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The Estée Lauder Companies, Inc. (EL)

Barclays Global Consumer Staples Conference

CORPORATE PARTICIPANTS

Tracey Thomas Travis

Executive Vice President of Finance and Chief Financial Officer, The Estée Lauder Companies, Inc.

OTHER PARTICIPANTS

Lauren R. Lieberman

Analyst, Barclays Capital, Inc.

MANAGEMENT DISCUSSION SECTION

Lauren R. Lieberman

Analyst, Barclays Capital, Inc.

Okay. So just a few weeks ago, Estée Lauder reported fiscal 2019 results, which rounded out a decade of standout performance. Over this time, Estée Lauder has transformed its business into one which can boast strengths across its brands, channels and geographies and categories. After a decade of net reinvestment, the company is now seeing better leverage on its sales growth, which would translate into a more balanced earnings algorithm going forward.

I'm pleased to welcome the company's CFO, Tracey Travis, with us again this year. And we're going to be doing fireside chat, obviously, so please be ready with questions if I run out, which is doubtful, just in case.

QUESTION AND ANSWER SECTION

Lauren R. Lieberman

Analyst, Barclays Capital, Inc.

Q

So Tracey, first, I just wanted to start off talking about the strong financial performance that you've just reported. Maybe looking back, what was sort of the most surprising thing in the last 12 months?

Tracey Thomas Travis

Executive Vice President of Finance and Chief Financial Officer, The Estée Lauder Companies, Inc.

A

I'm not sure that there was anything terribly surprising. Against the macro environment, which we've been operating in over the last several years, a lot of volatility, we still saw terrific momentum in our Asian markets. So China, travel retail, and we're able to really capitalize on growing the business there. With the expanding middle class, really focused on investing more to get new consumers and all of our brands doing terrific in the region, so I think that wasn't a surprise. We had certainly planned for that, but it was a pleasant outcome for the year.

Lauren R. Lieberman

Analyst, Barclays Capital, Inc.

Q

And as you look ahead to 2020, the guidance you've given for revenue growth is the high end of the long-term range and focusing in on 7% to 8% and that's looking slightly above the long-term algorithm. Despite all the macro uncertainty, what made you so comfortable to give that kind of outlook for next year?

Tracey Thomas Travis

Executive Vice President of Finance and Chief Financial Officer, The Estée Lauder Companies, Inc.

A

Yeah. Well, we're coming off of a year of 12% growth in constant currency and a quarter of the same, and it has been two years of double-digit growth for us. So, as we look at fiscal 2020, obviously, there is increasing macro uncertainty all over, certainly including the U.S. But given the penetration that we have now in emerging markets, we felt comfortable that given some of the strategies that we've put in place when we look at our innovation program for fiscal 2020, even though it reflects a moderation that, that guidance of 7% to 8%, it reflects a moderation of the growth that we've seen over the last couple of years, we still feel comfortable with that guidance.

Lauren R. Lieberman

Analyst, Barclays Capital, Inc.

Q

So, I'm going to jump into some of the topics that we've been hearing a lot about in the, I guess now, two weeks since you reported earnings, and the first would be China. So, I remember back in 2011, Fabrizio talked about sales from Chinese consumers globally and it was roughly around \$1 billion, which would – at the time was 11% of company's sales. At the time, the sales within China were just – I think it was 3% of company's sales, so it was a lot about Chinese people traveling. Is it possible to give us a sense for how much the Chinese consumer worldwide account for today? So, just let's start there.

Tracey Thomas Travis

Executive Vice President of Finance and Chief Financial Officer, The Estée Lauder Companies, Inc.

A

Yeah. So, China, we just closed our fiscal 2019 year, China represented about 12% of our growth, Mainland China. Hong Kong is another 2% to 3% of growth. And then travel retail is about little over 20% of our growth and

about half of that is Chinese consumers. So, about a quarter of our sales right now are driven by Chinese consumers.

We've had terrific success, we gained share in China last year. We gained 80 basis points of share. Brands like La Mer, M•A•C, Tom Ford are doing incredibly well. We have about half of our brand portfolio in China. So, we certainly have more brands to expand in China when the timing is right. And we've had success both in department stores in China and freestanding stores and, obviously, online with Tmall.

