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Estee Lauder Cos., Inc. (EL)

Q2 2018 Earnings Call

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MANAGEMENT DISCUSSION SECTION

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

Dennis D'Andrea

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, provisioned one-time impacts of the new U.S. tax law, and other adjustments disclosed in our press release. You'll 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 the call. And I'll turn it over to Fabrizio now.

Fabrizio Freda

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

Thank you, Dennis, and good morning to everyone. We delivered terrific financial results in our fiscal second quarter as our momentum accelerated. Our double-digit growth in both sales and earnings per share reflected broad-based gains across all regions and product categories.

Sales rose 14% in constant currency and we leveraged the growth into substantial earning improvement, boosted by cost savings and greater efficiencies. Our adjusted diluted earning per share increased 23% in constant currency. Our sales grew at more than twice the rate of global prestige beauty, enabling us to accelerate our market share gains.

Fueling our success was a strong innovation program focused on supporting our iconic, high-quality products and heritage brands that have demonstrated their power by driving strong loyalty and repurchase rates. Our performance caps a very strong first half. Based on these results and continued confidence in our prospects, we are again raising our full year adjusted forecast.

Many factors contributed to our achievements. Beauty was popular for holiday gift giving and performed well across a variety of categories and channels. Our prestige brands, respected for their high-quality and authenticity, offered compelling products that resonated strongly with global consumers. To fuel our performance in a balanced and diversified way, we focused our resources on priority areas within our multiple engines of growth.

To expand our targeted consumer reach, we increased our investment in fast-growing countries and in channels where more and more consumers are shopping. We also further enhanced our digital capabilities and social media, created in-store displays that grabbed shopper attention and implemented new technologies that modernize and enhance the consumer experience.

Strong execution by our talented global teams was crucial to our excellent results. Our winning strategy fueled many areas of our business. Brands representing 95% of our sales achieved gains this quarter, while brands that accounts for half of our sales grew double digits. Each of our three largest brand, Estée Lauder, Clinique, and M·A·C posted highest sales. And combined, they grew double digits.

Estée Lauder had a standout performance. And Clinique and M·A·C delivered solid global growth. Sales increased in about 80% of our markets and in virtually all of our channels. Our strategy to focus on the best-performing categories leverage consumer shopping preferences and offer innovative product and services is clearly working.

Both skin care and makeup, our largest and most profitable categories, generated strong double-digit growth, giving us two solid engines. The resurgence in skin care that began about six months ago accelerated, making it our best-performing category. Skin care was led by our Estée Lauder and La Mer brands, which posted excellent growth in every region of the world.

We have driven our skin care growth by honing our research and development on innovations that support our hero franchises. We are creating products that provide instant benefits and long-lasting efficacy and appeal to large and fast growing demographic segments, including Millennial and Ageless consumers.

Skin care had remained the priority for us even as global consumptions lowered because we anticipated that demand will rebound. We took steps to strengthen our offering in many key subcategories and now our brands are benefiting from renewed interest.

Our makeup strengths came from several brands, in particular Tom Ford and M-A-C. Across our portfolio, makeup was strongest internationally. Our growth was also aided by incremental sales from Too Faced and BECCA, which we acquired near the end of the previous year's second quarter.

Our best-performing brands included our flagship Estée Lauder, whose sales growth accelerated, rising double-digit for the third consecutive quarter, making it a star in our portfolio. The brand sales grew across the board in every category, in every region and in most markets, with particular strengths in online globally, in China and in travel retail worldwide. Its success is due in part to executing a digital-first mindset and emphasizing social media, a strategy which has helped it reach more consumers especially younger ones.

In addition, Estée Lauder focus on hero franchises and iconic products has paid off beautifully. In the first six months of this fiscal year, seven of the brand's top franchises increased double digits. Estée Lauder is a prime example of a heritage brand benefiting from continued consumer loyalty as it successfully innovates around its core products and engages consumers in modern ways.

Although we continue to face strong competition or trial from upstart and in the brands, we believe many of them won't have the staying power and the repurchase rate of our established brands and core products. Trial is often an investment. Loyalty is the key profitability driver.

Momentum also continued in our luxury portfolio. Most products were in high demand worldwide. As global economies continue to improve, we expect our luxury brands will continue to ascent. La Mer, Jo Malone and Tom Ford each delivered double-digit growth online, in travel retail and in the European and Asian regions. Some midsized brands such as Origins were also among our best performers and helped boost the skin care category.

From a channel perspective, our online, travel retail and specialty-multi businesses continued their rapid pace. Our sales in each climbed strong double digits. Our online business rose sharply in every region, led by Asia/Pacific, where sales nearly doubled. Tmall now accounts for the majority of our e-commerce in China. And our sales on the platform surged.

This was M-A-C first holiday season on Tmall, which helped lift its online sales in Asia sharply. And La Mer successfully attracted many new consumers on Tmall on Singles Day. We expect to launch more brands on Tmall this fiscal year.

In North America, the key period encompassing Black Friday and Cyber Monday were important drivers of our online business. And sales on our brand sides and on retailer sides grew strongly. Mobile continue to be a key component, with sales rising more than 70%. And users of mobile live chats was five times greater than last year.

With this key shopping period becoming a global event, our online teams in each market create a locally relevant offers to drive growth. We continue to roll out more brands online internationally. Our products are now available online in 38 countries, which approximately is one quarter of the market, where we have brick-and-mortar presence, giving us plenty of opportunity for expansion and future growth.

