

29-May-2019

The Estée Lauder Companies, Inc. (EL)

Sanford C. Bernstein Strategic Decisions Conference

CORPORATE PARTICIPANTS

Fabrizio Freda

President, Chief Executive Officer & Director, The Estée Lauder Companies, Inc.

OTHER PARTICIPANTS

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC

MANAGEMENT DISCUSSION SECTION

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC

Let's get started to maximize our time. Good morning. Welcome to the second session of the 35th Annual Strategic Decisions Conference here at Bernstein. I hope you're all ready for a great week. Lots of companies, lots of information, hope it'll be helpful. I'm Ali Dibadj, Bernstein's U.S. household and personal products and U.S. beverages and snacks analyst. And we're very, very pleased to have with us Fabrizio Freda, the CEO of Estée Lauder. Thank you very, very much for being here.

Fabrizio Freda

President, Chief Executive Officer & Director, The Estée Lauder Companies, Inc.

Thank you.

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC

As you probably know, Fabrizio has led a incredible transformation for the past roughly 10 years now at The Estée Lauder Companies growing top line and bottom line better than anybody else in my coverage by a long shot and consistently doing that, driven by innovation, driven by M&A, driven by investments and cost savings to drive those investments, China, emerging market expansion, et cetera.

The question, really the singular question, although I have about 40 of them, but the singular question people really want to understand is, what's next. Can this continue? And so, we'll try to elucidate that a little bit today. Fabrizio will have some beginning remarks, and then we'll go to a fireside chat format. As is traditional for that format, you have cards. Feel free to ask questions on the cards. Pass them to the aisles, monitors will be walking around and we'll bring them forward.

So without too much more, Fabrizio, thank you and please.

Fabrizio Freda

President, Chief Executive Officer & Director, The Estée Lauder Companies, Inc.

Thank you, Ali. Thank you. So, good morning. I will give you a brief overview of our company and explain why we believe we will continue delivering our goals [indiscernible] (00:01:44) and sustainable profit or growth for the long term. So, I want to remind you that some of our remarks contains forward-looking statements that includes certain non-GAAP measures. These materials reflect the guidance given on our third quarter earning release and conference call on May 1 and during our Investor Day in March.

So, our company is beautifully positioned in the sweet spot of high quality consumer goods. Global prestige beauty combines the best features of consumer product company with those of luxury houses. Our aspirational brands and their high quality products generate superior consumer loyalty, which is evident in our strong repurchase rates as high as 60% for our bestselling skincare products.

And like luxury companies, our excellent product quality and personalized services give us pricing power. But unlike expensive prestige goods, beauty is an affordable luxury, which has historically been less sensitive to economic downturns. So, these characteristics position prestige beauty as one of the most attractive consumer sectors and we are 100% focused on it. However, within prestige beauty we have multiple engines of growth. And we are now well-diversified across geographies, brands, categories, channels, consumer segments and price points, making us what we believe it is the best diversified pure play.

Now, China is expected to become the world's largest economy and account for much of global GDP growth over the next 10 years. Our research indicates that Chinese consumers will account for about 50% of the entire prestige beauty growth in the next 10 years. The other 50% will come from consumers in other emerging markets such as India, Brazil, as well as large developed markets, including Hong Kong or the United States. We have a leadership position in all of these markets today and we are number one or two in prestige beauty in more than 42 countries worldwide. Countries representing half of our sales are growing more than 6% that is the low end of our annual sales target range. We are well-diversified through also the rest of our business. Our brands span four categories and offer price points from entry level of prestige to ultra-luxury. Their positioning ranges from classic to more progressive, and they appeal to consumer from [indiscernible] (00:05:00) through ageless.

Our brands are available in multiple channels, and we are the leader in two of the fast growing ones, travel retail and global online. Brands representing more than 70%, 7-0, of our sales are growing more than 6%. Since 2014, global prestige beauty has generated average sales growth of 6%, double the 3% growth of Consumer Staples, and we are 100% focused on that segment. Our growth has been even stronger and we have gained share. Our sales accelerated last year rising 13% in constant currency, and we expect another year of double-digit gains in 2019. We delivered these results despite challenges in the U.S. for us, where we are implementing a robust strategy to return to growth. It involves a continuous expansion into fast-growing channels such as specialty-multi using new consumer insights and analytics to tailor our messaging to different populations even in the same city and increasing and optimizing our digital media spend. We expect to see growth again in fiscal year 2020.

Over the past decade, we delivered average annual sales growth of 8% in constant currency, and through disciplined expense management we created operating leverage resulting in EPS growth of 22% compounded annually. We have achieved very consistent results either when China's spending contracted and in years where we didn't have any acquisition. Different engines drove our sales growth over the period and we delivered increased profitability every time.

Our success also generated resources to make more investments in advertising and new capabilities. We strengthened our brand's portfolio, extended our global reach and increased our digital presence. We believe that the combination of our winning strategy and positive trends driving prestige beauty growth will enable us to continue to deliver strong profitable growth for the long term.

A few of the underlining trends are the following: the middle class is projected to grow to 600 million people in both emerging and developed markets, many of these women aspire to prestige beauty and have been trading up from us. The digital revolution provides new opportunities across business and retail from product development and technology to marketing and consumers are putting a greater importance on health, wellness, purpose-driven brands.

Our diverse portfolio of 30 distinctive prestige brands is one of our greatest strengths, and we actively manage it as our brands grow in size. We have four brands that each have more than \$1 billion in sales, three of the four are growing in this moment, two by strong double digits. Below them, we have a solid collection of mid-sized brands that we are scaling and expect some to advance to the \$1 billion growth in the next few years. And as our developing brands get bigger, we fill the pipeline through M&A to address the strategic areas that we choose to address. Our brands are key engines of our organic growth.