So across all channels of distribution, they're all growing double digits – strong double digit. And we are increasingly growing not only skin care, but makeup and fragrance as well. So, Jo Malone has had good success in China as well. So it's been a great market for us.

We look at China, obviously, not just for the Mainland China business, but the traveling consumer business as you indicated. So, we have a fair amount of growth outside of China within the APAC region largely from Chinese traveling consumers as well. And so we look at the traveling corridors and make sure we're aligning our investments and aligning our marketing programs across the traveling corridor where the Chinese consumer tend to shop and – when they're traveling in order to capture sales throughout that corridor.

Lauren R. Lieberman

Analyst, Barclays Capital, Inc.

Q

And can you just talk about the outlook for China? I mean, you've talked little bit about what are the areas of [audio gap] (00:05:13) continued strength, but obviously, I get asked every day, [indiscernible] (00:05:18) about signs of slowdown in China, slowing GDP, that's a fact. So government crackdown conversation as well, if that's on the Mainland as well could materialize. So how are you factoring that into your outlook and are you seeing any signs yet of things slowing, and if not, why not?

Tracey Thomas Travis

Executive Vice President of Finance and Chief Financial Officer, The Estée Lauder Companies, Inc.

A

Yeah. No. We – and I think we like many other companies that have a strong business in China have not seen a slowdown. We just reported earnings a couple of weeks ago. We're still seeing very strong growth across all channels of distribution in China. So, yes, we've seen the reports on GDP slowdown. It is not to this point affected prestige cosmetics. And why that is, I don't know. I would say that we are a luxury company, but we're an affordable luxury. And so I think that while other categories might be slowing, we're not seeing that slowdown in prestige beauty.

Lauren R. Lieberman

Analyst, Barclays Capital, Inc.

Q

How quickly – when Chinese consumer shifts kind of broad strokes the travel corridor, how quickly can you adapt your marketing plans or your merchandising mix or your staffing in the relevant airports?

Tracey Thomas Travis

Executive Vice President of Finance and Chief Financial Officer, The Estée Lauder Companies, Inc.

A

Yeah. No, it's a great question. We're much better at it today than we were a few years ago. And so the Chinese traveling consumer we have noticed shifts with currency shifts. And so we have – one of the things that we've done with the buildup of our travel retail network, really investing a lot in the presentation of our brands in travel retail. We are able to shift the merchandise to distort more towards the products that we know that Chinese travelling consumers like.

And like I said, more and more, we're actually pre-aligning our marketing programs with the traveling corridor to make sure that we're running the same programs, whether it's an innovation program like Sakura was for the Estée Lauder brand or [ph] the DD iD (00:07:22) moisturizer that we launched last year for Clinique, making sure that we've got representation in all of the corridors that Chinese consumers travel in.

But when that shifts to the UK, with the pound devaluing, then we also make sure that we've got Chinese-speaking assistants at the counters in order to serve Chinese consumers. And we're also more and more having marketing material in Chinese to reflect again the growing Chinese traveling consumers. We've talked about the fact that Chinese consumers right now have 8% or 9% in terms of passport. So, consumers have still a fairly low amount of passport. So, we expect that that consumption in terms of travel will only grow.

So we're making sure that we are prepared to serve whether it's Chinese traveling consumers, Middle Eastern traveling consumers, Russian traveling consumers and Brazilian traveling consumers are the consumers that tend to shop the most when they travel. And so we've gotten very sophisticated over the last, I would say, four to five years in particular in making sure that we understand the traveling corridors and are merchandising and marketing accordingly.

Lauren R. Lieberman

Analyst, Barclays Capital, Inc.

Q

Great. So, going to continue on to Hong Kong, so sticking with travel, it's actually a surprise to learn on the earnings call how much you've shifted the business from being away from tourists in Hong Kong to a local business. But still I have to imagine there's risk and Tiffany I think reported last week, they talked about losing six selling days in Hong Kong because of the protests. So, could you just talk a little bit about how big the potential impact could be to the first quarter and to fiscal 2020 from the unrest in Hong Kong?

Tracey Thomas Travis

Executive Vice President of Finance and Chief Financial Officer, The Estée Lauder Companies, Inc.