Travel retail growth came largely from Asia as well as from our five largest brands in the channel, all of which rose strong double digits. Our investment in emerging markets, as well as a rise in the number of Chinese tourists helped fuel the improvement.

Investment in the biggest local markets not only drives demand in those markets but also results in demand in travel corridors. We gained share with Chinese consumer across all corridors and also in skin care in the European region with the increasing number of Brazilian travelers.

We have continued to expand our less distributed brands into more airports and a wider portfolio provides a stronger foundation. Even with greater distribution, the large majority of our growth this quarter came from like-door increases. We are benefiting from our efforts to increase conversion among travelers, which encourages more of them to be buyers.

To this end, we implemented several new capabilities. These included improved shopper insights, better merchandising and enhanced digital marketing throughout a traveler's journey. We expect continued strong growth in the channel, both short and long-term. Solid passenger growth is expected to continue, particularly from Chinese consumers who are driving global luxury consumption.

The specialty-multi channel continues to enjoy strong traffic. Some of our brands are positioning themselves, where a growing number of their target consumers are shopping. So they're entering select specialty-multi retailers globally and we are broadening their consumer base. Many of our brands, such as M·A·C and Estée Lauder, also had the power to bring new consumer to the channel, like what is happening for example in Ulta Beauty in the U.S.

Our brands has had terrific success and they've expanded their targeted worldwide reach in the channel. Some examples from the second quarter include Jo Malone, which launched in Sephora in France and Italy, Clinique added more doors with [indiscernible] (12:40) and Boots in Korea, M·A·C opened in MECCA in Australia and Too Faced deepened its presence in Sephora internationally.

Our freestanding stores are growing internationally but the results have been mixed by market. We continue to focus on productivity and open new ones where distribution options are limited. Some brands are experimenting with retail stores format in strategic new ways.

Estée Lauder has continued to refine its store concept and experienced strong sales acceleration throughout Asia. Recently, it debuted in a new store in Milan, its first in Western Europe, as part of a selective rollout in the region to strengthen brand awareness.

Tom Ford chose London as the location of its first beauty-only store, designing a space that combines luxury with technology. And it's had positive early results. In a new concept, M·A·C and Bumble and bumble created a full-service makeup and hair studio in Dallas.

Now let me touch on our regional performance. Asia/Pacific posted the largest percentage gain. In China, we generated superb growth across categories and channels. Virtually, every brand grew double digits in China, led by M·A·C and Tom Ford, whose businesses more than doubled. Estée Lauder is our biggest brand in China and it posted stellar growth.

Our business in Hong Kong continue to recover and we achieved double-digit sales growth, making our best performance for a second quarter in the last five years. This was driven by a strong rebound in local consumption

as well as a greater number of inbound Chinese travelers. Successful holiday programs and hero products accounted for a large portion of purchases.

Most countries recorded growth in Europe, the Middle East and Africa. And among the strongest was Italy, where our sales grew at five times the rate of prestige beauty. We also grew well in Benelux, the Balkans and the Nordic countries. We faced a slower market in the U.K. and challenges in Germany due to a decline in some brick-and-mortar stores. The Middle East continue to be difficult as lower retail sales caused destocking.

In our emerging markets, investment we have made in distribution, digital marketing and other areas have been effective. In total, these countries grew sharply. The best performers outside of China included India, Turkey, Russia and Brazil. We will leverage our investment during the next phase of acceleration in these markets, which are poised to continue expanding.

Our sales grew solidly in North America, fueled by incremental sales from our newness brand, Too Faced and BECCA, and strong online results from retail sites and our brand sites. We are still challenged with a slowdown in U.S. brick-and-mortar department stores. And although our business in them declined, there was improvement from the first quarter.

Our brands helped drive traffic to stores with influential appearances and special events. During holidays, our gift sets were well received. And Clinique, thanks to desirable product and sharp price points, the brand recruited more consumers than the previous year and also drove basic business well. Estée Lauder Annual Blockbuster Gift Set sold out in the U.S. before the end of the season.

Social media has become the most effective and significant vehicle for our brands to communicate with consumers. We are skilled at working with relevant global and local influencers to generate engaging content and drive traffic. Tom Ford, for example, launched the popular lipstick collection in Shanghai with an event for celebrities and influencers. This approach drove significant growth on the brand's digital channels, generated millions of engagements and was featured on Vogue China online.

These sort of activities across our brands have helped the company to continue to lead in social media. For the quarter, we were again the top company among prestige beauty brands in earned media value in the U.S. accordingly to Tribe Dynamics.

Staying ahead of the curve, our brands are exploring new technologies to enhance the consumer experience. Estée Lauder collaborated with Google to offer voice-activated nighttime skin care advice over Google Assistant, extending high touch into the home. We are also bringing breakthrough technology into skin care and foundation products. Our innovations are accelerating and we are excited about scientific advances in new products that we believe will help fuel our momentum and continue our share gains.

Overall, global economies are healthy, which should help continue driving consumer demand. Asia and emerging markets are projected to show strength. With upcoming tax cuts, the U.S. economy is expected to accelerate. We should continue to benefit from greater consumer spending online but believe brick-and-mortar retail in the U.S. will continue to be challenged.