Another other unique strength is our innovation, which has been at the heart of the company's success since its founding. Today our creativity is completed by data analytics and consumer insights, which helps focus our innovation effort on the best opportunities worldwide. We are developing fewer bigger launches supporting our most popular hero products and improving speed to market. New product launches are expected to account for a record 30% of our sales this fiscal year. Our Leading Beauty Forward initiative and other activities have enabled us to dramatically change our cost structure.

Since 2009, we nearly doubled our advertising spending in absolute dollars while holding promotional cost flat. We more than quadrupled our operating income while lowering cost of goods and other expense. Global prestige beauty is dynamic, competitive and changing fast. And we recognized the need to continuously adapt. We established a Transformation Office that is still in the agility of a start-up to an organization that has advantages of scale. We'd like to say that our business model is run to win and transform to lead. We believe our outstanding performance can continue. This fiscal year, we expect net sales growth of 10% to 11% in constant currency, and EPS growth of 18% to 19% before restructuring and other charges.

Over the next three years, we are confident that our goal of 6% to 8% sales growth, 50 basis points of average annual operating margin improvement, and double-digit earnings per share gains are achievable. Our position of strength fuels our ambition to continue increasing market share in this desirable industry.

Being a responsible corporate citizen is integral to who we are. We have a long history of giving back and our brand supports many philanthropic, environmental, and social causes. Now, we are stepping up our efforts even farther and announced new ESG goals across numerous focused areas. They include the improvements in our packaging, greater transparency of our ingredients, and lowering emissions. We have made much progress already as you can see from these awards and recognitions that we got recently.

So since 2009, we have created an incredible \$56 billion of stakeholder value. Our total stockholder return has exceeded 1000%, well-above the S&P 500 and the S&P Consumer Staples Index, and also above our peer group putting us in a league on our own.

In closing, we have the best diversified pure play with strong consumer loyalty and pricing power, and a proven strategy to continue generating sustainable profitable long-term growth.

And now, we will have our Q&A.

QUESTION AND ANSWER SECTION

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC

Q

Thank you, Fabrizio. Thank you very much for that background. Again, very impressive results, and want to go through some of these topics in more detail, almost in the order that you described it. The first one that we get many, many questions on is around China and the Chinese consumer, right. So, as best as we can tell almost 20%, 18%, 19% of company sales is the Chinese consumer somewhere in the world. About 26% of operating profit is the Chinese consumer buying somewhere in the world. And 50% or more of growth has come from the Chinese customer. It's not going to continue, and you said this. It's not going to continue at this pace, so what do you think the realistic growth rate of the Chinese consumer is over the next few years? Significantly lower than now or roughly where we are today? How do you guys think about modeling that?

Fabrizio Freda

President, Chief Executive Officer & Director, The Estée Lauder Companies, Inc.

A

First of all, we believe that the Chinese consumers is a very, very important long-term investment for the company. And we have spent in the last years to position ourselves as the leader in our industry for that group of consumers through our portfolio brands and through other many activities we've done with them. So, the first thing is positioning for growth. Now, your question is how much can they grow? I personally believe that over the long run, Chinese consumer will continue to grow at double-digit rate globally. Why this is the case? And again, when I say over the long term, obviously in any emerging markets you can have up and downs. So, there will be up and downs, but the long-term trend is going to be fantastic [indiscernible] (00:13:56) double digit. Why is the case? First of all, in our industry, the Chinese consumer is absolutely passionate about cosmetics, and they are very much into it.

Now today, the use of – the people that use cosmetics are mainly concentrated in Tier-1 and Tier -2 cities, but Tier-3 and Tier-4 cities where there are million and million of consumer are just initially approaching the industry, mainly by being online and more opportunity, and mainly when they travel. So, there is an enormous amount of consumers in China that today can only access prestige beauty online or during traveling, because there is not yet physical distribution. Just to give a sense of this. Our most distributed brand in China which is The Estée Lauder brand is in 121 cities. But, many of our fast-growing brands, take going Tom Ford are in 10, 15 cities. That's it. In this moment, there is demand for our brands from 600 cities.

So, there is this huge wave of more consumers coming from more cities that over the years will develop and will be unstoppable. Now what has changed? Why all of a sudden in our industry in China all these cities where there is no physical distribution today had been activated internal consumption? What's happened is that the world has gone from traditional media to social media. You should know that traditional media in China till only five years ago, actually four years ago, was local. You could buy Vogue Shanghai, you could buy television only in Beijing. So, we were not doing any advertising in places where we could not sell obviously, in order to stay effective. Social media is national. So with the advent of social media, all of a sudden there is million and million of consumers that get to discover brand equities, brand opportunity, innovation, even if there is no physical

distribution in their cities. The result of that is they buy when they travel much more and the other result is they buy online mainly on Tmall, which is the most luxury of our online solution or on our brand sites much more than in the past. And this is going to continue. This is an amazing trend in my opinion which is unstoppable.

The second reason why I believe there is still this double-digit long-term opportunity is that by categories, Chinese consumer today are very much into skin care. They are just discovering makeup. Makeup is today less than 25% of the total business, which is very different what is in countries like U.S. or in Europe, and I believe [indiscernible] (00:17:04) and fragrances are still 5% to 6% of the total business. So, today the Chinese consumer are still mainly skin care consumers, but they will become, like in any other part of the world that we have seen these trends in every emerging market, will become good consumers also in makeup, fragrances, and hair. And so over time, that's another engines of growth that will allow this.