A

Sure. Well, as we reported a couple of weeks ago, we did not see any impact in fiscal 2019. The protest started towards the end of June and our fiscal year, obviously, is June 30th. So we did see an impact in July and through August. We did not shut down across the board our points of distribution, but we did allow stores to close where employees felt uncomfortable if protests were going on in the market. So, we have seen a decline.

Obviously, given the fact that we only gave guidance a couple of weeks ago, we certainly reflected our expectations of softness in Hong Kong, what we were saying and what we anticipated into the guidance for the first quarter and for the full-year. So, Hong Kong is down double digits. That's reflected in our guidance. And we see that remaining at least for the balance of the calendar year and softness in the second half of the year as well, not quite as severe.

Now, good news this morning apparently coming out of Hong Kong that they have pulled back. The leader of Hong Kong has pulled back on some of the legislation that was causing some of the disruption or was the catalyst I think for the start of some of the disruption, so we'll monitor that closely. But we certainly expect there will continue to be softness in Hong Kong. Most of that softness is in the tourist areas. We are seeing some softness in the non-tourist areas, but much less than in the tourist areas as we spoke, Lauren, on the call, so.

Lauren R. Lieberman

Analyst, Barclays Capital, Inc.

Q

That's great. Super helpful. Let's just switch gears quickly to some of the other fast-growing emerging markets, because you've mentioned a broad range outside of China, I mean sort of everything, right. Latin America, India, Middle East, Turkey, Southeast Asia, through Africa in there, so kind of what's the market potential for some of the other emerging markets, maybe what are the areas in particular the most interesting right now? And as a group, are they really big enough to move the needle like, let's call it, over the next two years?

Tracey Thomas Travis

Executive Vice President of Finance and Chief Financial Officer, The Estée Lauder Companies, Inc.

A

So, as a group they are. The individual markets, obviously, none of them compare quite to Hong Kong or China. But we saw double-digit growth in the other emerging markets outside of China over the last couple of years. So, the markets that are the biggest and the most – we see the most potential for growth, Mexico, obviously, has had its ups and downs, but that's quite a big market for us. Brazil also has had its ups and downs in Latin America.

India is a big market potential for us and we're seeing great traction in India for our brands, particularly M•A•C, but other brands as well. Russia is also a big market for us in terms of fragrance. Some of the newer fragrance brands that we acquired over the last couple of years are doing quite well in Russia in addition to Estée Lauder and Clinique. So those were our primarily the emerging markets that we're focused on, and Southeast Asia. Southeast Asia continues to grow and accelerate, markets like Singapore and Thailand and Malaysia and those are markets also that we're focused on.

Lauren R. Lieberman

Analyst, Barclays Capital, Inc.

Q

Great. I'm going to switch now to North America. So let's just first start, I guess, how much of the company's recent weakness would you say is because of the slowing prestige beauty market and makeup, in particular, versus let's call it [ph] Estée (00:12:55) specific challenges and in particular sort of M•A•C and Clinique weighting towards department stores?

Tracey Thomas Travis

Executive Vice President of Finance and Chief Financial Officer, The Estée Lauder Companies, Inc.

A

Yeah. I would say, hard to answer specifically. We have – over the last couple of years, we certainly are and continue to be the share leader in North America. So, Clinique is the number one prestige brand in North America and has been for some time. But because so much of our roots were anchored in department stores, as so many doors have closed, so many department store doors have closed, we've lost a lot of distribution and the distribution, the traffic in fairness was declining before, before a lot of those doors closed.

So, we have been on a journey, as you know, Lauren, to pivot our distribution more into faster-growing channels in North America, like specialty-multi and online. It's interesting. We were just talking about emerging markets, probably the most disruptive market that we've had has been the U.S. market, because of all the channel dislocation, somewhat driven by digital and also driven by the influx of indie brands in the U.S.

So, I saw a number recently that there were a thousand new brands launched in the last six or seven years in the U.S. So, that's a lot of competition and we talk about trial and we talk about repeat. And one of the things that we focus a lot on, certainly we focus on trial and customer acquisition and that's one of the strategies we have in North America to get more trial and get more consumers and newer consumers, but our brands have great repeat levels.

And so, you see a lot of churn in the market, you see a lot of trial going on, but we have some of the strongest repeat rates in the market. So, I would say a good portion of it is just our distribution heritage in terms of the anchoring. We now have great representation in specialty-multi of our brands. We're still doing some expansion in Ulta. We've got a good brand representation in Sephora. And retailer.com continues to be quite strong for us across the market, whether it's in department store retailer.com or specialty or own brand.com.

