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Estee Lauder Cos., Inc. (EL)

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CORPORATE PARTICIPANTS

Lauren R. Lieberman
Analyst, Barclays Capital, Inc.

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

MANAGEMENT DISCUSSION SECTION

[Abrupt Start]

Lauren R. Lieberman
Analyst, Barclays Capital, Inc.

.... It's now been nearly a decade since Estee Lauder set off on a path that would take it to be one of the most proactive and forward thinking companies in our coverage universe with regard to brand portfolio, geographic and channel footprint.

Success has been breeding success and the company's greatest near-term challenge look to be comping the remarkable 13% local currency revenue growth in fiscal 2018, improving net profit margins, can in fact, continue to move higher. So clearly we're doing a little fireside chat. So Tracey, thank you for being with us this year.

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

Absolutely.

QUESTION AND ANSWER SECTION

Lauren R. Lieberman

Analyst, Barclays Capital, Inc.

Q

So given the performance of the stock since you reported on August 20, I thought it may be best to just kind of jump into some of what are surely the hot button topics and concerns that that we've been asked about.

So first, I'll start with China. So Fabrizio very early in his tenure, highlighted China as a market that was going to be of critical importance, and clearly in fiscal 2018 it was a dominant force. He said very, very, very, strong double-digit. I'm thinking it grew like 50%. Can you just talk a little bit about the current outlook for China? What you're seeing from a consumer demand standpoint, particularly with tariff concerns? Is there any kind of rollover in the consumer environment, the [ph] stock market or to shake (01:11) a little bit, anything you're seeing in China would be great.

Tracey Thomas Travis

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

A

Yeah. No. China is a very strong market for us, and I didn't realize I said three very's growth but we had, we did have very strong performance in China that manifested itself over a couple of years.

We have about half of our brands in China right now, so there is certainly more runway in terms of brand expansion and we've had tremendous success online in China as well with Tmall. So, it's been great in terms of the success.

This year, we expect continued success. What we said on the call is we expect double-digit growth, not maybe very, very and a half, not very, very, very. But it would not be prudent for us to anticipate the same kind of growth that we had in fiscal 2018 in fiscal 2019, but still strong double-digit growth. We are not seeing a slowdown in China. We are continuing to see brands like Estée Lauder, all of our brands – La Mer, Clinique, M•A•C, all of our brands grow quite nicely in China, both in brick-and-mortar as well as in online.

Lauren R. Lieberman

Analyst, Barclays Capital, Inc.

Q

So this is more about conscientious budgeting rather than flagging something you're seeing in terms of a current change in the business.

Tracey Thomas Travis

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

A

I think yes. I mean, again we're anniversary some very strong numbers from this past fiscal year. We would not be prudent, to your point, in terms of planning that same kind of growth every year. Things happen. And so – but there's nothing – we are continuing to expand points of distribution in China. Most of our growth last year was actually same-door sales growth, which is great. We do have more brands launching on Tmall this year in China as well. So, we certainly continue to expand our growth and our footprint in China and with Chinese consumers.

Lauren R. Lieberman

Analyst, Barclays Capital, Inc.

Q

So, which brands, if you can share, are launching on Tmall this year?

Tracey Thomas Travis

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

A

We expect – Jo Malone just launched recently and had a very strong performance in terms of launching. Towards the end of last year, we launched our Darphin brand, another skincare brand of ours which is doing nicely, and we expect that Tom Ford will be launching sometime during the course of the year as well and other considerations. We have about a third of our brands on Tmall at this point in time. So there's certainly more runway.

And one of the benefits that that platform gives to us, we are in about 119 cities in terms of our brick-and-mortar distribution. Tmall gives us access and reach to over 600 cities in China. So, we can actually see where demand is building for our brands.

What we've been able to do in our travel retail channels as well is a lot of times, capture some of the demand that we're seeing in some of the cities where we don't have physical brick-and-mortar distribution, the first physical interaction that a consumer might have is in our travel retail channel.

So, we've spent a fair amount of time and effort really building the travel retail channel, certainly in China but in other parts of the world as well to make sure that our brands have a terrific expression in terms of their equity in that channel distribution.

Lauren R. Lieberman

Analyst, Barclays Capital, Inc.