And last is the development of the middle class. I mean there are 300 million people in the middle class in the next 10 years in China that basically is half of the total middle class that will build globally, and there will be old and non-Chinese consumers. Then think of the Chinese consumer traveling just few other numbers. 9% of Chinese today have a passport. And the government gave the announcement that they believe there will be 20% in some years from now. So they will travel, and they will – if distribution is not in their cities, they will buy more in travel retail. So, and I could continue, maybe the last thing I want to say is about us. Even that's about – what I said was about the total consumers. But we have only some of our brands in China for the time being. So, we can deploy more brands, we can enter more cities with physical distribution, we can obviously continue to invest in building innovation, which is more dedicated to Chinese consumers that we are doing. We have an R&D center in China that studies Chinese skin and make sure that all our products are tailored and clinically tested on Chinese skin. So, all this will become more and more, and so there will be even better penetration.

So, the combination or the strengths of the market development and the combination of still the many things we can deploy make us feel very strong on the long-term power of Chinese consumer. But also I want to say that again there could be up and downs, and we are stay very objective on the possibility of up and downs. And we've built agility in our investment capability to make sure that depending on the moments we can invest more or less, and our investment are very much also variable. And so, we can, with agility, change the level of investment to ensure that in this long-term journey, there is always the possibility of having excellent rate of returns on our investment in this part of the world.

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC

Q

So, that's very helpful. Let me unpack that just a little bit. First one in terms of the ups and downs. Are you seeing anything to suggest we're going to start it down?

Fabrizio Freda

President, Chief Executive Officer & Director, The Estée Lauder Companies, Inc.

A

No. Not now, but we did in the past.

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC

Q

Yeah.

Fabrizio Freda

President, Chief Executive Officer & Director, The Estée Lauder Companies, Inc.

A

I showed this chart of the last 10 years. Just to be clear, there's been a moment where we had a growth like here like now, which was after the crisis of 2009-2010. So 2011-2012, China was growing like now. Then there's been the anti-corruption campaign in China. In those period, China went down growing 6% to 7%, and we always have been growing a bit more than the market, but still on a very different market. So, we went down in growth, but in that moment we still delivered our goals of 6% to 8% regularly.

And then, as I explained in the last three years, we have seen this tremendous acceleration. But this is happening because of social media, uncovering old consumers, all the elements I explained has created this huge acceleration. So no, today, I don't see a change which is – of these trends, but we remain conscious that the level of growth we see today are not sustainable.

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC

Right.

Q

Fabrizio Freda

President, Chief Executive Officer & Director, The Estée Lauder Companies, Inc.

They are extraordinary. So, we do expect a certain moderation. Again, when you look at percentages, percentages can be misleading. We don't look at percentages. We look at absolute growth based on the new number of consumers that we conquer every day. So, the absolute growth on China is going to be amazing. However, the base is becoming bigger and bigger. So, percentages may moderate over time, but absolute growth, which is at the end a driver of EPS, will remain very solid over the years.

A

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC

So, we were estimating about 40% to 50% growth recently in China and our long term is something closer to 20%, right? So, ups and downs, but that's how we think about it. I don't if that is how you think about it?

Q

Fabrizio Freda

President, Chief Executive Officer & Director, The Estée Lauder Companies, Inc.

That's enough up and down at 30%.

A

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC

Absolutely. That's a lot. That's a lot. The other part that you mentioned about brand. So Tom Ford now is the 10th brand I think you have on Tmall,...

Q

Fabrizio Freda

President, Chief Executive Officer & Director, The Estée Lauder Companies, Inc.

Yeah.

A

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC

...clearly growing faster because it just launched. Do you think there's an appetite for all of your 30-some-odd brands to go into China, so how many more brands do you think you can get, number one? And number two is,

Q

are you starting to see cannibalization at all between your brands or it's still kind of empty territory for new brands to come in?

Fabrizio Freda

President, Chief Executive Officer & Director, The Estée Lauder Companies, Inc.

A

No, great question. No, I don't see any cannibalization at all because our brand portfolio is going to be deployed in China based on the category development I was explaining before in the sense that as makeup become more and more important we will deploy more makeup brands. As fragrances grows, we will develop more high-end fragrance brands like Tom Ford, Jo Malone already done By Kilian, Le Labo, et cetera, et cetera.

So, the deployment will follow the growth of the different categories, subcategories. Our brand portfolio is pretty articulated. Every brand is very strong in one or two categories like skin care or makeup, and subcategories like I don't know foundation rather than lipsticks. So, we really cover the market depending on the market growth trends. So, we do believe there is still many brands we can deploy in China gradually over the years, and this will happen in conjunction to the development in China of the different subcategories. So, we avoid any cannibalization and just leverage the growth where growth is.

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC

Q

And do you need any regional or local brands do you think to be successful longer term?

Fabrizio Freda

President, Chief Executive Officer & Director, The Estée Lauder Companies, Inc.

A

We do. We believe that we should have a combination of global and local brands in by the way in many emerging markets not only in China. That's our strategy. Normally how we get to that are minority investments. We have a minority investment in a brand which is a Korean brand called Dr. Jart for example, which is in Asian brand. So, we have minority in brand in an Indian brand called Forest Essentials. And so we over time plan to have a portfolio which includes where relevant non-international brands, but still obviously in luxury, but also with local sense and local activity.

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC

Q

Okay. So, one of the questions we get a lot and I think all of us are wrestling with the investors is the whole tariff issue, right. Can you talk a little bit about how that impacts both your value chain in terms of China and perhaps the U.S.? And then secondly, if there is a backlash against American brands, are your brands viewed as American brands? Are they viewed as Jo Malone London brand or French brands, I mean, how are they viewed and will that impact to you do you think?