So, the North America team, we've done a lot of work over the last couple of years to really reorient our business to focus on and support multiple channels of distribution. I think that the team is well in place now, using a lot more data and analytics to really be targeted with respect to spending and what's working and what's not working from an advertising and a promotion standpoint, and we're encouraged about the market.

Makeup is a concern. Obviously, it – specialty-multi over the last few years was driven in general in terms of traffic, but certainly by the makeup growth that the U.S. has seen over the last few years. And we've called out softness in the last two years in makeup. We have grown in skin care, but we have been challenged like many others in the market in terms of makeup, so.

Lauren R. Lieberman

Analyst, Barclays Capital, Inc.

You mentioned specialty-multi...

Q

Tracey Thomas Travis

Executive Vice President of Finance and Chief Financial Officer, The Estée Lauder Companies, Inc.

I know where she is going.

A

Lauren R. Lieberman

Analyst, Barclays Capital, Inc.

... [indiscernible] (00:16:23) elephant in the room. But also before I mention Ulta by name, I guess both last year and this year, I've been thinking about just channel mix shift in your U.S. business getting to the point where just the channel mix is going to allow the business to kind of return to growth or at least flatten out, right, department stores getting smaller, specialty-multi, e-commerce and so on getting bigger. Market's been softer than expected in general.

Q

Now, we've got this interesting new wrinkle of the implosion at Ulta. I'm going to use words that everyone in the audience would probably use. So, how does that factor in and how is this Ulta disappointment – what degree of that magnitude of change and pressure there in your outlook, because I think everyone's pretty concerned coming out of that?

Tracey Thomas Travis

Executive Vice President of Finance and Chief Financial Officer, The Estée Lauder Companies, Inc.

Well, it was interesting looking at the transcript of the call. Our brands last year grew double digit in specialty-multi and grew double digit in Ulta. They grew double digit in the fourth quarter. And at least quarter-to-date, they have also grown double digits. So M•A•C is doing incredibly well. I think Clinique was specifically called out, Estée Lauder. We introduced Bumble last year and Origins. So, our brands are doing well in Ulta. Much of it's skin care, with the exception of M•A•C. I mean, M•A•C is growing double digits in Ulta. So, it's doing incredibly well in color cosmetics and in foundations. So we're not seeing some of the challenges that Ulta has called out in their call last week.

A

Certainly, across the market, we are seeing the softness in makeup, absolutely. And so that certainly impacts specialty-multi, again, given the fact that color cosmetics has driven a lot of growth in specialty-multi. Ulta is more hedged than others in the market. Certainly, they have skin care, they have their mask business, and then they have hair care as well. And hair care and fragrances have been growing from a market standpoint in the U.S.

But we weren't counting on a lot of growth out of the U.S. this year. When we gave our guidance for the year, we talked about the fact that we expect the U.S. for us to start to stabilize. We've lost share in the last couple of years. So, there's certainly a strategy that we have a very clear strategy to return to growth in the U.S., being not just sales growth, but growing market share in the U.S. and that's a multi-year strategy, but we see the path to get there. So we do see improvement in the U.S. this year, but again, with some of the strategies that we have, but we're not counting on that. So the moderation that is in our guidance really has more to do with Asia moderation than anything else.

Lauren R. Lieberman

Analyst, Barclays Capital, Inc.

Q

Okay, that's great. Let's focus a little bit on Clinique. So, I guess what would you say is the opportunity for Clinique in the U.S. and globally? And can it – do you think it can return to meaningful growth and recover share? And you've put a lot into that business, there's been a lot of – pretty interesting initiative on Clinique over the last couple of years...

Tracey Thomas Travis

Executive Vice President of Finance and Chief Financial Officer, The Estée Lauder Companies, Inc.

A

Yeah.

Lauren R. Lieberman

Analyst, Barclays Capital, Inc.

Q

...but not many have really taken hold.

Tracey Thomas Travis

Executive Vice President of Finance and Chief Financial Officer, The Estée Lauder Companies, Inc.