Against this global backdrop, we are also cautious about the potential risk of political and social challenges, including Brexit. As we focus on driving growth, we are also intent on creating greater cost savings and efficiencies. Our Leading Beauty Forward initiative is on track, delivering initial positive benefits and allowing

faster resource and talent reallocation to our biggest priority and [ph] pivots (19:10). By creating stronger leverage on our highest sales, we expect to sustain our earning progression.

In closing, I want to thank our global teams whose hard work, challenging spirit and incredible performance have resulted in many successes to celebrate this quarter. We couldn't be more proud of our talented workforce and their passion for excellence in execution.

The combination of our superb results and the new U.S. tax legislation give us an opportunity to invest in our workforce by accelerating benefit enhancements and other rewards to help attract, retain and motivate employees around the world. We expect to solidify our plan in the coming months.

As we look to the second half of our fiscal year, we are on solid footing. Importantly, we are optimistic about the state of global prestige beauty and confident in our continued leadership. To fuel our momentum, we plan to invest in the categories that are accelerating, continue driving our multiple engines of growth and become even more efficient and productive, as we embrace new global opportunities.

Now, I will turn the call over to Tracey.

Tracey Thomas Travis

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

Thank you, Fabrizio, and good morning, everyone. Before we review the financial results and expectations for the balance of the year, I'd like to take a few moments to discuss the implications for our company of the recently enacted Tax Cuts and Jobs Act. We believe the legislation allows us to build on our strength. We are a significant employer in the U.S. and a net exporter with our headquarters here in New York City and manufacturing, research and development and distribution facilities in Minnesota, New York and Pennsylvania.

The Tax Act will provide us with greater flexibility to deploy our cash more efficiently around the world and certainly here in the U.S. This further reinforces our already strong capital structure, high return on invested capital and effective deployment of our resources.

The reduction in the U.S. statutory rate supports the continuation of the downward trend we have already seen in our global effective tax rate over the past few years. It will also allow us to realize better returns on our recent strategic acquisitions and minority investments.

In the second quarter, we recorded three one-time items related to the new tax legislation, which we consider non-recurring. The first is a charge of \$325 million, equal to \$0.86 per share related to a tax on historical foreign earnings that have not been repatriated to the U.S. The effective tax rate of 15.5% for liquid un-repatriated earnings, generally held as cash and cash equivalents and 8% on earnings that have been reinvested in foreign operations. The cash impact of this tax is payable over eight years.

The second is a charge of \$51 million, equal to \$0.14 per share related to the re-measurement of U.S. net deferred tax assets at the lower statutory rate. The third charge of \$18 million equal to \$0.05 per share reflects the establishment of a net deferred tax liability for withholding taxes related to the expected repatriation of certain foreign earnings.

It is important to note that these charges, the combined impact of which is \$394 million or \$1.05 per share, are provisional and may require adjustment within the allowable one year measurement period. The tax bill is

complex and the final impacts may differ from these estimates due to changes in the regulatory interpretation of the Tax Act.

Now regarding our global effective tax rate for fiscal 2018, it is estimated to decrease to approximately 24%. This takes into account the reduction in the U.S. statutory rate, as well as our geographic mix of earnings and the year-to-date impact of the change in accounting for share-based compensation we discussed with you last quarter.

Additional provisions of the Tax Act become effective for us in fiscal 2019. We are continuing to review these impacts, which include additional provisions affecting taxes on our foreign earnings and the loss of certain deductions. Including these impacts, at this time, we estimate that the fiscal 2019 effective tax rate could be between 23% and 24%.

Overall, we have a smaller effective tax rate benefit than some other companies. The increased flexibility and liquidity, however, provides greater strategic support for our long-term sustainable growth. We expect further clarification on the tax legislation as the remainder of the fiscal year progresses and we will update you on the expected tax rate for fiscal 2019 in August when we also provide you with our guidance for the next fiscal year.

As it relates to cash and cash investments, at the end of December, we had \$3.4 billion of cash and liquid investments outside of the U.S. The ability to repatriate our global liquidity when needed could provide additional financial agility to an already strong balance sheet.

We will seek to maximize those repatriations in the most efficient manner as not all of the cash is available to immediately repatriate to the U.S. As our cash needs in the U.S. generally exceed our cash generation, the greater access to our global cash reduces our reliance on debt to fund seasonal working capital, dividends and other priorities.

Our strong balance sheet has provided us with financial flexibility to fund our growth opportunities and our capital allocation strategy has generated strong returns on invested capital over the past several years. Our priorities for capital deployment to drive shareholder value remain unchanged and include: first, investing in our business to support our profitable growth strategy; strategic acquisitions that we believe can earn a strong return on invested capital for our shareholders and enhance our global position in prestige beauty; and returning excess free cash flow to shareholders via a combination of share repurchases and dividends.

Now I'll move on to our financial results for the second quarter. I'll 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 U.S. tax legislation, which I just discussed.

Net sales for the second quarter were \$3.74 billion, up 14% in constant currency compared to the prior year period. This outstanding performance was broad-based across our business. Every region and most countries contributed to growth with exceptional performance in Asia/Pacific and travel retail. Every product category grew, led by a strong resurgence in skin care, double-digit growth in makeup and fragrance and solid results in hair care.

Incremental sales from Too Faced and BECCA contributed approximately 2 percentage points of this growth, which means our organic growth accelerated this quarter to 12%. Our gross margin declined 40 basis points compared to the second quarter last year. The unfavorable impact of our fiscal 2017 acquisitions was 55 basis points, which was partially offset by supply-chain efficiencies of 15 basis points.

