales were solid, but consumers demand is leveling off after several years of exceptionally strong growth. Our top performers were Estée Lauder, M·A·C and Tom Ford. The Estée Lauder brands gained share globally in makeup, largely driven by Double Wear foundation franchise. We are supporting Double Wear with a wider range of shades and forms such as Cushion Compact to address the needs of consumers worldwide.

M·A·C enjoyed growth internationally and has been well received as it enters new channels and retailers. It was our first brand to launch on ASOS in the UK, an exciting online platform that is especially popular with millennials, and M·A·C successfully reached new consumers. Its recent NICOPANDA collection with the edgy fashion brand has been a big hit.

Too Faced global growth was mainly driven by success in specialty-multi doors in Europe and Asia, and it has gained share internationally. The brand grew at a slower pace than in recent quarters because of tough comparison with the prior year as lower makeup category growth in the U.S. We expect Too Faced also will return to significant growth in the U.S. next quarter with roll-outs of new products and targeted expanded consumer reach.

Turning to our geographies, sales rose in about three-quarters of our markets. Asia/Pacific was our strongest engine, where nearly every country posted growth and most brands grew double-digit. In China, we achieved another quarter of stellar double-digit growth and gained share. Skin care, the predominant category, rose significantly. Yet, at the same time, our makeup business doubled and fragrance was sharply higher. All major channels posted strong growth, driven by online and specialty-multi, which more than doubled.

Our investments in China are creating even greater awareness of our brands among Chinese consumers, especially as we intensify our social media campaigns. Through our own brand sites and third-party sites, we can reach millions of consumers in more than 500 Chinese cities who desire our products, but don't have access to a physical store. This is evident in our online sales, which accounted for nearly one-quarter of our Chinese business.

Outside of travel retail, our strength in Europe, the Middle East and Africa was led by Italy, where our local currency growth far outpaced the market. Across the region, several emerging markets including Turkey, Central Europe, India and Russia posted double-digit gains. The Middle East, however, continued to be challenged. In the U.S., our brands generated stronger sales online and in specialty-multi retailers. But in total, our business declined slightly as a result of continued challenges in some brick-and-mortar department stores and free-standing stores.

As the physical retail landscape continues to change, most recently with the unfortunate news of Bon-Ton's liquidation, our business will be impacted in the short-term. Longer term, however, fewer stores should provide a healthier environment, as sales continue to migrate to experiential retail and to online. We are working with retailers to strengthen our brands' assets on their websites, where we are seeing good growth, as well as the experience in brick-and-mortar stores to increase sales in both areas.

Looking at our business by channel, nearly all posted improved results. I will highlight two of our most vibrant. Travel retail generated momentum in every region due to increase in demand for our brands worldwide and outstanding execution by our organization's teams. The channel had strong retail growth in Asia, double-digit gains in the U.S. and Canada, and retail sales in the European region outpaced the local market.

Our eight largest brands in the channel rose double-digits at retail and skin care accelerated sharply reflecting positive global trends. Travel retail results are driven by our investments in key local markets that are fueling our

conversion efforts in airports. We launched our seasonal fragrance brands and Too Faced and BECCA in more airports to meet growing consumer demand. We are seeing the clear success of our high-end fragrance strategy in the travel channel.

Fragrances are an important category in travel retail, and our luxury fragrance portfolio is already a strong growth engine. Most of our travel retail growth came from like-door gains. Starting in June, there will be more than 30 new flights a week between China and Europe, which is expected to help increase passenger traffic. Numerous growth engines are driving our online business, which once again climbed sharply. Sales grew double-digits across all platforms, regions and categories.

Even as our online business has become significantly larger, we are sustaining our momentum. In Asia, our online sales doubled led by Tmall in China. M·A·C's first Super Brand Day on Tmall delivered terrific results. One of M·A·C's most popular products is lipstick, and it sold approximately 180,000 during that brand day. In March, we launched Darphin on Tmall, our eighth brand on the platform with promising initial results.

Our retail dot-com business grew double-digits in every region. In the U.S., we had excellent retail sales on department store sites. Retail sell-through on Macys.com grew 30%, and the Estée Lauder brand is the number one beauty brand there. Social media is becoming an integral part of our brand dot-com business. By offering unique content and easy to use functionality, we are making them competitive destination sites and even more useful for consumers. We launched seven more brands dot-com sites internationally, including [ph] Origin (15:53) sites in France, Sweden and Hong Kong.

Our digital-first mindset continues to influence everything we do. Our brands are finding new ways to engage consumers by using big data to [ph] inform trends, pair (16:07) with the right influencers and create impactful content. To stay at the forefront, we are adding digital talent, leveraging new technology like augmented reality, monitor real-time campaign analytics across all brands and directing more advertising spending to search influencers and mobile-first videos.

In the last call, we discussed our intent to enhance the company benefits and invest in our workforce to help attract and retain the best global employees. As a first step, we are improving our family-related benefits for our diverse employee base in the U.S. This includes an expanded parental leave for all employees irrespective of gender and enhanced benefit around adoption, child and elder care, and enhanced flexibility when employees return to work. Our new policies are among the most comprehensive in the U.S. and underscore our commitment to family values and work-life balance. We plan to share additional benefit announcements in the coming months.

I want now to spend a moment discussing a situation which we disclosed in our press release this morning. We recently learned that some testing related to certain products advertising claims had been intentionally altered for some time by a small group of employees. We became aware of this when an employee brought this to our attention through our internal escalation process. This clearly does not meet our standards, and we immediately launched a comprehensive review of our product advertising claims support, which is ongoing.