A

Yeah. No, the Clinique team has done a remarkable job in the last couple of years really repositioning the brand for growth globally, but certainly in the U.S. When we look at last year in the U.S., skin care actually grew for Clinique, so skin care grew everywhere for Clinique and they had a tremendous year of innovation with [ph] DD iD (00:20:22). They launched...

Lauren R. Lieberman

Analyst, Barclays Capital, Inc.

Q

Sorry. That's dramatically different moisturizer iD, so not everybody knows.

Tracey Thomas Travis

Executive Vice President of Finance and Chief Financial Officer, The Estée Lauder Companies, Inc.

A

Yes, it's a customizable moisturizer, again moisturizers being the largest category in skin care and one that's a big one for Clinique obviously. So they had a breakthrough innovation in [ph] DD iD (00:20:44) and that impacted the U.S. They launched Moisture Surge Eye, which is another moisturizer for an eye serum and that has done well. They've launched – relaunched their Smart franchise, which is also doing well. So they had a good year of really strong skin care innovation.

They have a strong foundation portfolio and they, towards the end of the year, started focusing on foundation in terms of makeup where Clinique is really suffering. They had a very big makeup business in the U.S. And over the last few years, we've not seen as much innovation in color cosmetics. And so with the softness in color cosmetics from a total market standpoint and probably a lack of strong innovation in that category, that's where Clinique has suffered in the last couple of years, and that's certainly where the focus will be this year and next year to try to strengthen the color cosmetics, but again that being done in a relatively soft market. But color cosmetics are growing quite nicely in other parts of the world. So strengthening their color cosmetics innovation will help Clinique in terms of the overall global growth as well.

Lauren R. Lieberman
Analyst, Barclays Capital, Inc.

Q

Okay, great. I'm going to switch topics a little bit, something you should be very proud of, Leading Beauty Forward. So, what I think – what I found interesting about the program sort of from the start is that it was – I describe it as sort of like proactive in patient restructuring. It wasn't the – let's get cost savings, reinvest today, oh my gosh, we've got a problem here.

Tracey Thomas Travis

Executive Vice President of Finance and Chief Financial Officer, The Estée Lauder Companies, Inc.

A

Well, that was an element of the program for sure, but it was one of three. Yeah.

Lauren R. Lieberman
Analyst, Barclays Capital, Inc.

Q

But it's with time, right, it wasn't we're going to generate something in 12 months. It was – net cost savings was a couple of years out. So can you just talk a little bit I guess first with the evolution of the program and how it's now giving you or has given you more P&L flexibility?

Tracey Thomas Travis

Executive Vice President of Finance and Chief Financial Officer, The Estée Lauder Companies, Inc.

A

Yeah.

Lauren R. Lieberman
Analyst, Barclays Capital, Inc.

Q

And how you've been sort of – I guess the biggest areas of reinvestment coming out throughout that program?

Tracey Thomas Travis

Executive Vice President of Finance and Chief Financial Officer, The Estée Lauder Companies, Inc.

A

When we started Leading Beauty Forward, it was in 2016. And when we looked at our strategy, the company has always been very strong in terms of developing a very robust strategy and then executing against the strategy. And as we looked at the opportunities for the company over the next few years, we started to look at capabilities in terms of executing the strategy.

So, when you looked at the growth of social media, you looked at the growth of digital advertising, you looked at the channel diversification that we had established as part of our strategy, we needed to make sure we had an organization that could execute against that. At the same time, we recognize that our cost base was not as leverageable as we thought it should be.

So there was an opportunity to do some organization structuring so that we could leverage our sales growth better, because we certainly saw with our compass that we had growth opportunities over a much longer period of time when you looked at prestige beauty and in particular emerging markets and the growth that we anticipated there.

So, Leading Beauty Forward was started really to help us accelerate some of the org redesign and development that we needed to do to invest behind capabilities that we needed to have in order to capitalize on the growth opportunities that we saw, and certainly to take cost out. And that was Leading Beauty Forward.

So we started with about half the program that we ultimately ended up with. And the program gained quite a bit of momentum as we started to see some very early results from the program. So it's been transformational for the company in terms of being able to invest back into areas of opportunity that really allow us longer term sustainable growth.

And you're right, we started it when we were still growing at 6% – more in the lower end of our growth range, but still within our 6% to 8% growth and double digit EPS growth is when we started the program. So it wasn't a take cost out, that is not our focus every couple of years to do a restructuring program to take cost out to hit our earnings numbers.

