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The Estée Lauder Companies, Inc. (EL)

Q1 2019 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good day, everyone, and welcome to The Estée Lauder Companies Fiscal 2019 First Quarter Conference Call. Today's call is being recorded and webcast.

For opening remarks and introductions, I would like to turn the call over to the Senior Vice President of Investor Relations, Ms. Rainey Mancini.

Laraine A. Mancini

Senior Vice President-Investor Relations, The Estée Lauder Companies, Inc.

Good morning. On today's call are Fabrizio Freda, President and Chief Executive Officer; and Tracey Travis, Executive Vice President and Chief Financial Officer.

Since many of our remarks today contain forward-looking statements, let me refer you to our press release and our reports filed with the SEC where you'll find factors that could cause actual results to differ materially from these forward-looking statements. To facilitate the discussion of our underlying business, the commentary on our financial results and expectations is before restructuring and other charges, changes to the provisional amounts related to the recently enacted U.S. tax law, the new accounting standard for revenue recognition and other adjustments disclosed in our press release.

You can find reconciliations between GAAP and non-GAAP figures in our press release and on the Investors section of our website. During the Q&A session, we ask that you please limit yourself to one question so we can respond to all of you within the time scheduled for this call.

And now I'll turn the call over to Fabrizio.

Fabrizio Freda

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

Thank you, Rainey, and good morning, everyone. Our fiscal year is off to an excellent start as our multiple engines of growth once again drove double-digit sales and earnings per share gains, reflecting strength across our categories, brands, markets and channels. Strong double-digit advances in many areas of our business enhanced by targeted investments drove comparable sales growth of 11%, our sixth consecutive quarter with a double-digit increase. We leveraged our strong top line growth and benefited from ongoing disciplined cost management, fueled by our Leading Beauty Forward initiative, which led to diluted earnings per share climbing more than twice that rate, up 24%.

With these strong results and confidence in our ability to execute effectively, we are raising our EPS guidance for the year. We now expect EPS growth of 10% to 12% in constant currency on sales growth of 7% to 8%, which is at the top of our long-term sales goal.

The macro environment was particularly challenging this quarter, with initial impact of tariffs in Europe and China, a softer UK beauty market stemming from concerns about Brexit, and the closure of some department store doors including Bon-Ton in the U.S. and House of Fraser in the UK.

Despite these factors and overall volatility, we not only delivered our sales and financial targets, we exceeded them. Our success was widespread throughout our business and driven by the strength of our diverse brand portfolio, innovation and growth engines in every region and channel. Many brands grew double digits including three of our four biggest brands, Estée Lauder, M•A•C and La Mer, reconfirming the power and desirability of strong, established brands.

Many markets delivered robust growth. In the Asia region, China, Hong Kong, Japan and every country in Southeast Asia advanced by double digits. In China, our sales accelerated. Consumer demand for our products was also vibrant in our other emerging markets excluding China. Importantly, our retail sales growth in the United States turned positive and global e-commerce and travel retail posted significant increases.

A sharper focus on strategic innovation drove our brand growth, particularly in the most popular hero franchises. Deeper analytical insights are giving us a greater understanding of consumer needs by market and amplifying our innovation power. We developed high-quality products for targeted consumer groups and a diversity of skin types that attracted new consumers and achieved strong repurchase rates.

We supported our innovations with increased digital advertising and influencer attention that enhanced storytelling, led to higher awareness, traffic and sales. Our strong innovation program is a sustainable growth engine that is broad-based, flowing across all our brands and geographies.

In skin care, our Estée Lauder brand's hero franchises drove impressive growth. The brand's Advanced Night Repair franchise increased nearly 50% globally, fueled by new supercharged hero product. In Asia/Pacific, sales of the new eye gel soared. La Mer was a star in our portfolio. Its sales climbed double digits in every region on strong demand for luxury skin care and new launches including its Treatment Lotion Hydrating Mask which boosted its global mask business. The brand is number one in luxury skin care in North America and in the UK, it gained share in both markets also reflecting loyalty from devoted consumers.

Clinique's skin care business grew globally supported by new innovation and established favorites. To accelerate one of its key product lines, Clinique launched a unique hydrating jelly in its Dramatically Different moisturizer franchise. Initial sales are exceeding our projections. Clinique also modernized its historical ingredient philosophy, making it more relevant for today's consumers. We are also excited about a new Clinique skin care innovation that we'll launch in December and can be personalized for each consumer's needs.

Another brand with strong global skin care sales was Origins, thanks to its moisturizer and hero products. Origins is riding the growing wave of interest in natural beauty products and with its strong positioning is leveraging demand with new innovations.

Innovation and creativity in makeup contributed to M•A•C's success in the quarter. Its global growth was led by its international business and reflected its focus on bigger innovation with more impact. Its new Powder Kiss lipstick brought renewed attention to the brand-coveted lipstick collections. It was developed by M•A•C artists backstage and launched during Fashion Week in New York and Milan.

Estée Lauder brand also achieved excellent growth in makeup. Sales of its Double Wear foundation, its biggest makeup franchise, increased more than 20%, aided by shade extensions and a new product in the line, as it continues to serve and appeal to all skin types worldwide with a broad range of shapes and formats.