Q

Sticking with China, I have to ask about tariffs. So, as I understand it, about a third of your products sold in China are manufactured in the U.S.

Tracey Thomas Travis

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

A

Yes.

Lauren R. Lieberman

Analyst, Barclays Capital, Inc.

Q

So, what's your current read on the tariff situation, sort of planning that you've done ahead to potentially deal with what may prove to be a worsening trade term? Are you seeing any signs of an anti-American backlash that would, in terms of consumer behavior, impact on your brands?

Tracey Thomas Travis

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

A

So the answer to the second question is no, we're not seeing that. We're still seeing very strong, strong sales and support for our brands in China. We've been in China for more than 20 years. And so, that has boded, I think, well for us. We have more than 5,000 employees in China. So, it's been a market that we've participated in for a long time.

In terms of the tariff situation, we have been following it for months now, obviously. And the initial set of tariffs did not impact us. Some of the discussion about tariffs in the near term that could impact our category, we're certainly mindful of it. As we said on our last call, we believe we know that there – we have room in the construct of our P&L this year to be able to absorb at least what some of the discussions that we've been following would suggest the tariffs would be. Be mindful of the fact that we have pretty high gross margins. So, the tariff impact for us

relative to perhaps another company would be a bit less in terms of overall impact and something that we believe we can absorb within our P&L structure and not suffer from a margin standpoint.

The other thing we are doing given the tremendous growth that we've had, Lauren, in the business is we are investing more in capacity. And certainly, that capacity would be closer to where we're seeing disproportionate growth. So, that also will help us in terms of sourcing even more products closer to areas of fast growth like China and Asia, in general.

Lauren R. Lieberman

Analyst, Barclays Capital, Inc.

Q

Let me turn to travel retail. So that's been another tremendous story and also starting really from, again, the beginning of early in Fabrizio's tenure identifying travel retail, and the company being probably the first, I think, to really have very channel-specific strategies and doing some very interesting things in terms of travel corridors and having the persons speaking the right language in the right terminals, the right airport and the right brand mix and so on. But that's an area I've been hearing more concerns about. [ph] Duty Free's (7:45) revenue growth slowed pretty materially in the second quarter and yet your business is still strong double digits. So, can you talk a little bit about resiliency in the business?

Can you continue to grow with this kind of strong double-digit rate? How much of the growth right now is about incremental distribution, continue to drive conversion or just travel corridors and passenger traffic?

Tracey Thomas Travis

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

A

Yeah. No, travel retail is certainly, as you indicated, Lauren, a great success story for the company for the past few years. What we did about four or five years ago, recognizing that all of the elements of travel retail in terms of being a good channel of growth and distribution for the company, we really looked at our brand portfolio and which brands we could actually expand in travel retail channels as retail development was growing faster in the channel in order to grow our portfolio.

And it's a great channel. As passenger traffic increases, as retail development increases in travel retail, we see passenger growth. We see increasing conversion with brand expansion. And adding brands like Jo Malone and M•A•C and Bobbi Brown and other brands really see – and Tom Ford, which have done tremendously well in travel retail, that continues to allow us to grow, grow in the channel.

We still think and certainly, travel retail, there are shifts in traffic patterns where our team is excellent at identifying travel corridors. We partner very well with the local markets to identify and coordinate programs that are happening in a local market and understand the traveling behavior of consumers in that market, so that we can make sure we're capitalizing on a lot of the launch activity and advertising that's happening in the local markets in our travel retail corridor. And it's doing well for us. So, we too are not seeing a slowdown in our travel retail channel and continue to expect it to grow disproportionately along with our online channel and certainly in China as well.

Lauren R. Lieberman

Analyst, Barclays Capital, Inc.

Q

And so far, travel retail has been clearly sort of unaffected by the, let's call it, macro growth in e-commerce. So how are you thinking about, if at all, kind of in e-commerce digital, what that means for travel retail long term? Is there an omni-channel discussion to be had about travel retail with e-commerce?