Fabrizio Freda

President, Chief Executive Officer & Director, The Estée Lauder Companies, Inc.

A

So, on tariffs. Tariffs, we had the flexibility to manage tariffs. First of all, as we said in this fiscal year, we were always assuming the tariffs to be the 25% because the trade agreement is not yet. And so, we always assume for the worst as we said very clearly officially. So, this fiscal year, they're already in our guidance. As for the future, we do have the flexibility to manage them. With 80% gross margin and the flexibility to manage supply chain origin or production that we have globally, frankly, tariffs are manageable.

Just to make sure and give you a number, if the tariffs were the one that today gets threatened, this next fiscal year for us will be extra cost of \$20 million. So, manageable.

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC

You can handle that.

Q

Fabrizio Freda

President, Chief Executive Officer & Director, The Estée Lauder Companies, Inc.

We can handle \$20 million more or less cost. So tariff is a, I would say, is a non-issue for our brands and for our portfolio, at least the tariffs that today are threatened. The second question is about if there was any...

A

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC

Yeah, anti-American sentiment.

Q

Fabrizio Freda

President, Chief Executive Officer & Director, The Estée Lauder Companies, Inc.

...anti-American sentiment.

A

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC

Are your brands American brands? Are they UK brands? Are they French brands? Are they – how do the consumers in China think about that?

Q

Fabrizio Freda

President, Chief Executive Officer & Director, The Estée Lauder Companies, Inc.

So, our brands are really truly global in essence, and they are not considered by any – and we have all the data, so it is my point of view. To give you an example, Jo Malone London obviously is British. M·A·C is a Canadian brand, and every consumer knows it, it's M·A·C Canada. Darphin France, Estée Lauder actually is interesting, Estée Lauder is obviously American, but is confused as French, so. And...

A

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC

Don't take the accent away. Without the accent...

Q

Fabrizio Freda

President, Chief Executive Officer & Director, The Estée Lauder Companies, Inc.

Frankly the accent was there since the founder,...

A

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC

Yeah. Yeah.

Q

Fabrizio Freda

President, Chief Executive Officer & Director, The Estée Lauder Companies, Inc.

A

...Mrs. Estée Lauder. And her intention to put this accent was because she wanted to give the sense of luxury and prestige that at that time was very French. But now as a result of that, is also creating in the consumer the sense of French, American, frankly they don't know, but there is a lot of – many consumers, particularly in the emerging markets, they believe is a French brand. Clinique is a French word, et cetera, et cetera. So frankly, we do not feel that our consumer see our brands as only American or only French, they don't even ask themselves the question globally. That is the portfolio brands is very big, and there are different brands which are in different positions. And most importantly, we are very local in the way we act in every market of the world. And I just want to clarify, in China today, we have 6,000 employees, 99.9% Chinese. Our General Manager in China is Chinese. We are a local brand. And in India, the same thing. We have many Indian employees and the General Manager is Indian. And our Brazilian General Manager is Brazilian, and our people are mainly Brazilians. So since the beginning, our philosophy is we are local everywhere we go.

So, in the sense we are a truly global company. Obviously, we are an American company, we are proud to be, but we are an American company which has chosen to operate globally and to be locally relevant wherever we are. And I believe in today's world, these very deep local relevance that we have with our employees and our brand portfolio is global in essence, is paying dividends, and make us a bit more insulated by short-term variation in crisis than what would be in a different situation.

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC

Q

Okay. So, we spent a lot of time on China. I think that's a lot of our people we want to talk about. Let's step away a little bit, and let's talk about travel retail. So, a little bit of a second derivative of China in some sense. Our estimate is you have been growing 25% to 30% in that channel for a few years, much, much higher than what you're seeing from a traveler traffic perspective which is 6%, 7%, 8%. Can you talk about the sustainability of that 25% to 30%? And then, if you have numbers around this conversion rates and potential target conversion rates to give us confidence in that travel retail growth?

Fabrizio Freda

President, Chief Executive Officer & Director, The Estée Lauder Companies, Inc.

A

Yeah. No. I'm not going to confirm 30%...

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC

Q

Okay.

Fabrizio Freda

President, Chief Executive Officer & Director, The Estée Lauder Companies, Inc.

A

...rate forever because obviously also travel retail today is on a very strong trend in general for us. And there could be up and downs in travel retail frankly even more than in a single country, because imagine there could be a flu, epidemic or things like that.

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC

Q

There have been.

Fabrizio Freda

President, Chief Executive Officer & Director, The Estée Lauder Companies, Inc.

A

So, I just want to stay as it happened in the past. So I want – I say we stay very realistic and objective of this. In term of potential risk of volatility one day, but to be clear, no visibility today on any volatility, today is a very strong trend of travel retail globally, and the long term on travel retail is to me the most exciting channel that is there. I define travel retail has become the biggest and most exciting market of luxury in the world, and for sure for us and for our company for prestige beauty it's super exciting.

Why that has happened? First of all because the number of travelers increases every year by 6%, 7%, which is extraordinary, and the fact that there is more security rules around the world makes people spend much more time in airports. And so, they have more time to shop. And finally, the fact that the increase of travelers is mainly in population like the Chinese, the Russians, the Brazilians, the Middle Easterners. So, that whole population that do shopping as a big entertainment event. And so, the time people spend in airports, which tend to be boring, they get entertainment by shopping, and beauty is the number one category which is growing.