Lauren R. Lieberman

Analyst, Barclays Capital, Inc.

Q

So, coming out of that program or where you are now, how do you determine priorities for reinvestment versus margin expansion?

Tracey Thomas Travis

Executive Vice President of Finance and Chief Financial Officer, The Estée Lauder Companies, Inc.

A

Well, we're pretty proud of the fact that if you look at the last 10 years, we've had a 1,000 basis points of margin expansion. So, our guidance is always 50 basis points. In the last two years alone, we've had 90 basis points last year and 70 basis points the previous year. So, we're able to grow top line and we've been able to consistently deliver margin expansion within or above the range, obviously over a 10-year time horizon, above the range of the 50 basis points. And it's important for us to continue to do that.

In terms of prioritization of resources, we've gotten a lot better at building analytical capability. It was one of the investment areas as well under Leading Beauty Forward. But some of the tools that we've put in place, the return on investment as it relates to digital advertising is something that we have much better understanding of today than we had a few years ago.

So we are able to target our media investments much better as well as our capability investments much better given the terrific work that we do in the strategy and the strategy process. And we balance – again, as we see opportunities to grow at 12%, we're going to invest behind that.

If we only see opportunities to grow at 7%, we're going to pull back on investment in line with that 7% growth. So we have that flexibility Leading Beauty Forward has created, allowed us to create more flexibility. But then we also have at the beginning of the year contingency where Fabrizio and I really look at during the course of the year what areas warrant more investment and we also shift resources away from areas that aren't meeting expectations in terms of investments.

The more we have been able to shift from fixed to variable cost, the more we've been able to execute against that. So we have much greater flexibility today and certainly when the Leading Beauty Forward program is done, completely over, than we had in the past in order to be able to shift resources.

Lauren R. Lieberman

Analyst, Barclays Capital, Inc.

Q

I think there's two years left in the program.

Tracey Thomas Travis

Executive Vice President of Finance and Chief Financial Officer, The Estée Lauder Companies, Inc.

A

Yeah, we closed the program at the end of fiscal 2019 to new – new adds to the program and the program runs out over the next couple of years in terms of finishing some of the programs that were started.

Lauren R. Lieberman

Analyst, Barclays Capital, Inc.

Q

Okay. Because you've already had so much leverage on the selling line in particular, so how much margin – I know the guidance is 50 basis points. I got it. But on a 6% to 8% growth rate, not 12%, with already so much leverage having come through particularly on the selling line, is there really that much margin expansion and room for reinvestment?

Tracey Thomas Travis

Executive Vice President of Finance and Chief Financial Officer, The Estée Lauder Companies, Inc.

A

Certainly over the next three years, which is the guidance that we gave, yes, we certainly see that there's continued leverage in our organization model, given some of the organizational structures that we've put in place and some of the return that we're seeing in some of the markets from an investment standpoint [ph] in media (00:28:38).

Lauren R. Lieberman

Analyst, Barclays Capital, Inc.

Q

All right, great. So just let me jump to cash flow. So, you've laid out very attractive long-term cash flow goals at the Investor Day in March. But one area there hasn't been that much progress still is inventories, like, we've been talking about this for a long time. So, can you just talk a little bit about why inventory levels have remained so high, why SMI or SAP hasn't really had more of an impact?

Tracey Thomas Travis

Executive Vice President of Finance and Chief Financial Officer, The Estée Lauder Companies, Inc.

A

Yeah. No, SAP, the biggest benefit we got from SMI which was our SAP initiative and a few other initiatives combined in there gave us more visibility to our global inventory. I mean, we basically prior to the implementation of SMI did not have global visibility.

What it did not do is give us the ability to actually manage an increasingly complex business in terms of SKUs, in terms of channels of distribution, et cetera. So we needed far more sophisticated tools, which we're investing in now, to improve our forecast accuracy, demand planning, allocation of inventory, et cetera. So that's in terms of SMI. We're very pleased with the SMI program, the SAP program. Probably the biggest near-term benefit that we've had over the last couple of years not only the visibility the inventory has been helpful, the visibility to our

cost structure and how it's enabled our cost saving programs has been a big benefit that we realized out of SMI and SAP.