Operating expenses, as a percentage of sales, improved 70 basis points. Higher investments in advertising and promotion expense were more than offset by lower selling expenses, which reflected both our channel mix shifts and our ongoing success in reallocating resources through Leading Beauty Forward as well as productivity improvements and indirect procurement sales.

As we indicated last quarter, the change in the timing of stock compensation expenses adversely impacted operating expenses in the second quarter and is expected to have an additional impact in the third quarter. Operating income rose 19% and operating margin increased by 40 basis points to 20.9%.

Our effective tax rate this quarter before restructuring charges and the one-time charges from the tax legislation was 24.4%, a 450-basis-point improvement from the prior year quarter. The rate improved primarily due to a favorable geographic mix of earnings as well as the impact of the lower U.S. statutory rate.

Diluted EPS of \$1.52 increased 25% compared to the prior year and grew 23% in constant currency. Earnings per share for the quarter included \$0.03 of favorable currency translation. The strong EPS performance reflected the continued outstanding results from our Asia/Pacific and travel retail businesses, our innovation success in skin care and the momentum in expense management and cost savings programs.

We are obviously pleased with our first half results, with our net sales increasing 14% in constant currency and diluted EPS rising at more than double the net sales rate at 30% in constant currency in our first six months of the fiscal year. And our free cash flow nearly doubled as well as we generated \$1.45 billion in net cash flow from operating activities in the first half and invested \$263 million in capital expenditures. We used \$398 million to repurchase 3.5 million shares of our stock and paid \$267 million in dividends.

So now let's turn to outlook, our outlook for the third quarter and the full year. Given the strength of our first half performance, we are again raising our full-year guidance. We expect continued strong execution to drive performance in our second half as well even as our growth comparisons become more difficult.

Too Faced and BECCA are now in the base year of comparison and will therefore be part of our organic growth going forward. We are also comparing to the strong acceleration in growth in China, Hong Kong and travel retail that began in the second half of last year and we are slightly more cautious on the brick-and-mortar retail environment in North America and the U.K.

And it is always worth noting that as a global enterprise, there continue to be a number of macro and geopolitical risks, which are outlined in our press release and which Fabrizio referred to as well. That said we are raising our sales growth expectation for the fiscal 2018 full year to 10% to 11% in constant currency. This includes approximately 2 points of growth from the incremental sales from Too Faced and BECCA.

Currency translation is expected to benefit reported sales growth by 2.5 percentage points, reflecting weighted average rate of \$1.19 for the euro, \$1.33 for the pound and \$1.12 for the yen for the fiscal year.

Our Leading Beauty Forward initiative and our cost savings programs have excellent momentum and continue to evolve. For example, we continue to reallocate resources to strengthen our capabilities in global digital marketing, which amplifies our ability to connect more directly with consumers. We've also made progress streamlining some of our global functions.

We expect to continue to maintain the flexibility to invest a portion of the sales leverage and savings into our brands and end markets, where we have experienced strong momentum as well as areas of strategic importance while also expanding our operating margin.

We are raising our EPS expectations to a range of \$4.27 to \$4.32 before restructuring and other charges and the one-time charges associated with tax legislation. This includes approximately \$0.15 of benefit from currency translation.

In constant currency, we expect EPS to rise by 19% to 20%. At this time, our effective tax rate is expected to be approximately 24% for fiscal 2018. This reflects the blended U.S. statutory rate of 28% from the new U.S. tax legislation, which was effective, as you know, January 1.

For the fiscal 2018 third quarter, our sales are expected to rise by approximately 9% to 10% in constant currency. Currency translation is estimated to add approximately 3 percentage points. EPS is forecasted to be between \$1.02 and \$1.04 before restructuring charges. This includes an approximate \$0.06 benefit from currency.

Our expectations for double-digit growth in both sales and earnings per share for our fiscal year reflect the strength of the execution by our talented global teams and the investments we have made focused particularly behind successful innovation.

We will continue to support our abilities to invest in our growth priorities as we also continue to deliver cost savings and expense leverage with our Leading Beauty Forward initiative. All of these elements position us well in the context of accelerating economies around the world.

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 Joe Altobello with Raymond James.

Joseph Nicholas Altobello

Analyst, Raymond James & Associates, Inc.

Q

[audio gap] (34:12-34:19) and that U.S. was down about 3% excluding acquisitions. And it sounds like at least in brick-and-mortar stores, things are a little bit better but still not positive yet. So can you give us that number what U.S. was up ex acquisitions that would be great?

And then secondly, how fast is the market in China growing? And how much are you outgrowing that market? Thanks.

Tracey Thomas Travis

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

A

So the U.S. was slightly down ex acquisitions. And we talked about some of the successes that we had in the U.S. with our holiday programs, which we felt very good about. And some of the challenges as well as it relates to brick-and-mortar in the U.S.

Online was up strongly in the U.S. and globally as well. So mixed results in the U.S. And again, our teams are working quite well with our retailers to try to accelerate growth in the second half of the year and beyond. China?

Fabrizio Freda

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

A

Yeah, on China, China market was growing double-digit, the total market. And we are growing much, much stronger than the market, much stronger than the market. So we are gaining market share in China. And in quarter two was our strongest share market gain in a given quarter in China.

Joseph Nicholas Altobello

Analyst, Raymond James & Associates, Inc.