It is – this is not a safety issue. All of our products are completely safe. Our ingredients remain of the highest quality and consumers can continue to use the products they know and love with confidence. As we undertake this review, we expect that many of our claims will not change, but others will. Some changes may be minor and others could be more significant, and we will make any necessary changes as quickly as possible and bring this area up to our high standards.

We have resolved this testing issue by now, so that claims for new product launches will not be affected. We are investing in strengthening our talent, resources and independent validation to ensure that this does not happen again. This matter does not reflect our strong commitment to our consumers or the integrity that is at the heart of our company. We are sorry this occurred and we take full responsibility for this matter. We will continue to address this in a way that reflects our values and our high standards.

So, we are proud of our many successes this fiscal year and confident about our future. We believe our broad brand portfolio, strong innovation, global reach, amazing people, greater channel diversification and agility to take advantage of new opportunities position us well to continue outpacing the industry. Our focus on being financially disciplined will help us further fuel our multiple engines of growth to continue our momentum. We are extremely pleased with our results and are on track to deliver outstanding sales and earnings gains in fiscal year 2018.

Now, I will turn the call over to Tracey.

Tracey Thomas Travis

Executive Vice President & Chief Financial Officer, Estee Lauder Cos., Inc.

Thank you, Fabrizio, and good morning, everyone. I remind you that my commentary excludes the impact of restructuring and other charges and adjustments primarily related to our Leading Beauty Forward initiative and the new U.S. tax legislation. Net sales for the third quarter were \$3.37 billion, up 13% in constant currency compared to the prior year period. Once again, our performance was broad-based across geographies and product categories with exceptional strength in the Asia/Pacific region, travel retail and online channels and in the skin care category.

Our gross margin improved 40 basis points to 79.8%, driven primarily by a favorable comparison to the inventory step-up in the prior year period post the acquisitions of Too Faced and BECCA. Operating expenses as a percentage of sales were consistent year-over-year. Higher investments in advertising and promotion of 110 basis points and stock compensation expense of 50 basis points were offset primarily by lower selling costs.

Operating income rose 21% and operating margin increased by 40 basis points to 17.4%. Our effective tax rate this quarter was 22.8%, a 490 basis point improvement over the prior year quarter. This reduction was driven primarily by excess tax benefits on share-based compensation. As a result, and as a reminder, provisional charges related to the recently enacted Tax Cuts and Jobs Act will be finalized within the allowable one-year measurement period.

Diluted EPS rose 30% to \$1.17 compared to the prior year and grew 17% in constant currency. Earnings per share for the quarter included approximately \$0.11 of favorable currency translation. The higher-than-expected EPS primarily reflected better sales growth, a slightly lower tax rate and more favorable currency translation.

For the nine months year-to-date, we generated \$1.93 billion in net cash flows from operating activities, a 54% increase over the prior year due primarily to higher net income and improvements in certain working capital items. We invested \$368 million in capital expenditures, repurchased 5.5 million shares for \$676 million, nearly double what we spent last year, and paid \$407 million in dividends.

Now, let's turn to our outlook for the fourth quarter and for the full-year. Global prestige beauty is a vibrant category that continues to grow. With the outstanding performance we've seen year-to-date, we are again raising our full-year guidance, as Fabrizio indicated. We expect continued strong execution to drive performance in our final quarter, although our fourth quarter comparisons are the most difficult against the strong growth in the prior year quarter, and we remain cautious on the brick-and-mortar retail environment in North America and the UK.

We anticipated some risk for Bon-Ton in our previous estimates and our current guidance reflects the new reality. Furthermore, there continues to be a number of macro and geopolitical risks that could disrupt the positive trends we have seen. That said, we are raising our sales growth expectation for the fiscal 2018 full-year to 11% to 12% in constant currency.

This includes approximately 2 points of growth from the incremental sales from Too Faced and BECCA in the first half of the year. Currency translation is expected to benefit reported sales growth by 4 percentage points, reflecting weighted average rates of \$1.20 for the euro, \$1.35 for the pound and [ph] ¥110 (24:29) for the yen for the fiscal year. We are maintaining a degree of prudence in our outlook as we work through the review and retesting of some of our product advertising claims.

Nevertheless, we are raising our EPS expectations to a range of \$4.38 to \$4.42 before restructuring and any other charges and adjustments. This includes approximately \$0.22 of benefit from currency translation. It also includes an estimate for accelerated claims review and testing, consumer call center support, changes to some of our product communications as necessary, advisory fees and other costs related to the advertising claims review. In constant currency, we expect EPS to rise by 20% to 21%.

For the fiscal 2018 fourth quarter, our sales are expected to rise by approximately 8% to 9% in constant currency. Currency translation is estimated to add approximately 4 percentage points. We expect to increase investment substantially behind advertising and promotion and select brand expansion, reflecting the increased flexibility we have from higher-than-expected sales growth and our desire to support a strong start to fiscal 2019.

EPS is forecasted to be between \$0.48 and \$0.52 before restructuring charges. This includes an approximate \$0.07 benefit from currency. With two months left in the fiscal year, we remain encouraged by the momentum in global prestige beauty and our ability to execute our strategies effectively to exceed that growth. Our outstanding organic sales increase reflects the thoughtful investments we have made in innovation, advertising and promotion, digital and talent development.