Tracey Thomas Travis

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

A

Yeah. Actually, we're doing some of that now. Our retail partners in travel retail are doing some of that, allowing, what we call, pre-tailing. So, ordering online, obviously as long as you have a boarding pass, to be able to pick up in the airport or pick up at your destination. So, it actually makes it easier to purchase in travel retail, and we're seeing that be a growing part of the travel retail business as well. So, they're actually a little bit ahead in some parts of the world in terms of travel retail omni-channel as it relates to that activity.

Lauren R. Lieberman

Analyst, Barclays Capital, Inc.

Q

Never packing my Advanced Night Repair again. Just reload on my way to the airport. So, just shifting a little bit towards portfolio and long-term strategy. So, the 10-year compass process is something that you and Fabrizio both referred to many times on conference calls, but I would say it's sort of – it's a mention rather than a real articulation of that process. So, I'd love to know more about the work that you go through, sort of the how often you're looking at that, updating it, the inputs to the equation, if you will, as you're setting that long-term strategy and evaluating the portfolio and where the near-term or intermediate terms of areas of opportunity will be?

Tracey Thomas Travis

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

A

Sure. So, our typical long-range planning cycle is a three-year time horizon. And every two to three years, we actually take a longer – longer-term view, and this is something that Fabrizio has started after he joined the company. And really, what it allows us to do is make sure that we are prioritizing investments in the fastest-growing areas of the prestige beauty arena. So what the compass does -again, it's a 10-year time horizon – we look at consumers and consumer demographics. We look at the rise of the middle class, which is a good predictor of where we will see future growth and spending power. We look at shopping behavior in terms of channels. We look at categories and subcategories as well. And really, try to understand over a 10-year time horizon where we can expect to see the fastest growth in the category and how we can position ourselves in order to capitalize on that growth.

So we did update the compass this year, and certainly had validated that travel retail, the dynamics and the drivers of travel retail will continue to be drivers over the course of the next – over the next several years. Certainly, the Asian corridor being a very strong driver of growth but also parts of parts of Europe as well. And we are well-positioned there.

Gen Z and millennial customers are big drivers of growth in both makeup and skincare. They tend to be using skincare products earlier than we, boomers, did. So I expect that they will look much better than I do today as it relates when they get to be my age. But that bodes well as well for us in terms of recruiting consumers into the skin care franchise, younger consumers, at an earlier age and being able to hopefully retain them into their middle ages. And so that's a trend that we've identified. Online will continue, as well, to be a very, very strong growth driver for us and certainly omni-channel as well.

We see growth in Asia. We also see quite a bit of dollar growth in North America as well. So our focus as we indicated on our last call is to continue to have the kind of success we're having in the Asian markets, in China, in Hong Kong and in Singapore, in Thailand and other markets as well to position ourselves to grow again in the Middle East which we are, this year. That's a big emerging market for us as well and we have historically done well in that market. It's a heavy fragrance as well as makeup market. And to grow again in the U.S. And one of the things we mentioned a couple of weeks ago is the fact that in the fourth quarter, we started to see a turn in the

U.S. where the decline in brick-and-mortar department stores were more than offset by the growth in other channels including retailer dot.com or the department store dot.com sites.

So that bodes well for us in terms of starting to reap the benefits of some of the repositioning that we've done over the last couple of years in the U.S. market related to our brands and our channel distribution.

Lauren R. Lieberman

Analyst, Barclays Capital, Inc.

Q

Great. In terms of the compass and even the shorter term trends, do you feel like the portfolio, [ph] you talked a little bit about (15:43) channel, but the portfolio from a brand standpoint, are there trends that you're not able to address with your current brand portfolio?

Tracey Thomas Travis

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

A

No. One of the trends that, I think, everyone is aware of and you're seeing across multiple categories and certainly, beauty is not different, is natural, organic, ingredient-based free from products. And so, we have brands in our portfolio that meet those characteristics or we have sub-franchises within brands that meet those characteristics.

So we have started doing work, Origins and Aveda are two brands that meet a lot of those characteristics. Clinique is a brand that's free from fragrance and several other ingredients that we are making sure our communication addresses as well. And there are white space opportunities in that category certainly over the next 10 years as those trends continue.

Lauren R. Lieberman

Analyst, Barclays Capital, Inc.