Q

Great. Okay. Thank you.

Operator: Your next question comes from the line of Andrea Teixeira with JPMorgan.

Andrea F. Teixeira

Analyst, JPMorgan Securities LLC

Q

Hey, everyone, and congrats on the results. I was just following up. I understand the tough comparisons that Tracey had mentioned. But embedded in your guidance for the fourth quarter, it seems like you are decelerating EPS to about 6%. So it was at the top of the guidance. So I was hoping to get some clarity, perhaps, on you reinvesting some of the gains that you had in the year into more advertisement or innovation, how should we think about the balance of profitability, I should say? Because definitely I understand the tough comparisons. So if you can elaborate, I would appreciate. Thank you.

Fabrizio Freda

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

A

Yes, let me say, as we say, we are delivering – we plan to deliver our margin growth goals for the fiscal year in total. But in the second semester, we are planning to invest on our strengths. And so you mentioned advertising. In absolute term, advertising will increase significantly, particularly in the digital areas, in the [ph] influencer (37:14) global strategies and with focus in the markets where there is momentum.

So we are investing on strengths. And advertising would also increase a little bit slightly in terms of percentage of sales. But we are also investing in technologies which are driving our business drivers. We are investing in reinforcing our analytics, which are driving our ability to make choices on the business, that I believe this quarter proves they're becoming sharper and sharper every time.

We are investing more in the key markets where we see momentum and in subcategories where we see momentum. And obviously, on our key brands and hero products and the hero product franchise strategy that we are pursuing, which is working so well. And we will continue to invest online, where we see strong growth, both in the area of our brand dot-coms and in the retailer dot-coms with all our partners. So we will continue to invest in our strengths and we plan to solidify and make sustainable the strong accelerated growth trends.

Andrea F. Teixeira

Analyst, JPMorgan Securities LLC

Q

Fabrizio, this is very helpful. You mentioned digital. So the question that we all asked back in the last call was about Amazon. So you mentioned that it wouldn't be included, if anything, on this fiscal year. How do you feel like, because you're increasing investments in digital, you're feeling that is going to be a decision that will remain independent, basically you will remain independent on your digital investments in terms of channel?

Fabrizio Freda

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

A

Yeah, we are not changing our strategy. We continue to invest in our brand dot-com, in our retailer dot-com and in the platforms where we control our assets and our destiny.

Andrea F. Teixeira

Analyst, JPMorgan Securities LLC

Q

On a first party basis? Yeah, okay. On a third party basis, I'm sorry. Thank you very much.

Fabrizio Freda

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

A

You're welcome.

Operator: Your next question comes from the line of Nik Modi with RBC Capital Markets.

Russell Miller

Analyst, RBC Capital Markets LLC

Q

Hey, good morning. This is Russ Miller on for Nik. We wanted to ask on Leading Beauty Forward. Are you seeing any specific new opportunities that perhaps you did not see initially?

Tracey Thomas Travis

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

A

Great question. Yes, we actually have seen new opportunities. So there's been – relative to Leading Beauty Forward, we launched almost two years ago now. And I think I have mentioned and Fabrizio has mentioned on previous calls we've gotten quite a bit of engagement throughout the organization for the program.

And it's allowed us to move forward in a lot of areas as it relates to changing some of our organization structures to be a bit more efficient and more leveraged as well as bringing new capabilities into the organization along with reducing costs. So we have added some programs to Leading Beauty Forward.

Russell Miller

Analyst, RBC Capital Markets LLC

Q

Thank you very much.

Operator: Your next question comes from the line of Erinn Murphy with Piper Jaffray.

Erinn E. Murphy

Analyst, Piper Jaffray & Co.

Q

Good morning and congratulations.

Tracey Thomas Travis

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

A

Thank you.

Erinn E. Murphy

Analyst, Piper Jaffray & Co.

Q

I just had a couple of questions. Just first, just trying to understand on the BECCA and Too Faced in the quarter, [ph] they (40:47) contributed a couple of points of growth. I think the plan initially was for 3 points, I know it's not significant, but more. Was there anything that changed versus what you expected with the competition?

And then Fabrizio for you, if you talk about reinvesting in expanding some of these newer brands, like a Too Faced internationally, can you just help outline for us what the intermediate roadmap can look like there?

Fabrizio Freda

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

A

I think I can answer the two question in one. Basically, we are still in line with our plans on Too Faced and BECCA and we are very happy of how these brands are performing within our portfolio. And particularly, they are filling one of our strategic priority, which to increase our market share in the specialty channel globally. And this is really, really working.

In term of how the plan changes, the plan changes continuously. Our big strength is the agility to adjust the plan when we see market variation. So in that sense, Too Faced has been growing a bit less than what we originally thought in the U.S. and we have been accelerating on the contrary the growth internationally more than what we thought.

And that's why in the short-term, there's a slightly different impact on profitability because the international expansion is slightly more expensive than the North America expansion. But those are variations of agility within the overall plan, which we are very happy with.

Erinn E. Murphy

Analyst, Piper Jaffray & Co.

Q

Okay. And then if I can just ask one for Tracey on the gross margin, now that you're lapping acquisitions, can you just help us think about the back half outlook? What are you seeing in terms of input cost versus some of the supply chain efficiency opportunity you've been delivering on? Thanks.