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

QUESTION AND ANSWER SECTION

Operator: The floor is now open for questions. [Operator Instructions] Our first question today comes from the line of Lauren Lieberman.

Lauren R. Lieberman
Analyst, Barclays Capital, Inc.

Q

Great. Thanks. Good morning.

Fabrizio Freda
President, Chief Executive Officer & Director, Estee Lauder Cos., Inc.

A

Good morning.

Tracey Thomas Travis
Executive Vice President & Chief Financial Officer, Estee Lauder Cos., Inc.

A

Good morning, Lauren.

Lauren R. Lieberman
Analyst, Barclays Capital, Inc.

Q

So, I guess for a couple of years I've been interested in the question of the impact of channel mix on profitability and seeing that as a long-term positive. My sense is that Leading Beauty Forward is still kind of in like a net investment mode, but I still would have expected to see I guess better operating leverage this quarter just given the magnitude of the upside to top line. So, I was curious if you can talk a little bit about why we didn't see that. Were there may be some expenses accounted for this quarter related to the advertising claims dynamic? You talked about wanting to start off 2019 strongly, if you're kind of putting some money to work today more aggressively than you maybe initially planned before the top line came through as strongly as it did? Thanks.

Tracey Thomas Travis
Executive Vice President & Chief Financial Officer, Estee Lauder Cos., Inc.

A

Thanks, Lauren. So, I'll start by answering that question. We have talked all year about our incremental investment in advertising and promotion. You're correct that Leading Beauty Forward this year, we did indicate that there would be some savings related to the program that we plan to reinvest, reinvest in capabilities as it relates to digital marketing, reinvest in some of our analytical capabilities which we've referred to earlier in the script, and other areas of capability for the future.

So, that has been the result of some of the savings that we have generated from Leading Beauty Forward. We've seen a big step-up this year, and again, mostly in this quarter and next quarter, so the second half of the year, more investment in advertising and promotion than even in the first half of the year. So, that is also what you're seeing in the quarter and what you're also seeing in the full-year guidance. And we have done a terrific job, as Fabrizio indicated, of reallocating resources to invest in more advertising and promotion and other areas of investment like IT support for some of our consumer-facing activities.

Fabrizio Freda
President, Chief Executive Officer & Director, Estee Lauder Cos., Inc.

A

Yeah. I want to add, we are really in a transition period of using these resources to accelerate, but mainly advertising a new capability like digital, data analytics, ability to anticipate trends, new talent in these areas, improvement in retail. But the advertising piece frankly is very exciting. Yes, in these two quarters, quarter three and quarter four, we have a serious improvement of the investment and increase on the investment.

This is aiming at obviously preparing hopefully the continuation of a strong fiscal year 2019, but is also the result of going from an era, where certain brands were advertised and others were not were mainly driven by their brick-and-mortar experience, to an era where every single brand will be leveraged by social media and in a way advertised. And in this transition, we are putting more advertising funds in every single brands, also the brands in the past had not a lot of advertising. The result of this transition is frankly a very promising acceleration of top line that will be leveraged, that will be leveraged better over time.

Operator: Your next question comes from the line from Michael Binetti, Credit Suisse.

Michael Binetti

Analyst, Credit Suisse Securities (USA) LLC

Q

Hey, guys. Good morning. Thanks. Thanks for taking my question, and congrats on a nice quarter.

Fabrizio Freda

President, Chief Executive Officer & Director, Estee Lauder Cos., Inc.

A

Thank you.

Michael Binetti

Analyst, Credit Suisse Securities (USA) LLC

Q

Tracey, there's obviously a lot of [indiscernible] (30:43) go through the margins and the different reporting lines but – and you spoke a little bit about advertising, Fabrizio. But the 110 basis point step-up in this quarter, can you maybe help us think about the medium-term a little bit as far as – you said there's an – I guess a leverage point on the horizon. But could you walk us through whether you guys feel like you're getting – you're obviously landing it on the top line. But as we think about the medium-term and how that was a 110 basis point hold-back in the quarter, is the best strategy to keep spending that faster than revenue growth for the next year to keep playing offense? Or do you think in the next year, we start to see a leverage point on that line?

Tracey Thomas Travis

Executive Vice President & Chief Financial Officer, Estee Lauder Cos., Inc.

A

I think in the next year, you will start to see that normalize more. One of the things that we have done this year, we have such great momentum behind terrific brand innovation like what we're seeing in Estée Lauder and La Mer. Some of the expansion that we've done in our travel retail channel behind new brands in addition to the existing brands in the channel that we have taken the opportunity and we have some terrific social media programs as well. So, this was the year really to invest behind to capitalize on that growth. We don't expect that we will see deleverage in advertising and promotion on a go-forward basis.

Michael Binetti

Analyst, Credit Suisse Securities (USA) LLC

Q

Okay. And then, if I could just follow up quickly on the gross margin, nice inflection in the quarter. And I know you mentioned that there was some things in the compare on the inventory step-up from Too Faced and BECCA. I'd be interested [ph] in hearing (32:20) how you think about the puts and takes on that over the next couple of

quarters and then maybe what we should think about by geography or product mix and whether we can continue to see that kind of leverage flow through.

Tracey Thomas Travis

Executive Vice President & Chief Financial Officer, Estee Lauder Cos., Inc.