The other phenomenon, and if you look at travelers as a mix, and you look how much women travelers are growing versus men travelers, women travelers are accelerating much more than men travelers which obviously as a group are more interested in beauty. So, there is a lot of combination of elements that show that the traffic increase in travel retail is guaranteed for many years to come. The second point is that how does travel retail work? Traffic, I already spoke to. The second important point is conversion. So, out of the travelers, how many people shop? Now, the answer is about 12%, 15% depending by region is today reality, it was 10% few years ago. So, it has been improving a bit. And today 15% of people entering our airports shop anything in travel retail.

We are focused enormously on that number because beyond – the reason why we are growing much more than the traffic as you stated is because we've converted more than average and more than in the past because every person convert and buys more. So, those are the three elements. How it's happening? First of all, why every person convert and buys more because they are mainly Russian, Chinese, Brazilians, they buy more than American, Italian and British. So, all the developed market consumers buy less per person on average than these new travelers. So, the change of travelers mix – and sorry, I already mentioned women versus men also. So, the change of the travelers mix increase the purchase per traveler.

The secondary phenomenon is conversion. Today, we have done some work in Korea mainly for the moment, which is called pretailing, meaning when you have a ticket to travel, you can go on this site and buy at the airport, putting your ticket in, and then what you buy will be on the chair of your airplane when you arrive in your seat. So, you don't need to have been non-convenient experience to go through the store. That idea where we are testing it is almost doubling conversion, because many people go to the airport, they would like to shop, but no time, I'm late, I'm under pressure, too traffic, I don't like the store, whatever. This is increasing the conversion. Marketing in airports like advertising is increasing the conversion. Activity on innovation is increasing the conversion.

Importantly, investments in the country of origin of the travelers is increasing the conversion. So, if we invest more advertising in China, in these secondary cities where we have no distribution, these people see what they desire in social media, they cannot buy it locally, but the first trip of a friend they even ask, please buy it for me. So, there is travelers that bring it back. So, all these phenomena give me very big confidence that over time we will see the commercial number to grow.

You were asking how much? We said in the Investor Day that we had a goal to get from 15% to 30% conversion and we are still at this goal and we're working on it over time. Obviously to be clear, this is not a few months'

work. This will take years, but this will probably generate an ongoing travel retail growth above traffic for many years to come.

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC

Q

Okay. Let's switch gears to a more problematic area so far, and you've seen some challenges there which is as you'd imagine the U.S.

Fabrizio Freda

President, Chief Executive Officer & Director, The Estée Lauder Companies, Inc.

A

Yeah.

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC

Q

Americas like-for-like was down 6%. Most recently, you stated that you're making investments, you want to start growing now by fiscal year 2020. Can you talk about some investments that you've made so far? What success they've had? There're a couple of success areas I think, and how do you have confidence that you'll actually start growing again in that marketplace?

Fabrizio Freda

President, Chief Executive Officer & Director, The Estée Lauder Companies, Inc.

A

So, the U.S. is in this moment also is a market and before speaking Estée Lauder I want to say the U.S. market is softer than it has been for many years to come in this moment. So...

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC

Q

Makeup especially, is that fair?

Fabrizio Freda

President, Chief Executive Officer & Director, The Estée Lauder Companies, Inc.

A

Makeup especially. Skin care actually has a good moment, but makeup which is very big in this market is really soft. And fragrances are just okay. Interestingly, the two growing category in this moment are skin care and hair care or prestige hair care. But in general, the market is softer than it has been in a long time.

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC

Q

How much growth would you say? Is it shrinking and...

Fabrizio Freda

President, Chief Executive Officer & Director, The Estée Lauder Companies, Inc.

A

The market in total I believe is growing 1%, 2%, but with makeup shrinking 3%, 4%,...

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC

Q

Okay.

Fabrizio Freda

President, Chief Executive Officer & Director, The Estée Lauder Companies, Inc.

...which is enormous for a market of that size.

A

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC

Okay.

Q

Fabrizio Freda

President, Chief Executive Officer & Director, The Estée Lauder Companies, Inc.

Okay. So, we have been – yes, minus 6% last quarter was obviously not exciting, but we were not expecting a market at this level of softness. So, part of it is the market. We are still doing improvements, but in a market which is softer than what we originally expected. The other thing I want to say, the reason why the market is softer particularly in makeup, is also because the trade dynamic and the traffic is changing more than in many other market around the world that is speed or light. And then, there are many macroeconomic issues that you can have your point of view of what is influencing certain behavior of consumer, but there've been many things that influenced in the last month the consumers, particularly the traffic in brick and mortar has gone down in a significant way.

A

So, it has a bit more difficult to turn around with speed a market where consumer traffic is weak, because to turn around a consumer, you need to see the consumer, and speak to them and give them an opportunity to make different choices.

So, it's taking a bit more time than what we originally hoped. But to answer your question directly, we have a goal, and I believe we will go back to grow in the U.S., and as I said in my prepared remark, we see growth again in fiscal year 2020, so in the fiscal year we have in front of us.

Now, why we see that is first of all we have done an enormous amount of work to analyze the market by consumer segments, and there are very different consumer segment, we call them catchments as had been explained to you in our Investor Day, where we can now, thanks to data analytic, go much more in depth even by city and speaking to different consumer group about different preferences. So, we can offset the lower traffic by much better focus on the consumer groups, which are growing.

The second thing is because we are investing more in social media in better social media. So, we are increasing the amount of investment. So, if consumer come less to the stores, we can speak to them more in social media and advertising, and still have a better engagement with them to influence their choices.

Third, we are dramatically increasing the level of innovation, and in certain brands this is really hitting the market in the right way. Then, we are changing the mix or channels to faster growing channels. We have growth the mix in specialty that now are 15% of our business in the United States. The mix of online is growing, and those channels are growing very well. To be clear, for the market and for us online is growing very well, specialty is growing very well. Department store are still declining and are still losing traffic. And so, they are now a smaller percentage of our business, but still today they are 45% of our business. So...