Tracey Thomas Travis

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

A

Yeah. So on – no, it's a great question. We don't expect to see the year-over-year reductions and negative impact on our gross profit margin now that we're lapping the acquisitions in the second half of the year. We do expect some increases in input cost as well. There'll be a bit of a delayed impact from that, but we certainly are mindful of fuel prices going up and the impact that that could have on us as well as a few other impact input cost. But in general, we're expecting slight favorably in our gross margin for the balance of the year.

Operator: Your next question comes from Steve Powers with Deutsche Bank.

Steve Powers

Analyst, Deutsche Bank Securities, Inc.

Q

Maybe turning back to China, I was just hoping you could just compare the same-store sales trends that you saw in the second quarter to those that you saw in Q1. Because I think they were up over 30% in the first quarter. I'm just trying to figure out how they compare.

And more broadly, I'm just wondering if you would characterize demand in China as sort of comparable on a sequential basis or whether you're seeing actually signs of further underlying improvement, obviously, adjusting for the seasonality. Because I think we're all just trying to understand how sustainable the strength that you're seeing in China is when we normalize it out over the next 12 to 18 months.

And maybe just, perhaps, as you comment on that, you could just expound on how much benefit you think maybe the categories been receiving this year from the lower import taxes. And then, Tracey, maybe just tactically, whether you see any benefit in the third quarter this year for maybe a later Chinese New Year? Thanks.

Fabrizio Freda

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

A

Yeah, I mean, to answer your China expectation, it's a difficult question to answer in the long-term. But we believe that double-digit growth is sustainable. That's basically the bottom line.

Prestige beauty has been growing double-digit in China in the past five quarters, and to your question, is accelerating. We see the market in quarter two was stronger and our performance was stronger than previously. So there is an acceleration.

What is driving this acceleration? Yeah, there's been an impact on the – the duty reduction on the pricing in the country that we all have executed. And this probably is part of what's happening in the market and building the consumption. And that is not only that, it's also the digital economy and the impact of social media is strong and is

getting better and we are getting very good in executing this. Our teams in China is executing in a fantastic way and a lot of the great results are to be attributed to their talent in executing our programs.

The other aspect is that, for example, we are not increasing number of cities and we are not increasing distribution in quarter two in a very big way. The majority of the growth has been same doors. And the other interesting aspect is that China is leapfrogging the model of many other big market like United States. In which sense? In the sense that the department store, the brick-and-mortar is still very focused in high-traffic areas.

For example, we are only in 170 cities. Today, we serve consumers from 650 cities because the remaining cities we serve it via online. That's why in China, online is already 27% of our sales in quarter two, which is making the growth in China pretty productive and the ability to make it sustainable, in my opinion, better.

So in a nutshell, we believe that double-digit market growth should be relatively sustainable, obviously, subject to short-term up and downs. And we believe we have a very solid position and this solid position should continue.

Tracey Thomas Travis

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

A

And regarding Chinese New Year. It is a few weeks later this year than it was last year. So we do expect to see slight – both from anniversarying a stronger acceleration last year as well as a later Chinese New Year this year, a bit of a mitigated growth in the third quarter from China because of that.

Operator: Your next question comes from the line from Olivia Tong, Bank of America.

Olivia Tong

Analyst, Bank of America Merrill Lynch

Q

Great. Thanks. Can you just talk about how many countries some of these brands that are on fire in like Too Faced, Tom Ford? How many countries they're already in and how much more opportunity there is?

And then in terms of e-commerce, how does the mix of your sales differ versus brick-and-mortar? Is it more skin care heavy versus makeup? Is it new customers or existing, or is it a consumer who's trying [ph] bring new (47:43) or existing who's replenishing? And as more consumers move online, how do you expect that mix to potentially shift? Thank you.

Fabrizio Freda

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

A

I'll start from the second question. So our online business is strong across. But the strongest category are skin care and makeup. And the business has a slightly higher percentage of replenishment and repurchase than the brick-and-mortar, which means, obviously, that the growth on online of hero products or franchises that have good loyalty is very important. It's very strong. Said another way, a strong position online allow better loyalty and better repurchase, so allow brand to be stronger and more profitable over time.

In term of the global distribution of brands, yeah.

Tracey Thomas Travis

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

A

Yeah, so Olivia, we still have quite a bit of upside, Too Faced in particular is still largely a U.S.-based brand. We have started the plans to rollout internationally. And given the potential that we believe the brand has, actually are accelerating those plans over the second half of the year and into fiscal 2019.

Our most broadly distributed brands are Estée Lauder and Clinique. And as we said, we – Estée Lauder has experienced double-digit growth in the second half. So distribution certainly is a factor in growth but also strong consumer engagement, strong innovation also can drive even a more broadly distributed brand to grow as we're seeing with Estée Lauder and Clinique grew as well this quarter, as did M·A·C.

So we have with our 30 brands quite a bit of flexibility. We talk about multiple engines of growth and we've certainly built that over time from a company standpoint both brands, regions and obviously channels. And we are executing against that I think as you can see from our quarter results and our year-to-date results.

Fabrizio Freda

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

A

Yeah. But to give a general perspective on this, [ph] regional (49:57) distribution is, some of our brands today are in one-tenth of the distribution of Lauder and Clinique, some others in one-fifth. So, if the benchmark will be Lauder and Clinique, will be infinite opportunity of further distribution.

But the reality is that we have a different distribution target by brand. And some brands, particularly our luxury brands portfolio, will be – is and will continue to be less distributed and more focused and more selective than our broader distributed brands.