A

Yeah. One of the reasons we saw deleverage in the first half of the year was because of the comparison year-over-year with the non-comp and the acquisitions, and I think I did mention that we would see favorability in the second half of the year when our two acquisitions became part of our base. So, we – really, our gross profit margin is very much dependent on our category mix and our channel mix. And so, the real measure, if you will, of margin that you should be focused on is the operating margin, because mix does have a differential benefit on our gross profit margin mix. But you could expect to see certainly some level of expansion in gross profit margin on a go-forward basis, not perhaps what we saw in this quarter, because of anniversarying the inventory step-up, but some benefit in gross profit margin given the near-term programs that we're expecting to launch.

Operator: Next question comes from the line of Linda Bolton Weiser, D. A. Davidson & Company.

Linda Bolton Weiser

Analyst, D. A. Davidson & Co.

Q

Yeah, hi. So, I was wondering if you could give a little more detail just on the margin performance in the Americas, because the profit was down about over \$50 million year-over-year. I don't think that includes any charges in there. And you mentioned a comp issue, which I think you had referred to earlier. Maybe you could quantify that.

But also you mentioned investment in social media and digital, I think. So, I was curious about that and what areas – like are you putting more toward the smaller brands that you've recently acquired or more towards some of the larger brands, which seem to be slipping a little bit in social media prominence.

In particular GLAMGLOW is quite lacking in prominence on social media compared to some of your other even smaller brands. So, is that one of the areas receiving more investment? And then, on the bigger brands, Bobbi Brown, Clinique, Smashbox and Origins appear like they need a little more investment. So, could you talk about the investment side and then the comp issue there in the margins? Thanks.

Fabrizio Freda

President, Chief Executive Officer & Director, Estee Lauder Cos., Inc.

A

So, Tracey will take the margin question. But on the advertising, basically the answer is yes. The short answer is we are increasing social media activities on our big brands and on our mid-sized brands and on some of our new acquisitions. Particularly, we are looking for accelerating [ph] this area (35:12). You mentioned GLAMGLOW, which actually is a brand which is doing very well behind these extra investments recently in the social media in the U.S. and in other areas of the world.

So, our intention is to do that. As I said before, our intention is to make sure that also the brands that historically has been driven more by in-store activation and innovation that get driven by investment in the social media arena. And in order to do that well, we don't need only more money on the advertising line. The real big difference in going from a brick-and-mortar brand to a social media-driven brand is creative assets and the amount of talent in communication.

And that's the areas where we – in each one of the brands you mentioned, we are making some excellent progress, and we will continue. The way we produce creative assets, the way we expose consumer to our

creative assets, the way we involve and engage consumer in actually, in some cases, the generations of the assets is really changing, and that's very exciting. [ph] That thing will (36:24) produce better results over time as we learn how to practice on every single brand this new reality. And finally, on margin, Tracey?

Tracey Thomas Travis

Executive Vice President & Chief Financial Officer, Estee Lauder Cos., Inc.

A

Yeah. So, on margin, a bit of it is a step-up in advertising, you mentioned due to some of our newer smaller brands. So, we are investing more in advertising in Too Faced for instance and some of our other brands as well. We are investing a bit more in digital marketing as well in the U.S. I mentioned the change in accounting in stock-based compensation. That is also impacting the Americas segment. So, that is also a margin drag, if you will, on the segment for the quarter.

Operator: Your next question comes from the line of Mark Astrachan from Stifel, Nicolaus.

Mark Stiefel Astrachan

Analyst, Stifel, Nicolaus & Co., Inc.

Q

Yeah. Thanks, and good morning, everybody.

Fabrizio Freda

President, Chief Executive Officer & Director, Estee Lauder Cos., Inc.

A

Good morning.

Mark Stiefel Astrachan

Analyst, Stifel, Nicolaus & Co., Inc.

Q

Probably a bit too early to talk about fiscal 2019 expectations, but I guess maybe looking at it sort of a different way. Any thoughts on what would impact global prestige beauty growth from current 6% to 7% levels and even up from the 4% to 5% that you were expecting back in August, and then anything that you were seeing that potentially impacts your ability to continue growing ahead of the global market?

Fabrizio Freda

President, Chief Executive Officer & Director, Estee Lauder Cos., Inc.

A

Yeah. So, obviously, today is not the day to speak about guidance for 2019. But to answer your question on the market is, so we believe that our above 5% long-term market growth potential is still the right estimate for the long-term, meaning that year-after-year, the 4% to 5% average that we quoted in the past will likely continue to be the reality in terms of what are the global forces that drive that. This is an extraordinary year. The 6% to 7% is happening in fiscal year 2018, we believe, is an extraordinary strong year.

The reason why it's extraordinary is it's a year where there is the combination of very positive factors. One is the consumption in China has jumped as we see in the market. The social media boom that in the past was mainly on makeup is coming through also in skin care. That's behind the sudden reacceleration of skin care. The U.S. tax cuts give some push to the U.S. consumption. International passenger traffic for travel continues to increase. So, the combination of factors of accelerating all together is there.

We believe this acceleration started at the end of last fiscal. Obviously, this somehow will normalize in the future, and that's why we continue to believe that above 5% growth is the current long-term estimate. As far as your second part of your question, we continue to believe that we will grow ahead of this 5%, and we say that 6% to

8% is our long-term algorithm. We are continuing to be behind that. And in some years like this one, we are growing double than the market, because many of our activities are coming together in a brilliant way. So, we are still confident our long-term algorithm is pretty strong and pretty right.