Q

Just another topic that came up in the earnings call that you, [ph] at the time, (16:52) was discussing the Estée Lauder brand and the remarkable turnaround that you've seen there. And, I think, probably one of the most interesting parts of this, of course, is it's a big brand. It's a big old brand. It used to be only the grandmother brand. And now, it's the hot brand.

So, can you just revisit maybe a little bit around what it is, sort of what were the key elements of that turnaround? And also, what's the repeatable model, so that it can be – we can see that be applied to other – some of the other big brands in your portfolio that still need a little bit more love?

Tracey Thomas Travis

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

A

Yeah. So, no, it's a great question. The turnaround of the Estée Lauder brand began multiple years ago when the brand really started to think about communicating and recognizing that they weren't communicating and connecting with younger consumers.

So, there were things that were done from a product perspective, from an advertising perspective in terms of using younger or different supermodels to really be a bit disruptive and...

Lauren R. Lieberman

Analyst, Barclays Capital, Inc.

Q

Kendall Jenner.

Tracey Thomas Travis

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

A

...and connecting with younger consumers. And actually developed a special line along with Kendall for one of our retail partners in the U.S., which was their entrée into Sephora into specialty-multi. So, very different from what you think about the traditional Estée Lauder brand.

But the other thing that the brand did was really look at the hero franchises. So, you mentioned Advanced Night Repair. Advanced Night Repair could be a brand on its own. It's that big of a franchise for the company and certainly for the Estée Lauder brand. Much of the innovation in the development had happened in other sub-franchises outside of the hero franchises of Estée Lauder, Advanced Night Repair, Re-Nutriv, Double Wear makeup, Pure Color Envy, which is a new makeup line that they launched a few years ago. And developing innovation under those hero franchises really is something that allows us to leverage the strength of the franchise. Introducing new forms underneath those franchises really allowed us to reach a broader audience and really start to see different traction and elevate the brand from the sales perspective.

The other thing they did, Estée Lauder was the pinnacle of traditional marketing for the company. They did television advertising, print advertising, and then obviously the in-store representation of the brand. They shifted in a big way to digital and social, recognizing that that was the way to initially reach consumers and communicate the benefits of the brand and connect certainly with younger consumers.

The combination of all of those things allowed us to have the remarkable success that the Estee Lauder brand had really in every market last year. And so, when you think about some of the things that the Clinique brand is doing with some of their franchises and some of their innovation and what they're doing in social media and M•A•C is starting to do as well, yes, we believe that while the fundamentals of each of the brands are different, their market penetration is different and categories are a bit different in terms of how they distort. Nevertheless, some of those same strategies can certainly work to accelerate those brands as well. So, we're very encouraged as we look at the next few years for all of our large brands as well as some of our mid-sized brands and getting more of them to be large brands in the next few years.

Lauren R. Lieberman

Analyst, Barclays Capital, Inc.

Q

Because [indiscernible] (00:20:48) I put the sort of last two questions together, the U.S. has been interesting because the intersection of brand and channel, right, some of the biggest challenges for Clinique and M•A•C which has been simply the fact that they are distributed in U.S. department stores. So, can you just talk a little bit, I guess, first about how Clinique and M•A•C have done over the last, let's call it, two years or so, if you looked at it in non-U.S. department stores point of distribution? So where the people are, let's put it that way.

Tracey Thomas Travis

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

A

Yeah. So, M•A•C has done – both M•A•C and Clinique have done very well in Asia. We launched M•A•C on Tmall a little over a year ago. We saw tremendous growth. I think it was at that time the biggest makeup launch that Tmall had seen. And we also saw a lift in the brick-and-mortar distribution in China related to that. And in general, across Asia the M•A•C brand is doing quite well but we saw the online launch actually lift the brick-and-mortar distribution which was already strong for M•A•C in Asia.

Europe has been mixed. As I mentioned, we saw softness in the Middle East for M•A•C as well as for Clinique, and Clinique I would say was mixed as well in Europe. They have some of their new innovation like Moisture

Surge and Fresh Pressed are doing quite well. They've been a bit soft in makeup in recent years but more to come as it relates to innovation around makeup.

So, again we're starting to see growth in multiple markets, more markets for Clinique which is encouraging and again M•A•C continuing to be strong and hoping for more of a turnaround in the U.S. in the very near term.