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC

In America.

Q

Fabrizio Freda

President, Chief Executive Officer & Director, The Estée Lauder Companies, Inc.

A

In America, in America. No, no, globally, the percentage is much, much lower. But in America, it's 45% of our business. And that's frankly the reason why it's difficult to turn. There is a lot of growing part of our business, but they are not in this moment sufficiently big to turn the percentage that is going down, but it's going to happen. We are close to the moment where the swing is going to be there.

Last thing I want to say is that our brands are very solid in the United States. There are [indiscernible] (00:39:50) which are growing very strongly even in a tough environment, at least for example, Lauder, La Mer. So, we see certain of our brands which already show the way, and others they need to follow to make sure that our portfolio go to growth again. So, it's a bit lower than expected, but it's happening.

I also want to clarify one thing however that we have the patience to do this right for the long term. Because at the end, we have been growing 13% last year, and 10% to 11% this year with the United States declining. So, the power of the company give us the ability, the resources, the patience to do the change to turn around in the United States avoiding to rush into short-term promotions, solutions that we will regret later. We are doing this for the long term, and the price of doing it in the right way and for the long term is that we are a little bit lower than ideal. But I think once we'll have done it, it'll be the right thing for the long term.

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC

Q

Okay. So, let's talk about that a little bit in at least two instances. One is Clinique, which has had challenges trying to innovate its way out, Clinique ideas and innovation that we've heard a lot about.

Fabrizio Freda

President, Chief Executive Officer & Director, The Estée Lauder Companies, Inc.

A

Yeah.

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC

Q

Can you talk about the price points you ended up with, which continues to kind of make you think a little bit about the short-term versus long-term dynamic? \$39 is the price point, that struck as me as not prestige when I initially saw it, and we did further analysis, it's tough to call it prestige in our minds, so how do we get comfortable with that not diluting the brand? Great idea, I would argue lower price point, and why that's not a short-term versus a long-term solution?

Fabrizio Freda

President, Chief Executive Officer & Director, The Estée Lauder Companies, Inc.

A

Tracey will be very happy to the price up. But, it's...

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC

Q

If it sells, we'll all be happy, right?

Fabrizio Freda

President, Chief Executive Officer & Director, The Estée Lauder Companies, Inc.

A

By the way we may. But, no, frankly, I personally don't agree in the sense that we have a clear understanding of the price extension of prestige, and there is an entry price point to prestige which by the way today is challenged close by, what we call [ph] masstige (00:42:01) and it is very important that certain of our brands are acting in this area. And Clinique has always been in that price segment or entry price for prestige, \$39 for a novelty moisturizer is a big deal because it has the ability to source consumer from mass. So strategically, I don't see it like, is it in luxury or not? Is it? It is at the entry price of prestige. And the reason why it is that the entry price because the role of Clinique and the role of [ph] Clinique D (00:42:35) is to source consumers from mass into prestige, and Clinique be the door for that sourcing.

Mass is being growing 1% in the last 10 years on average, prestige 6%. So, we are converting mass consumers into prestige, by the way, everywhere in the world but also in the United States. Our technique for conversion is occupy this entry price of point of prestige and making sure that they can experience the brand in the right way. If we had to position all our brands in the middle of the pricing of luxury, frankly we will lose the strength. So that's the reason why it's \$39, definitely it is not to be promotional or to be too much inviting. It's just to source people from us. And in fact this, if the product is successful over time, we could...

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC

Take prices to a level.

Q

Fabrizio Freda

President, Chief Executive Officer & Director, The Estée Lauder Companies, Inc.

...take prices over time as we do in many other cases.

A

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC

So then the other question I had about the U.S. in terms of short term versus long term is...

Q

Fabrizio Freda

President, Chief Executive Officer & Director, The Estée Lauder Companies, Inc.

Sorry, you asked a question on Clinique also. I want to say that Clinique which is very much – 40% of Clinique global business is the U.S. which is one of our brands, the most represented. Today 25% of our global business is in the U.S., 25%. For Clinique, it's 40%. So, Clinique is the brand in our portfolio, most represented in the United States. I want to say that Clinique skin care, which is the biggest part of Clinique, in the last nine months, meaning the first nine months of the fiscal year in March 31, had been consistently growing skin care, thanks particularly to [ph] Clinique D (00:44:17), but not only and this is extraordinary because yeah, we still need to get makeup going and we will, but this is really a good sign for Clinique in general.

A

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC

Okay. The other piece just on the U.S. that I want to push on a little bit and we've this discussion before around short term versus long term, are things like channel expansion for example M·A·C into Ulta [ph] a few years ago or so (00:44:40). How do you think about the brand value and the brand not being tarnished in some sense being one aisle away from something that's a third of a price? How do you expect the price premium that you maintain to stay when you're in a channel which is much more varied from a pricing perspective?

Q

Fabrizio Freda

President, Chief Executive Officer & Director, The Estée Lauder Companies, Inc.

A

Actually it works very well. So, the first point is it works and not only in Ulta, it works in many other retail over the world where if there is a clear separation also service and clear separation of communication and looks, et cetera, the brands get expressed in the correct way the consumer does get the difference between a mass experience and a luxury experience. Remember the main...

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC

Q

Okay.

Fabrizio Freda

President, Chief Executive Officer & Director, The Estée Lauder Companies, Inc.