Operator: Next question comes from the line of Steph Wissink from Jefferies.

Stephanie Wissink
Analyst, Jefferies LLC

Q

Hi. Good morning, everyone. Tracey, a question for you on the balance sheet. I'm wondering if you can talk about your comfort level with stretching the debt load, what kind of leverage would you like to see over time in the model, just thinking about your M&A capacity over the next couple of years. Thank you.

Tracey Thomas Travis

Executive Vice President & Chief Financial Officer, Estee Lauder Cos., Inc.

A

Sure. We feel very comfortable with our balance sheet. As you all know, we've been very prudent in terms of managing our balance sheet, and the biggest acquisition that we've done from an M&A standpoint was last year with Too Faced, where we took on additional debt in order to fund that. We typically are in the 2 to 2.5 times range in terms of leverage. That's a comfortable position for us to be, certainly to maintain our credit ratings. But we certainly have more capacity than that. So, we are not restrained at all from an M&A standpoint in terms of doing further acquisitions. And given the strong free cash flow that we have, we certainly can fund all of the needs of the business. And certainly, we have our debt payments spread out in such a way that we can certainly manage the repayment of that with no problem whatsoever.

Operator: Your next question comes from the line of Jonathan Feeney from Consumer Edge Research.

Jonathan Feeney
Analyst, Consumer Edge Research LLC

Q

Good morning. Thanks very much.

Fabrizio Freda
President, Chief Executive Officer & Director, Estee Lauder Cos., Inc.

A

Good morning.

Jonathan Feeney
Analyst, Consumer Edge Research LLC

Q

Fabrizio, could you comment on maybe the economic cyclicity? Particularly, if I look at the Europe luxury business or even the development of North America, it seems like a lot of the growth comes from – I guess how – maybe more simply, how does the development of your luxury portfolio relate to what's going on economically and what happens when the economy slows down? How has beauty changed in the past 10 years or not changed that makes the economy drive that high into the business? Thank you.

Fabrizio Freda
President, Chief Executive Officer & Director, Estee Lauder Cos., Inc.

A

So, obviously, the global economy overall is stronger this year, and this benefits our high-end part of the portfolio. But what benefits even more our high-end part of the portfolio is the growing consumption in Asia. Asia, among the various regions, is the most oriented to the high-end of our portfolio. So, brands like Tom Ford or La Mer are

doing very, very well there. And the new high-end fragrance portfolio that we have recently developed, which includes again Jo Malone, Tom Ford, Le Labo, those brands have huge potential in that region at the high-end. And so, we believe this will continue.

Asia economically is on a roll, and we count on that. In the past years, which is also the other part of your question, what happened is when there was an economical crisis or an economical cycle, actually what suffered the most is the entry price point of the portfolio, not the high-end. The high-end part of the portfolio is the most resilient, because even during economical cycles, the wealthier part of the population tends to be the ones that suffer the least. And so, that is the reality. So, we believe that the fact that the high-end of our portfolio is solid, increasing and becoming bigger is actually an element that over time will mitigate volatility in our results.

Operator: Your next question comes from the line of Dara Mohsenian from Morgan Stanley.

Dara W. Mohsenian

Analyst, Morgan Stanley & Co. LLC

Q

Thanks, and good morning, guys. So, Fabrizio, clearly you're delivering substantial upside to your long-term top line algorithm this year. I was hoping you could just take a step back and discuss two of the key drivers behind that in terms of China and travel retail. You gave a bit of detail in your answer to Mark's question. But, A, just a review of what drove the greater-than-expected growth in those areas this year; B, have your long-term expectations changed at all looking out over the next few years in those areas with the outperformance; and then C, is there risk you could see an abrupt deceleration in fiscal 2019 with the difficult comparisons, et cetera? Thanks.

Fabrizio Freda

President, Chief Executive Officer & Director, Estee Lauder Cos., Inc.

A

Yeah, sure. First of all, there are several factors which are behind this acceleration. Let me mention at least some of which are among the most important. The first one is the fact that we are winning again of our big brands, and particularly our Estée Lauder brand, which is really growing at a strong double-digit everywhere in the world. So, this proves that the big brands, when big brands make the necessary changes and speak the language of the new generations and [ph] tailor (45:12) like the Estée Lauder has done by region their activity in a brilliant way, big brands are still a stronger proposition than small brands, because big brands have the tools in terms of money to spend, money to invest, quality of talent, global reach, level of consumption and level of awareness with the consumers.

When they do the right thing, this becomes immediately impactful. And I think the story behind our Lauder brand shows that when we do good things, they become fast – very fast they become impactful on the business. And that's very positive news for us, and that's a big change versus what was [ph] at a certain moment the dynamics (45:59) a couple of years ago. The second – and by the way, this is sustainable in our opinion. Actually, it could get better and stronger with the time.

The second driver has been Asia and particularly China. Now, in China, what's happening is very interesting. What's happening is that the social media reality is making the awareness of these beautiful brands, innovation, propositions, idea and the conversation with the consumer is getting to a large majority of the population, because social media is very popular. And so, the conversation goes on in 600 cities, 700 cities, but the physical distribution is actually today the Lauder brand, which is the most distributed, is [ph] 117 (46:48) cities. So, there are hundreds of cities where there is awareness, there is demand, there is desire and there is no physical distribution.