Lauren R. Lieberman

Analyst, Barclays Capital, Inc.

Q

So how has M•A•C performed? If you can remind me what the footprint is now for M•A•C in Ulta, how many doors, it's sort of off the top of your head?

Tracey Thomas Travis

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

A

Yeah. Yeah.

Lauren R. Lieberman

Analyst, Barclays Capital, Inc.

Q

How extensive that rollout has been? And what proportion of those roughly? [ph] Were there's (23:06) actually a makeup artist there because I think part of the launch was that this is going to be a sort of the service model as well and they were going to be the service provider for makeup within some of the Ulta door.

And then also the trends that you're seeing in the standalone, the freestanding stores for M•A•C in the U.S. because it's probably been about two years now since the brand really kind of rolled over?

Tracey Thomas Travis

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

A

Yeah. So M•A•C has been around 200 doors in Ulta. So, obviously not full distribution and they are there with a demonstrated model and it's doing quite well in Ulta. And I think in more than 50% of the distribution they are the top brand. It's doing well in the doors that it's in and it's doing well online at Ulta as well. So, we certainly have more opportunity there.

We have been thoughtful in terms of the expansion of the brand relative to other points of distribution within the geographies, so we don't cannibalize ourselves, and yet, at the same time maximize the overall opportunity for the brand.

Freestanding stores have been challenged because most – many of the freestanding doors are-mall based. And so, M•A•C started to see a bit of softness a few years ago with some of the decline in tourist traffic in the U.S., and then with the softness in particularly, mall-based retail, their freestanding footprint has been challenged.

So there is a lot of work going on, everything from the in-store experience. We have renovated about 300 M•A•C doors in the U.S. and created more of a self-serve hybrid model along with an assisted sell model which is typically the M•A•C model in freestanding stores.

There's some work going on with innovation, as I mentioned, more hero franchise and a bit other activity that's going on in terms of in-store, the in-store selling model and the in-store environment and, hopefully, leveraging a bit of technology as well. And so, we're hopeful that we start to see those trends change in the U.S. as it relates to the freestanding store environment as well, recognizing that a lot of the stores are mall-based. And so – but

they're not – they're in – M•A•C doesn't have – they're not – they're in primarily, A malls. So their distribution – they're in the better malls, the malls that aren't declining as much in traffic. So there is an opportunity for a bit of a turn in many of those stores.

Lauren R. Lieberman

Analyst, Barclays Capital, Inc.

Q

And last question on M•A•C for me was in Ulta, do you have a sense or data that lets you know whether or not these are consumers that are new to the brand or if it's people that were historically M•A•C consumers that are shifting where they're buying?

Tracey Thomas Travis

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

A

Yeah. So I don't have the most recent data but I know as of a few months ago, we were attracting new consumers to Ulta and also we were benefiting from new consumers to the brand. So, hence, the reason both of us were quite positive on the relationship and the expansion that we had done.

Lauren R. Lieberman

Analyst, Barclays Capital, Inc.

Q

Great. I'm going to switch gears a little bit and talk a bit about industry disruption sort of is an ongoing theme, of course. But beauty has always been the land of disruptors and the land of creativity and the land of something new. But it's continued to attract new competitors, right? Your gross margins don't go unnoticed. I'll say it that way.

So, to the degree that e-commerce, social media has accelerated all these trends that already existed in beauty, but it's really accelerated it, to what degree has the cost of growth gone up? I get asked that probably twice a week when I'm talking about Estée Lauder. Has the cost of growth gone up? And if so, what does that mean?

Tracey Thomas Travis

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

A

Yeah. No. We can certainly understand that question. I would say – and we've talked about this as well. More of our brands need to do more advertising. And so, historically, much of our brand portfolio had done in-store advertising only. M•A•C would be one of those brands. They didn't do print advertising. They didn't do television advertising.

Fast forward to today, and all brands have to do some level of digital outreach and social media outreach. So, from that perspective along with new entrants to the category and breaking through the clutter, there certainly is the need to invest more in advertising, also expanding in other channels of distribution. Obviously, there's an investment in that as well. It's very important to do things like we've done. And Leading Beauty Forward will be one of those where we are really focused on reducing costs where we can and reinvesting it where we need to in order to support growth.