In terms of other drivers of inventory, obviously, the growth we've seen in Asia, given where our manufacturing footprint is today in North America and in Western Europe, in-transit times have gone up. The tremendous growth that we've seen over the last couple of years, double-digit growth, means we're staging more component inventory for growth, et cetera. So all of those things have driven up our inventory levels, but we are investing in more sophisticated tools in order to address the inventory levels.

We've also stood up a planning organization to help oversee a lot of these efforts as well. And I am joined at the hip with our Head of Supply Chain to make sure that over the next three years we actually do start to make some meaningful progress in inventory levels. We have made progress in the other areas of working capital and expect to continue to make progress in those areas, and you saw some of those at Investor Day. So, accounts payable, accounts receivable. I think last year – oh, I know last year, we had a 40% increase in free cash flow, fiscal 2018 versus 2017, not as much progress in fiscal 2019 because of the inventory levels, but certainly we expect that we'll continue to start to see cash flow growth in 2020 and beyond.

Lauren R. Lieberman

Analyst, Barclays Capital, Inc.

Q

Great. So, I'm going to merge together two questions...

Tracey Thomas Travis

Executive Vice President of Finance and Chief Financial Officer, The Estée Lauder Companies, Inc.

A

Okay.

Lauren R. Lieberman

Analyst, Barclays Capital, Inc.

Q

...in the interest of getting it in. So, first is just reminding us of priorities for cash. And then the other is just around M&A. So, kind of comment on pipeline, multiples, and also the fact that with all of the fragmentation in the industry that you mentioned earlier, Estée has clearly taken a position of buy versus build, arguably you buy things you're going to build, but why is that the right model? Doesn't it have negative implication for ROIC versus trying to do more homegrown?

Tracey Thomas Travis

Executive Vice President of Finance and Chief Financial Officer, The Estée Lauder Companies, Inc.

A

Well, we ended last year – I think our ROIC was over 25%. So we have within our beauty peers at least, we have the highest ROIC, and we're quite proud of that even with the acquisitions that we've done thus far.

So, in terms of priorities for cash, obviously, given that high of a return, investing back in the business is our first priority. We have a number of brands, we have our large brands growing, some growing two – or some of them growing double digit, but we have a lot of midsize and smaller brands that require investment to grow. So, certainly investing back in our portfolio of 30 brands to continue growing organically is the number one priority that we have from a company standpoint.

The second would be acquisitions. And acquisitions, we are quite disciplined in terms of looking for whitespace opportunities that are complementary to our portfolio, but not cannibalistic directly within our portfolio. So we have been – we have quite a bit of cash that we could deploy for the right acquisitions with the right returns. And I

would say that's the second area of focus for us. It leverages our branding capabilities, it leverages our distribution network, and so we see where we add value to an acquisition in order to earn the return. So again, that's the second area of priority.

Dividends and share repurchase would be the last. And so we certainly – if we don't have other higher return uses for the cash, we return cash to shareholders via those two mechanisms.

In terms of acquisitions and the fragmentation that we see, we have a terrific, very robust process in looking at targets and things that we're interested in. And oftentimes, we'll have an interest because we start with where are there gaps in the portfolio, there might be a brand that we've looked at for some time where the owner has not been ready to sell. So we have lots of relationships throughout the industry, it's great being part, having the Lauder family and [indiscernible] (00:34:39) and others have these relationships as well in our company that when it is time, when they are ready to sell, certainly we are top of mind and in the conversation already.

The fragmentation in the industry, I think we have the ability with a lot of our branding teams and we believe we do to understand what brands might be more fad like and what brands we actually think have brand characteristics that can carry globally and can carry for a longer period of time. And we either acquire them outright or we have minority investments like we have in DECIEM, like we have in Dr. Jart and like we have in Forest Essentials that – at some point, those brands will be part of our portfolio as well. So, we have a pretty sophisticated process, very comfortable with the fact that we can maintain high ROIC with our acquisition strategy as well.

Lauren R. Lieberman

Analyst, Barclays Capital, Inc.

Great. We are exactly out of time. So, please join me in thanking Tracey for being with us again this year.

Tracey Thomas Travis

Executive Vice President of Finance and Chief Financial Officer, The Estée Lauder Companies, Inc.

Okay. Thank you.

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