A

...difference between mass and prestige is not only the location, it is the quality of the product that create repeat purchase. So, as I said in my prepared remarks, the biggest strengths of our business is repeat purchases, and repeat purchases and not obtain neither by marketing, neither by position in any store. You can get trial with the right position in a store with the right marketing idea, but I have not again yet met any woman that after having tried a product and she didn't like it, because it didn't perform, she buys it again. This consumer doesn't exist. So, the repeat purchase happens only when the product perform and satisfy the consumer because of its quality, and that's the core of prestige. And that's in Ulta close to a mass or not doesn't change. So, in a situation like Ulta, the trial challenge is tougher, and we work on it with activation support, we have people doing service, particularly for certain brands. We have innovation, which is uniquely tailored to that group of consumers. We have many marketing activity to address the challenge you have described, which is real on top of quality execution of our brands. But the big part of our business, which is repeat really is not touched by that phenomenon...

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC

Q

Okay.

Fabrizio Freda

President, Chief Executive Officer & Director, The Estée Lauder Companies, Inc.

A

...and that's what we see. The other thing I want to say on this trial repeat is very important. When we have brands that we have mentioned that with our best brands get to 50%, 60% repeat, by the way in consumer goods where I've been all my life those numbers are amazing. Imagine the strengths of the rate of return of our advertising investments once we get a consumer, 50% of them buy for many years to come. Wow, it's a powerful machine. So, that's really where we are focused on. And it's only about R&D, consumer understanding, product quality, which is independent by the distribution.

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC

Q

Okay. So, we've intentionally spent a lot of time on top line because that's the win that helps your sales go. Switching a little bit, I'll try to get the three to four more questions on margins. You mentioned 50 basis points of margin expansion going forward as your long-term goal, how do you think about cost savings versus reinvestment? So, your R&D at 1.7% at the peak is now back to 1.3%, much lower than your peers, your advertising spend right now is obviously very efficient, but less than many of your peers as a percentage of sales.

How are you comfortable with saying you're going to continue to expand margins here even though you clearly have to invest more back in the business?

Fabrizio Freda

President, Chief Executive Officer & Director, The Estée Lauder Companies, Inc.

A

We are very comfortable for a couple of reasons. The one that I explained in my prepared remark is leverage. So, I think we have...

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC

Q

Yeah.

Fabrizio Freda

President, Chief Executive Officer & Director, The Estée Lauder Companies, Inc.

A

...we have demonstrated in 10 years that our growth creates great leverage because the new volume comes without bringing extra costs into the system. So first of all, we continue – assuming the 6% to 8%, then the double digit over the last two years is even stronger obviously and offer us even more opportunity to reinvest or have more profits or both. But even in the 6% to 8%, there is a lot of leverage power in this 6% to 8% to generate the 50% margin points with it. If you add to that cost savings, which frankly we had a cost saving program, which is focused on our areas where we are not efficient. And frankly, there are still areas where we are not...

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC

Q

There's still room.

Fabrizio Freda

President, Chief Executive Officer & Director, The Estée Lauder Companies, Inc.

A

...efficient. There are still area where we are not efficient and trade is not in, and yes, we are working very much on it. And so, there is still fact to be trained and we are working on it year after year, we'll do it. Obviously, I don't know, want to take all the areas connected to demand management, distractions, inventories, it is a big area where we had a lot of opportunities. But, I hope you understand that we go very gradually in these areas, because with 80% gross margin you don't want to miss this, okay. And so, because of an inventory project to optimize to the last penny risking to be efficient. So, it is a fine balance that we are looking for, and we are – but there is fact to be trained. So, there are more cost savings to come.

The third is the Leading Beauty Forward savings, which is not savings of fact, in this case is transformation activities, where we are making things more efficient and improving the return of our investment in many areas starting with advertising. You mentioned advertising. Advertising is not going up in percentages, but is going up in absolute because of the double-digit growth. So again, percentages could be misleading. We have almost doubled, 88% more advertising power in the last two years, 88%. I mean in my consumer goods experience, if somebody would have given me almost double advertising, I would have conquered the world when I was a young marketers, and today we have many – few organization who have double money to spend to achieve their objective. This is super powerful in absolute. Now, the great of the fast growth or being a growth company that you achieve this double amount of spending advertising almost with taking your percentage of spending down, which is extraordinary. And so, we are proud to do that, and that's what's happening.

So, there is Leading Beauty Forward saving, which comes from the transformation, that also will continue to help us. And the combination of these factors, if you add another factor, which is softer, but is very important to me, is that Leading Beauty Forward allow us not only to save money, but to change resource allocation from areas that were less efficient in the past to areas which are more efficient in the future. So, this generates better return on investment in the areas which now are getting better resourced.

The other important thing, the Leading Beauty Forward has taken down fixed costs and we have reinvested in variable costs. This dynamic has increased our agility. Today, I can make decisions or we can with Tracey make decisions to invest more in China and less in Brazil or vice-versa in a week. When the costs were fixed mainly, this decision would have taken at least a year to make all the changes. And when I say fixed, imagine, when many of costs were in selling people in the store. How fast can you change that versus advertising in social media that you can make a decision in two months? So, I just want to be very practical.

Today, we are much faster in resource allocation, thanks to Leading Beauty Forward. I believe that is also a reason for adding credibility to the long-term profit development, because better resource allocation generate better returns for each one of these resources that we are allocating.

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC

Q

Okay. Let me try and get a couple of more questions here. You are the longest tenured and ideally the most successful CEO in my coverage. I don't ever want to see you going, but I'm losing friends at the CEO level, so you're my only friend as CEO at this point...

Fabrizio Freda

President, Chief Executive Officer & Director, The Estée Lauder Companies, Inc.

A

Thank you, Ali. I was scared when you started.