And these hundreds of cities, the people can buy it online or during their travel, their travel within China or their travel outside of China. And that shows that is a big implication of the great results we are seeing on Tmall, on our brand dot-coms, in the online in general, in the travel within China of Chinese consumer, and obviously, in travel retail. So, this other thing which is happening in China, which is sustainable, is China has been for years mainly driven by skin care, and this is continuing. Actually, it's accelerating. But importantly, it's also driven by makeup and fragrance acceleration.

So, our portfolio [ph] now in place in China is (47:39) leveraging its scale at full, while in the past was mainly a skin care discussion. That's another big change that is here to stay. And finally, the quality of our execution. We have an extraordinary China team that does an amazing job in China, and so the quality of our execution with our team in China is second to none, and we believe this is a lot of what is behind our success there.

The other driver is travel retail. The travel retail is working. We are today the market leader in the combination of skin care and makeup that we call beauty. And with the recent activation of the fragrance business, which is huge in travel retail, we chose a niche, meaning we are now the leaders in what we call the high luxury artisanal fragrance, which includes brands like Jo Malone, Tom Ford or [indiscernible] (48:38) acquisition. We have chosen really to leverage that piece of the fragrance market, because we believe that's where a lot of the future is, and we are making great inroads there.

So, very solid. Our position is very solid, and we believe the trend of growth will continue to be there. So, this is another strong driver and is globally – is a good driver globally. Now, the reason behind this driver is that many of the emerging market consumers, Chinese, but well beyond Chinese, Russians, Brazilians, Middle Easterns are among the big purchasers in travel retail. So, our investments on our brands in these markets of origins of the travel is what really makes the difference. And again, we have an amazing travel retail team that is learning better and better how to convert travelers into purchasers at the airport.

And so, this combination of investing in the market origins and learning how to convert in airport is really working for us, and we believe will be another strong driver for the long-term. So, we feel comfortable that this will continue. Now, said these, you were asking about 2019, 2020, the future. Obviously, the base period is becoming stronger and stronger. So, we need to imagine – even in these strong drivers, we imagine a certain normalization of the trends. But even in thinking of a normalization of the trends, we still believe there will be a lot of exciting growth opportunities.

.....
Operator: Your next question comes from Wendy Nicholson from Citi Investment Research.

Wendy C. Nicholson
Analyst, Citi Investment Research



Hi. First thing on the product claims issue that you disclosed, it surprises me – number one, it just seems so un-Estée-Lauder-like. So, does it reflect anything internally? Are you growing too fast? Do you feel like you've got the same level of control and corporate culture that you've always had? And what's the risk associated with that? I can't imagine consumers will care all that much, but it's interesting to me that you called it out so specifically. So, do you perceive any risk either in terms of your market share or sales trends or anything like that or any litigation associated with it? So, that's question number one.

And then, question number two, I heard what you just said, Fabrizio, in terms of the Lauder brand and the investments you've made and how, when you love a brand, it grows. But I'm still just struck by the slowdown in the U.S. market. With all the incremental distribution in Ulta, with the strength in online, your U.S. department

store business, is it down double-digits, is it down mid single-digits? It surprises me that that business isn't responding better to the stuff you're doing behind M·A·C and Clinique and Estée Lauder. So, if you can just address the U.S. department store business and maybe your outlook for that going forward, that'd be great. Thanks.

Tracey Thomas Travis

Executive Vice President & Chief Financial Officer, Estee Lauder Cos., Inc.

A

So, Wendy, let me start with your question on what we've included as it relates to the review of the product claim – the advertising product claim issue in our estimates. So, clearly, I said in my prepared remarks that we're being prudent in the full-year estimate and the fourth quarter, as we are doing a review of the situation and making sure that as we look at some of the claims on some of our products to the extent that we have to do retesting, we are in fact doing that retesting and we're doing it in an accelerated way. And so, that certainly is incorporated into our Q4 expectations.

So, there are some communication vehicles such as websites that have to change to the extent that we can't prove a claim. And to your point, we don't know at this point that these are – how many of the claims are impacted. We don't think that there are that many, but we don't know. So, we prepared ourselves at least in the estimate to be able to address this entire situation as quickly as possible, and we have advisory fees, et cetera. We certainly do not have any cost in the estimate related to any legal activity from this, as you indicated.

Fabrizio Freda

President, Chief Executive Officer & Director, Estee Lauder Cos., Inc.

A

And so, to continue on that – on the first question is – obviously, you're right. This is definitely not typical of Estée Lauder. And that's why as soon as we learned that, we decided to act on it with, first of all, maximum transparency and maximum speed. We have decided to analyze the situation, retest and invest in retesting everything we have to retest to validate our test – our advertising claims.

And in the cases where there will be a minor change to do or there's more serious change to do, we will do it immediately [ph] and transparently (53:58) communicating with our retailers, consumers and everyone, and we'll take care of that. Second thing we have decided to do to invest into improving our process in that area, first of all, and to be clear, as I said in my prepared remarks, we already fixed it. So, everything we are doing from now on is under control, and we have invested and fixed it immediately [audio gap] (54:25-54:30).

Operator: Your next question comes from the line of Jason English from Goldman Sachs.

Jason English

Analyst, Goldman Sachs & Co. LLC

Q

Hey. Good morning, folks. Thank you for squeezing me in.

Fabrizio Freda

President, Chief Executive Officer & Director, Estee Lauder Cos., Inc.

A

Sorry.

Tracey Thomas Travis

Executive Vice President & Chief Financial Officer, Estee Lauder Cos., Inc.