So the reason why we feel very comfortable with continuing our model in this environment of growing 6% to 8% top line growth and, on average, 50 basis points of margin expansion is because programs like Leading Beauty Forward allow us to make the investments that we need given the environment as well as deliver profitable growth. But that's an important element of our growth model for us to be able to move resources where they are more productive in terms of growing the business.

Lauren R. Lieberman

Analyst, Barclays Capital, Inc.

Q

You mentioned earlier the expectation that in 2019, you're going to see this inflection point on U.S. growth. Does that open up opportunity to take out structural costs in the U.S. or reallocate costs in the U.S. from the sort of more – I think, more expensive to operate department store channel into other channels, or is this sort of – as expected, this is – 2019 was always a year you thought you'd hit this inflection point and it's all sort of already encapsulated in expectations for Leading Beauty Forward.

Tracey Thomas Travis

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

A

No, under Leading Beauty Forward, we've already taken actions as it relates to the U.S. market and reallocating resources. I mean, we spoke about a couple of weeks ago, Lauren, on our call, one of the programs under Leading Beauty Forward allowed us to actually look at our historic field selling structure in the U.S. which had been built over time to support department store distribution.

Fast forward to today, we have department store distribution. We have a specialty distribution, online distribution and freestanding store distribution. So we need to provide appropriate coverage to all of those points of distribution and they're all growing at different rates.

So looking at the structure of that organization, the geographic coverage of that organization, the responsibilities, what our field selling organization was actually doing and the opportunity to actually make them more productive by taking some of the administrative burden off to allow them to have more coverage, as well as reducing some of the cost in the area of our field selling organization are some of the things that we've done under Leading Beauty Forward. So, it's been very granular in terms of the projects that we've executed under Leading Beauty Forward. Looking at how do we leverage technology, how do we reorganize to position people for more success and growth in the areas that, where the business is growing.

So we've done some of that and we'll continue to see some of the benefits of that over the next couple of years. So it's less about the tipping. The tipping, as we see more doors close in the U.S., certainly there's a short-term impact as it relates to that. But, overall, the U.S. market is quite healthy in terms of prestige beauty, some of that driven by competitions. The online growth, which everyone is benefiting from and other channels of distribution, in addition to the strongest department store doors, are still growing quite nicely in the U.S. as well.

So, making sure that we're allocating resources appropriately where the growth is, is something that we've done over the last couple of years. And, I think, we're starting to see the benefits of that this year.

Lauren R. Lieberman

Analyst, Barclays Capital, Inc.

Q

[ph] I am going to (32:10) switch to the UK, which is a good transition point. So UK has been a market that probably had high-single-digit growth for a couple of years, and the last probably 12-ish months has slowed to flat to maybe down slightly. Can you talk a little bit about kind of what's been driving that, the degree to which this is a department store dynamic and overall market dynamic, how channel-specific is it versus region-specific? We'll start there.

Tracey Thomas Travis

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

A

Yeah. Yeah. I think the UK challenge is more macro-oriented. We saw a shift in the market when Brexit happened. And it was a bit delayed because when the pound depreciated so rapidly, we actually saw quite a bit of tourist flow into the UK, but the domestic market slowed quite a bit. And we've continued to see with tourists being less a factor in the economy today as the pound has strengthened from those days, we've seen that the domestic market in the UK is still soft.

That has impacted the department store channel in the UK, but we see it in other channels of distribution as well.

Online in the UK is still growing nicely and strong as it is in most markets, so we have certainly focused more on that channel of distribution in order to capture some of that upside growth. But I would say some of it is channel-related, but most of it is macro-related in the UK in terms of what we see. The department store mix of business in the UK is a bit less than what it is here in the U.S.

Lauren R. Lieberman

Analyst, Barclays Capital, Inc.

Q

I'm going to survey for questions quickly, if anybody wants to jump in. I got one.

Q

Can you give us an update on the profitability of selling direct to consumers relative to selling through retail partners? And currently online is what percentage of the business and how quickly is that growing?