So it's a complex portfolio and it's a very selected distribution by brand. That is what we are aiming. But the key point is there is further opportunity of distribution in our portfolio.

Operator: Your next question comes from the line of Jason Gere with KeyBanc Capital Markets.

Jason M. Gere

Analyst, KeyBanc Capital Markets, Inc.

Q

Hey, thanks. Good morning. Nice quarter, guys. I guess, one question that will kind of dovetail into the second. Maybe if you could talk just about the working capital improvements that you saw in the quarter, the free cash flow, how we're thinking about that going forward? And then when we think about the proceeds of free cash flow, while we're lapping Too Faced and BECCA, where do you see – and I wouldn't call them holes in the portfolio, but where you can continue to strengthen the portfolio, including maybe opportunities, if there are any tail brands in the portfolio to divest? Just how you're thinking about where the portfolio could be maybe a couple of years from now? Thanks.

Tracey Thomas Travis

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

A

So on the working capital, we thank you for recognizing that we did have improvements in working capital, both in terms of our inventory days to sell and certainly payables also. So we continued to have many strategies across the organization to improve working capital and we expect that to continue over the next few years, ongoing improvements in working capital.

As it relates to our capital allocation decisions and I talked about some of that in our prepared remarks. But our M&A strategies, we certainly feel very good about the portfolio we have. We have identified some whitespace

areas that if the right assets become available, we, given our strong balance sheet and strong cash flow, would certainly entertain those acquisitions if they have the right return on invested capital. So...

Fabrizio Freda

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

A

Yes, and just [ph] to begin (52:33), our M&A strategy is pretty articulated. And we have also minority investments that may become available in the next years, which were already part of our articulated portfolio strategy. And so our priority is filling our strategic opportunities and doing it only with brands, which are ready for doing that, which are strong enough for doing it and obviously, which are available at the right level of return on invested capital. And this will continue.

So how do we see our portfolio in the long-term? Stronger, better and better covering all our key strategic opportunities to help us deliver the real ultimate goal of sustainability, which is a multiple engine growth, well diversified portfolio, which is covering the key long-term opportunities that we analyze and envisage with our Compass and strategic process.

Operator: Your next question comes from the line of Caroline Levy with Macquarie.

Caroline Levy

Analyst, Macquarie Capital (USA), Inc.

Q

Congratulations from me on an amazing quarter.

Fabrizio Freda

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

A

Thank you.

Caroline Levy

Analyst, Macquarie Capital (USA), Inc.

Q

Can I ask about – on China, I was wondering how many consumers you think you're actually reaching in the sense of how many are buying your product today versus five or six years ago? And how much of your growth do you think will come just from middle class Chinese increasing and entering into your price points?

The second point on that is for many brands we've seen local competitors get stronger and eat away market share. But it actually seems like the reverse is happening even with Korean skin care being maybe less fashionable than it once was. If you could just comment on that. And I'm sorry but a final one, what are you doing in bricks-and-mortar to renovate the stores? Where are you having success with that?

Fabrizio Freda

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

A

So there's a lot of questions. Is how many consumers in China. Frankly, our business in the last year has been growing exponentially. And so we touched probably 5, 10 times the amount of consumers that we touched a few years ago depending where you start the benchmark. So the growth is exponential.

And what I want to – rather than a number, frankly it will not be the right way to answer but conceptually, what's happened is two things. There are more and more consumers which are entering quality products among the Chinese consumers, they are going for quality. And going for quality, they chose more and more many of our

brands and particularly our hero franchises. And then there is a great repeat purchase, which is increasing. So it's not only more consumers, which was the heart of your question but it's the same consumer using more of their total usage with high-quality products in our portfolio.

As you know, Chinese have a very intense regimen of product in skin care. And so they use, depending obviously by person, buy up to seven, eight products skin care per day. So the more you can penetrate that regimen, the more the growth is there and exponential. So we are acting on two levers. Yes, growing the number of consumer, but also growing the penetration of the portfolio usage of each consumer.

The second thing is the growth of consumers in Tier 2, 3, and 4 cities. This is exponential. And the reason why it's accelerating, as I explained before, because even if the physical distribution is now reaching these consumers, the online distribution is. And so there are more and more consumers, millions and millions of consumers get more and more access to our products via the online distribution. And this is very, very important.

And that's why we focus so much on quality of products, on safety of products, on the amazing hero franchises. Because at the end, it's not just conquering a consumer for one time, it's conquering a loyalty and a repeat purchase of the satisfied consumers. And that's where – that's what make the business sustainable in China, like in any other emerging market. Then I think you asked what we do on brick-and-mortar? What we do, we renovate. Tracey, you want to cover that?

Tracey Thomas Travis

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

A

Yeah. We are continuing to renovate our freestanding stores. In fact, as we said in the prepared remarks, one of the big focus areas for the company is improving the productivity of our freestanding stores. So in some of the M-A-C stores for instance, we have converted them to open sell. We are – and testing out services in freestanding stores and doing – investing in capital as it relates to that. So there is continued remodeling in addition to opening stores, new doors primarily in EMEA and APAC and really the focus on renovations are in the U.S. in terms of some of the tests.

Operator: Your next question comes from Ali Dibadj with Bernstein.

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC

Q

I just want to confirm a few things to make sure I understood it correctly. The first one is on the top line implied guidance for Q4. It's about 5%. Are you okay with that? Or are you saying that you're going to invest more to boost that number? I understand the tough compare, but I just want to make clear what you said.