A

Jason, can you hold on a second?

Fabrizio Freda

President, Chief Executive Officer & Director, Estee Lauder Cos., Inc.

A

Jason...

Tracey Thomas Travis

Executive Vice President & Chief Financial Officer, Estee Lauder Cos., Inc.

A

Fabrizio is still finishing his response to Wendy.

Jason English

Analyst, Goldman Sachs & Co. LLC

Q

Oh. Sorry. Yeah, yeah, I'll go mute.

Fabrizio Freda

President, Chief Executive Officer & Director, Estee Lauder Cos., Inc.

A

Sorry. I'll give you the word in a second, Jason. So, we are addressing every other aspect and checking for quality in everything we do, and we are further strengthening every one of our processes. So, we are acting on it fast, transparently, and making sure that while what has happened is not in line with our standards, I want to make sure that our reaction to what happened is fully in line with our standards and with our integrity. And that's what we have done.

Now, the last part of your question here was the risks. As we say, we don't know yet how much of this will be the impact. As Tracey said, we have put all the impact of our actions into our estimate. But in terms of the impact on our business in a broader sense, we don't know yet, but we will know soon. And as we know, we will decide if this has an impact or not on our overall results. On your other question very fast on the United States, the situation in the [ph] United States is clear (55:57). We are very successful in our new distribution. We continue to win online, as I explained in my prepared remarks, also in department stores.

We are doing fantastic in specialty-multi. Our brands are all growing there. The Estée Lauder brand by the way in the United States is very strong and growing overall. But particularly our M-A-C and Clinique brand exposure to the brick-and-mortar department store in percentage of the business is still so big that it's very difficult to offset that decline with the growth of online and specialty for the time being. But this will change. It is changing. And things like the closure of Bon-Ton will accelerate this change. Bon-Ton had – we had the business with Bon-Ton, it was more than \$50 million business in the past. So, these kind of changes are significant, and we need to recover this business in the other channels. Jason, back to you.

Jason English

Analyst, Goldman Sachs & Co. LLC

Q

Are we good? Am I still here?

Fabrizio Freda

President, Chief Executive Officer & Director, Estee Lauder Cos., Inc.

A

Yeah, you are on.

Jason English

Analyst, Goldman Sachs & Co. LLC

Q

Excellent. Okay, thank you. Hey, I guess I want to come back to the question on global category growth. If we rewind the clock the last couple of years, there's been a lot of consternation around potential market fragmentation, the rise of indie brands, the shift to online, shift to specialty-multi, where there's just clearly more brand assortment and more risk of brand fragmentation.

But if we look at results from you, it was solid 13%; [ph] LVMH Perfumes & Cosmetics (57:26) 17%; L'Oréal Luxe 14%; P&G's SK-II on fire also, either your market growth rate [ph] – either you're materially understating (57:35) market growth rate [ph] or we're in a (57:38) much bigger beauty super-cycle than the 6% to 7% range suggest? Or we're in a period where this fragmentation has gone entirely other way and we're concentrating growth within mega brands?

Can you weigh in on your view of – I mean, clearly, you have a view of which side we're at, and that's the concentration of growth behind mega brands. If that's the case, what's driving it? Where are the losers? What's causing this rise of indie brands to maybe stall out and go the other way?

Fabrizio Freda

President, Chief Executive Officer & Director, Estee Lauder Cos., Inc.

A

Yeah. Jason, thank you for the question. I've talked to that in the past. I don't know if you remember. But first of all, I believe we are in your second camp, meaning the growth is 6% to 7%. That's what Euromonitor is publishing and that's what we believe is happening. But it's obviously a very special growth. I don't know many other consumer markets which are growing 6% to 7%. So, definitely, we are in a booming of this industry, of the fact that particularly luxury cosmetics are driving, which means the first thing that is happening is consumers are trading up over time. So, the growth of the luxury part is much stronger than the mass.

Now, this is true since 10 years by now, and we are driving it. And the big companies that you mentioned including ourselves are all driving that phenomenon with good innovation, great service. But what's happening particularly in this new world of social media, consumers are interested not only in the product as a commodity, but in the how to use the product, in the service attached to it, in the creativity attached to it, in the case of makeup in the artistry that comes with it, in the case of skin care in the new learning and new habit to do what the previous generation didn't know how to do like the mask boom around the world. So, there is a lot driven by novelty and a lot driven by what the companies are doing in innovation and creating new market.

And then finally, there is all this growth of Asia and Asia consumers that are avid consumers of luxury beauty, and they are now getting wealthier and so they have better access. And finally, it's the access. Luxury beauty is at a click distance from any consumer around the world. In the past, people had to go to destination store, take the car, go there. So, there is a reason why this market is growing strongly. Now, why the big companies are growing so much better than the market, including Estée Lauder Companies, is because at the end, what really makes the market growth is repurchase. It's not trial. What is happening is the big competition of the many small brands is people try the product the first time because of the novelty. But there is no consumer that buys the second time a product unless was happy with that product.

So, what we see in our brands, that while the trial game has become more competitive and is in a way more expensive to do, the repurchase game is still driven by product quality. Our repurchase numbers are going up despite increased competition. And so, the big brands, the successful brands, where product quality and great performance in the long-term are winning, are driving repurchase rates. And that's the reason why companies with strong brands, with strong research and development, with strong formulation capabilities, with strong product quality, have a chance to continue winning even in this more competitive environment in the future.