Tracey Thomas Travis

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

A

Yeah. So, online is about 14% of our mix and it's growing – it's been growing between 25% and 30% a year. And we expect certainly as we look out over the next few years that it will continue to grow that strongly. It's a mixture of our brand dot.com sites as well as retailer dot.coms. So some of the strongest growth that we're seeing in the U.S., for instance, is with our retail partners, with Macys.com and Nordstrom.com and Sephora and Ulta as well. And so, that certainly is a trend that we've identified in our compass, we'll continue to grow, and we've positioned ourselves quite well globally as it relates to online.

In terms of direct-to-consumer, direct-to-consumer also incorporates our freestanding. So about half of that business is brand dot.com and the rest, retailer dot.com roughly. We also have freestanding stores. And freestanding stores have had mixed performance. So, as I just spoke about M•A•C, in the U.S., there have been some challenges in certain markets as it relates to freestanding stores that are tied to some of the malls in the U.S. and a bit in the U.K. Freestanding stores in Asia are quite strong and growing quite nicely. So, it's a bit of a mixed bag. But we've spoken for some time about expecting direct-to-consumer to be a greater portion of our business, and we certainly expect that that will continue to be the case even with some of the softness we see in some markets as it relates to freestanding stores.

The profitability is quite good, I mean, in terms of direct-to-consumers other than the momentary softness that we've seen in the U.S. market as it relates to some of the freestanding stores where we've seen some margin deterioration related to some of the traffic declines particularly for M•A•C.

Q

Would I be crazy to think that when you sell an item through your brand dot.com site, you're realizing a margin that's 20 or 30 points higher than you would if you were selling it through a retail partner?

Tracey Thomas Travis

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

A

We typically don't – we don't talk about margin by channel. But I would say that when you think about brand dot.com, we obviously have – we have a retail selling price, which is probably what you're alluding to versus a wholesale selling price. We have the cost of merchandising the site. We have the cost of maintaining the site and we have the cost of fulfilling the order.

So all of that nets out to be quite nice for us in terms of profitability. Retailer dot.com is also nice. It's a wholesale sale but we don't have any of those other costs. So, online, as a channel for us, whether it's retailer dot.com or brand dot.com is a very nice business and one certainly that consumers more and more are gravitating to. And we have an online presence in more than 30 markets now. So, it's very much a global business for us and we continue to expand.

Q

In China, by launching on Tmall, does that – I mean, if I think about how much of China you could access previously, did that – I mean, if I was in, I don't know, the top 10 or 20 cities, I guess, I mean, am I now able to access 50% more of China or 100% more?

Tracey Thomas Travis

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

A

So – great, no. You're very, very insightful and a great question. We are in 119 cities now in China in terms of brick-and-mortar distribution, and that's largely with two of our brands, Estée Lauder and Clinique. The other brands that we have in China are in somewhat less number of cities. So there's an upside opportunity for us to expand in those cities.

Tmall, based on the information that we have, allows us to reach customers in over 600 cities. So, it's quite a multiplier effect in terms of the broad reach and where we see demand coming from in China from – through the Tmall platform. That does a couple of things for us in terms of how we've been able to capitalize on that. It directs us in terms of where we should be expanding next in terms of brick-and-mortar distribution, but it's also allowed us to really focus on as consumers in China travel either within China or outside of China, oftentimes the first time they'll actually see brick-and-mortar distribution of our brands in a Tier 3 or Tier 4 city is in the airport.

And so, how we actually merchandise our products and represent our products in airports sometimes is the initial physical point of distribution of consumers in many emerging markets. And certainly, we see exactly where that demand is coming from in China. So it's been very beneficial for us in terms of insight and where we place investments and when.

Q

You mentioned two products in the 119 cities. Will it be all the products? Like how many products?

A

Tracey Thomas Travis

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

So, we have about half of our – we have 30 brands in our portfolio. We have about half of our brands in China today. Don't know if – it's probably will not be all of our products, but certainly there is an opportunity for more products in China. As it relates to the 119 cities, there's clearly an opportunity to increase brands like M•A•C and La Mer and Jo Malone and Bobbi Brown and others in more cities than what they are today. Origins.

Lauren R. Lieberman

Analyst, Barclays Capital, Inc.

So this is the international sign that it's time for breakout. So just join me in thanking Estee and go forward right now.

Tracey Thomas Travis

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

Thank you, Lauren.

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