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC

Q

How should investors think about your plans, how the company thinks about succession plans?

Fabrizio Freda

President, Chief Executive Officer & Director, The Estée Lauder Companies, Inc.

A

So, interesting question. So first of all, I'm...

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC

Q

Will you commit to coming back next year here [ph] at Bernstein (00:53:40).

Fabrizio Freda

President, Chief Executive Officer & Director, The Estée Lauder Companies, Inc.

A

I'm committing to coming back next year, and really, I believe I'm very incentivized to stay for as long as needed and possible to lead this company. I'm very passionate about this. So frankly, there is nothing at the horizon that [ph] disincentivate (00:53:59) me to continue having this amazing run that we're doing. There is still a lot of work to do. I hope that you'll see from the way and speak about our business how much I'm passionate not only about this business, but the strategic opportunities of this business, how much work is still in front of us in opportunity.

So for the time being, I'm here to stay first of all and – but the most important thing I'm not sure is that. But the most important thing is what we try to display in the Investor Day, and what we try to display in our Investor Day is that on top of creating a very promising business model, on top of delivering amazing results, and on top of positioning the company, I believe for having another 10 years or more of amazing results, we have developed an outstanding team and we showed you our team in investor meeting showing our leader of travel retail, our leader of China, our leader of Brazil showing that we have amazing talent, and so definitely Estée Lauder company is not at all a one-man show or a one-woman show. It is an entire team and this team is a high-performing team. The U.S. investor I believe you can trust for the long term.

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC

Q

Okay. And we have 10 seconds I apologize for this, for asking the CEOs at our conference desk, what are you investing in today that'll have the biggest payoff over the next five years you think? Just a short...

Fabrizio Freda

President, Chief Executive Officer & Director, The Estée Lauder Companies, Inc.

A

I'm investing today in to complete what I call the diversification, the creation of multiple engine growth. So, to continue obviously being very strong in China, but also to develop the rest of the emerging markets at the same level of China, and that's possible to turn around the U.S. as we discussed before and to continue winning in the fastest and I believe the next 10 years biggest growth in China, so the world which are online in every segment and travel retail and specialty-multi, and continue to invest into this, and leverage our brand. And finally, we are continuing to invest to make our big brands grow because the beautiful thing which is happening that the big brands are winning, and we have a portfolio of amazing big brands in this.

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC

Okay. Fabrizio, thank you very much for your time. We'll see you here next year.

Fabrizio Freda

President, Chief Executive Officer & Director, The Estée Lauder Companies, Inc.

Thank you very much. See you next year.

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC

Thank you.

Disclaimer

The information herein is based on sources we believe to be reliable but is not guaranteed by us and does not purport to be a complete or error-free statement or summary of the available data. As such, we do not warrant, endorse or guarantee the completeness, accuracy, integrity, or timeliness of the information. You must evaluate, and bear all risks associated with, the use of any information provided hereunder, including any reliance on the accuracy, completeness, safety or usefulness of such information. This information is not intended to be used as the primary basis of investment decisions. It should not be construed as advice designed to meet the particular investment needs of any investor. This report is published solely for information purposes, and is not to be construed as financial or other advice or as an offer to sell or the solicitation of an offer to buy any security in any state where such an offer or solicitation would be illegal. Any information expressed herein on this date is subject to change without notice. Any opinions or assertions contained in this information do not represent the opinions or beliefs of FactSet CallStreet, LLC. FactSet CallStreet, LLC, or one or more of its employees, including the writer of this report, may have a position in any of the securities discussed herein.

THE INFORMATION PROVIDED TO YOU HEREUNDER IS PROVIDED "AS IS," AND TO THE MAXIMUM EXTENT PERMITTED BY APPLICABLE LAW, FactSet CallStreet, LLC AND ITS LICENSORS, BUSINESS ASSOCIATES AND SUPPLIERS DISCLAIM ALL WARRANTIES WITH RESPECT TO THE SAME, EXPRESS, IMPLIED AND STATUTORY, INCLUDING WITHOUT LIMITATION ANY IMPLIED WARRANTIES OF MERCHANTABILITY, FITNESS FOR A PARTICULAR PURPOSE, ACCURACY, COMPLETENESS, AND NON-INFRINGEMENT. TO THE MAXIMUM EXTENT PERMITTED BY APPLICABLE LAW, NEITHER FACTSET CALLSTREET, LLC NOR ITS OFFICERS, MEMBERS, DIRECTORS, PARTNERS, AFFILIATES, BUSINESS ASSOCIATES, LICENSORS OR SUPPLIERS WILL BE LIABLE FOR ANY INDIRECT, INCIDENTAL, SPECIAL, CONSEQUENTIAL OR PUNITIVE DAMAGES, INCLUDING WITHOUT LIMITATION DAMAGES FOR LOST PROFITS OR REVENUES, GOODWILL, WORK STOPPAGE, SECURITY BREACHES, VIRUSES, COMPUTER FAILURE OR MALFUNCTION, USE, DATA OR OTHER INTANGIBLE LOSSES OR COMMERCIAL DAMAGES, EVEN IF ANY OF SUCH PARTIES IS ADVISED OF THE POSSIBILITY OF SUCH LOSSES, ARISING UNDER OR IN CONNECTION WITH THE INFORMATION PROVIDED HEREIN OR ANY OTHER SUBJECT MATTER HEREOF.

The contents and appearance of this report are Copyrighted FactSet CallStreet, LLC 2019 CallStreet and FactSet CallStreet, LLC are trademarks and service marks of FactSet CallStreet, LLC. All other trademarks mentioned are trademarks of their respective companies. All rights reserved.