Operator: Your next question comes from the line of Bonnie Herzog from Wells Fargo.

Bonnie L. Herzog

Analyst, Wells Fargo Securities LLC

Q

Thank you. Good morning.

Tracey Thomas Travis

Executive Vice President & Chief Financial Officer, Estee Lauder Cos., Inc.

A

Good morning.

Fabrizio Freda

President, Chief Executive Officer & Director, Estee Lauder Cos., Inc.

A

Good morning.

Bonnie L. Herzog

Analyst, Wells Fargo Securities LLC

Q

Hi. I have a bit of a follow-up question, the slowdown in growth of your makeup artist brands. You've stepped up spending. So, curious if you're starting to see a lift from the increased spend. For instance, did things improve for some of these brands by the end of the quarter and then into April? And then, I have a question on skin care. It's very encouraging that you're seeing the pick-up in demand among younger consumers that you mentioned, but curious to hear what your outlook is for this trend and how sustainable it is. And then finally, how do you think about the interplay of the two categories for this demographic and if you believe they can both accelerate or is there a risk that a shift from makeup to skin care could become more pronounced? Thanks.

Fabrizio Freda

President, Chief Executive Officer & Director, Estee Lauder Cos., Inc.

A

Okay.

Tracey Thomas Travis

Executive Vice President & Chief Financial Officer, Estee Lauder Cos., Inc.

A

So, let me start with makeup. Just to remind you that in the first half of the year, we had non-comp growth in our makeup category. So, Too Faced and BECCA obviously were in our results this year and not in the results the prior year. So, in terms of what we're seeing now given some of the investments that we're making, we are very recently seeing a slight pick-up in a couple of the makeup artist brands, and we are very encouraged by the strategies and some of the product launches, in particular Bobbi Brown with the new foundation launch and other brands as well. So, we are encouraged that we will see growth. But clearly, if you look just from a total category standpoint, skin care is growing faster than makeup. So, not just for us, but certainly for the category globally and in different markets. And then, in the interplay between skin care and makeup, Fabrizio?

Fabrizio Freda

President, Chief Executive Officer & Director, Estee Lauder Cos., Inc.

A

Yeah. The interplay is – what's happened in the last years, as you obviously have seen, is that the social media impact in terms of the impact of social media communication, social media impetus started from makeup, and makeup has been driven and accelerated by the social media phenomenon for a couple of years. Now, it's happening also on skin care. Still a lower level than makeup, but it started happening more intensively also in skin care. That's what's behind the acceleration of skin care.

And at the same time, some consumers start understanding that good skin care, just to take care of the canvas before you put the makeup on your face, is a great practice and make even your makeup work better. So, skin care is not an alternative to makeup in my opinion, but it's just preparing the canvas in a completely different way.

At the moment, social media started clarifying this opportunity to – particularly to young women, we see a boom of skin care. Interestingly, the boom of skin care or the acceleration of skin care is mainly about younger people, particularly in Asia. So, it's not anti-aging which is accelerating. It's really the skin care for natural benefit for preparing the canvas. Skin care is a base to makeup. So, the skin care which is complementary to great makeup results.

Operator: Your next question – the last question comes to us from Rupesh Parikh from Oppenheimer.

Rupesh Parikh

Analyst, Oppenheimer & Co., Inc.

Q

Good morning. Thanks for fitting me in. So, I just want to go back to your commentary on the mid-tier department store challenges in the U.S. So, as you look at your remaining exposure there, how much would you say of your remaining base is still at risk? And then, as we look forward with the Bon-Ton headwind that appears to be going on right now and may, I guess, linger into next year, how do you think about recapture rates when these department stores close down? Thank you.

Fabrizio Freda

President, Chief Executive Officer & Director, Estee Lauder Cos., Inc.

A

So, we had a lot of closures of department stores in brick-and-mortar. Now, we had some Macy's closures last year. We had Sears in Canada. We have Bon-Ton now. We assume that the reduction on number of stores in brick-and-mortar will continue. And we believe this will be for us in the short-term a negative impact. But in the long-term, this could be actually a positive impact, because the brick-and-mortar will need to improve the experiential part of retail, which is here to stay and in my opinion is here to be very successful over the medium, long-term.

So, we are working to improve the experiential quality of the strong brick-and-mortar and physical retail, and at the same time, we are focusing on leveraging the fast acceleration of online across every retail partner, and this is working. So, what will be the impact? As I said, depending by brand. On some of our brands, which are overexposed to brick-and-mortar department stores particularly in the country, we expect that this transition will take some time – is taking some time, particularly in presence of closures like the Bon-Ton situation now.

On other brands, which are more focused on specialty and online as the way they started, this will not be the case. And depending on how different brands will do, the mix will have an impact. But as I said, I believe that we are in front. In the future, we are going to stabilize and then to restart growth also in the United States [ph] the moment that's balanced (01:07:26) by physical and online distribution and by destination stores versus experiential stores will be adjusted. And I personally believe this will be a very booming and interesting retailing environment at the end of this transition.

Operator: Okay. That concludes today's question-and-answer session. If you were unable to join for the entire call, a playback will be available at 1:00 PM Eastern Standard Time today through [ph] May 16 (01:07:59). To hear a recording of the call, please dial 855-859-2056, passcode #9948347. That concludes today's Estée Lauder conference call. I would like to thank you for your participation and wish you all a good day.

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