On, secondly, BECCA and Too Faced, it was expected to be 3% of the growth. It was 2% and you kind of addressed this a little bit in the last – in one of the previous questions. But what is the underlying growth of BECCA and Too Faced today? Is it still in that kind of 70% to 80% range? And I had one more. Maybe those two I'll let you answer and then I have one more.

Fabrizio Freda

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

A

So...

Tracey Thomas Travis

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

Go ahead.

A

Fabrizio Freda

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

No, you go.

A

Tracey Thomas Travis

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

So in terms of Q4, you're correct that the implied growth is in the mid-to-high single digits for Q4 and we are anniversarying a very strong Q4 from last year, Ali. We will continue to invest in Q4, in higher advertising and promotion, more in Q3 than in Q4. But we have a tremendous amount of momentum as we're indicated in certain markets and behind certain innovation and we'll continue to invest for the balance of the year against that.

A

Fabrizio Freda

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

Yeah. And on this, I just want to clarify just the process that we go through. We analyze this, we analyze our risks, our opportunity in this 5%, there is a lot of our point of view on the base, as Tracey explained. The base period and the risks which are in front of us, including some risks specifically in the U.S, so, Bon-Ton announcement and many other things which are in this number. But anyway, our teams are always charged to beat our estimates. That's just the way we work. So to your question, are you trying to beat this number? Yes, it's every time. That's exactly the way our organization works. We are trying to mitigate the risks and better perform on our implementation.

A

In term of BECCA and Too Faced, no, they are not growing 70%, if that's the question. And they are growing more in line what the expectation will be over the long-term. In the calendar year 2017 that was our first calendar, they grew double-digit. That was what we wanted. And then by month, by quarter, there are up and downs, depending on competitive environment, I think that's why we are doing faster than what we thought also on these two brands, the creation on multiple engines of growth, meaning the internationalization of the brands and the acceleration particularly of the online platforms of the brands where we have plenty of opportunity of improve and accelerate. So we are going to invest and focus on creating more engines of growth also on those two brands in the next steps as was originally planned, but faster than originally planned.

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC

Okay. Thank you. My last question was just around SG&A. Clearly, it was good, it was down again 70 basis points, obviously, less down than it has been. And I totally remember and get the share-based compensation comment. But if you could help us kind of figure out the component of that underlyingly SG&A reduction? And in particular, if it relates at all going forward to a comment you made, just at the end, Tracey, of employee benefits and reward plan we're thinking about and we'll give more detail, you said that in your prepared remarks. Thanks.

Q

Tracey Thomas Travis

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

Yeah. So clearly, we are exploring some options, as Fabrizio said, as it relates to employee benefits. And that is embedded within our guidance. But in terms of the full year SG&A, what I indicated was we are seeing a

A

tremendous amount of growth from travel retail as well as online so just mix, obviously, impacts our selling expense. And beyond that, we've done a fair amount of work in terms of selling effectiveness, both to provide our selling teams with the tools to enhance their productivity as well as making sure we've got the right investment for the volume that is – the volume growth that we're experiencing across different channels that have selling in them. So that is the largest leverage, if you will, of expense. The other is employee productivity. So we have also leveraged our G&A expense as it relates to employee productivity.

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

Bonnie L. Herzog

Analyst, Wells Fargo Securities LLC

Q

Good morning. I had a question on prestige beauty in the U.S. and the growth you're seeing currently and then your outlook for the category as well as the consumer this year.

And then if you guys could frame that for us given the slowdown we're seeing in mass beauty that would be helpful. I guess, I'm trying to understand if it's realistic to assume the prestige beauty category growth could accelerate this year. And curious to hear how you think about the opportunities for increased purchases and possibly up-trading given the health of the consumer.

Fabrizio Freda

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

A

So I'm not sure exactly what the – the question is the U.S. growth, what we expect about prestige beauty in the U.S. So the overall prestige beauty market in the U.S. is solid. And we expect this to continue to be solid and possibly to accelerate because of the new consumption trend that the consumer is having.

So the overall consumption is positive and accelerating. It's more where the consumption is happening. And the consumption is happening more and more online. And so we see very good performance of the retail dot-com, of most of our partners, including department stores, which are having excellent performance there. We see a strong growth of our brand dot-com. We see some great performance in some specialty retailers.

But where we still see the traffic not picking up for beauty in the level we would like is the physical distribution of certain retailers, particularly in the area of department stores. And we see some potential changes like the recently announced change of the Bon-Ton department store chain that will impact store closures and reallocation of resources.

So the market is solid, but the physical retail environment is subject to continuous evolution and challenges. And so since we have a over proportion exposure to the physical department store distribution in the U.S., that's where our prudence on the estimate for that part of the market comes from, not from the consumption. The consumption is relatively solid.

Bonnie L. Herzog

Analyst, Wells Fargo Securities LLC

Q

All right. Thank you.

Operator: We will now turn the call back over to management for closing remarks.

Tracey Thomas Travis

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

Thank you everybody for participating in our call. And again, we're pleased with our results and incredibly pleased with the performance that our teams generated in the first half of the year and we look forward to the second half of the year.

Fabrizio Freda

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

Yeah, thank you. Thank you to everybody and thank you to our teams.

Operator: This concludes today's conference. You may now disconnect.

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