Too Faced retail sales in North America rose sharply, driven by new shades of Born This Way Foundation and Super Coverage concealer. Too Faced gained share in the U.S., and its Better Than Sex mascara continued to

be the best selling prestige mascara in the market. In fragrance, launches from several of our luxury and artisanal brands resonated with consumers, including Tom Ford Beauty's Ombre Leather and a range of scents from By Kilian called MY KIND OF LOVE that was created for specialty multi in North America and Western Europe. Estée Lauder introduced Beautiful Belle in advance of the holiday season.

Combined sales from brands we have acquired over the past few years rose significantly. We are expanding their target consumer reach by entering new markets, farther penetrating equity-building channels, while at the same time developing new products and integrating them into our operations.

Our pioneer digital strategy continues to support our brands in many ways. In terms of e-commerce, all three platforms, brand.com, retail.com, and third-party sites advanced sharply. Our 200 brand sites generated double-digit sales growth and also have become powerful equity-building vehicles. Our brand sites alone attracted nearly 90 million global visits in the quarter, making them also highly valuable media assets. For perspective, we estimate that those consumer visits were worth \$250 million in advertising equivalent, demonstrating effective and efficient new ways that our brands have to engage with consumers worldwide.

We continue to expand our brands on third-party platforms. We successfully launched Jo Malone on Tmall in China and five more brands on ASOS in the UK, a destination that attracts millennials.

Another rapidly growing areas was our global travel retail business, which continued its fast pace, driven by broad-based growth across brands and countries. Eight of our top-ten brands grew double digits at retail in the channel. And many key travel retail markets farther accelerated growth, including the UK, Italy, Germany and Turkey. This success contributed to our strong double-digit retail and net sales growth, far, far outpacing the 6% rise in international passenger traffic.

Travel has increased among many consumer groups, including Russians, Middle Easterners, Chinese and Nigerians, helping to increase demand in the channel. Our travel retail channel also benefited from successful launches, effective marketing, and exclusive products. We expanded distribution for our artisanal fragrance brands, which is helping to increase our share in the European region in travel retail.

We are making good progress on increasing passenger conversion with new programs. We believe that our travel retail business will continue to benefit in the long term from favorable fundamentals, including growing passenger traffic, increased conversion of passenger to shopper and a broader equity-building distribution of our new brands. Emerging markets, excluding China, were also strong growth drivers, advancing double digits, with the biggest gains in the Middle East, Russia, India, Turkey and Southeast Asia.

Finally, we are pleased that our North America results were also encouraging. Our overall retail sales in the U.S. turned positive. If we exclude Bon-Ton, this was the fastest growth rate in more than two years. Our push into fast-growing channels has continued to have a bigger impact, specialty multi and online, especially retail.com grew rapidly. In addition, we improved our business with our department store customers.

We expect a solid holiday season as we roll out exciting programs. Estée Lauder's blockbuster promotion hits counters and online sites in the U.S. tomorrow. And our brands have created compelling sets in innovation that we believe will drive traffic. The risk of moderation of prestige beauty growth in China, particularly in the second half of our fiscal year, is included in our full year guidance to reflect the possible volatility stemming from the current geopolitical and economical environment.

However, I want to be clear that we have not seen any slowdown, and luxury cosmetic historically had been less sensitive to the variability of economic trends because they are an affordable luxury. In fact, our net sales in China this quarter further accelerated, and our strong double-digit growth came from many drivers. Our brands like those sales were robust. We gained share in our department store distribution, and sales in specialty-multi freestanding stores and online grew even faster.

Our e-commerce business reached consumers in the many cities where we have no brick and mortar distribution, leveraging our efficient model. In addition, we achieved double-digit growth across every brand in every product category. Our efforts to diversify our business have been successful as our makeup and fragrance growth surpassed skin care growth. Importantly, our repurchase rates are strong, illustrating the equity of our brands and consumer applications for our products.

We have a long-term focus in China. We have invested there for two decades. It's an important part of our long-term emerging market strategy, and we plan to continue growing market share and serve our Chinese consumer with the highest quality products. We continue to be encouraged by attractive long-term demographics and economic trends in China as millions of new consumers enter the market. The rising middle class aspires to luxury, and today millennials and Gen Z consumers will have much more disposable income than past generations, particularly as more women enter the workforce. We believe demand for beauty in China and other emerging markets will continue to rise over the long term.

In summary, we achieved terrific progress this quarter. Most brands grew, and three of our largest climbed at double digits, including M•A•C which has gained more traction. Retail sales in the U.S. turned positive, generating encouraging business improvement. Many countries had higher sales. In emerging markets, we're strong overall. Our business in the Middle East, which had been depressed, started improving. Sales in China accelerated. Global online and travel retail continue to increase sharply. Our innovations created stronger hero franchises and attracted new consumers.

With these strong results to start the year, we are confident about our near- and long-term prospects. Our diverse brand portfolio, strong innovation pipeline and vast global reach supported by local insights and analytics should continue to fuel our success. We have the flexibility to invest where we see the best growth opportunities and are confident in the ability of our leadership team and talented employees to execute our strategy with excellence. We are well positioned to outperform global prestige beauty, deliver strong sales gains and generate double-digit growth in EPS this year and over the long term.

Now, I will turn the call over to Tracey.

Tracey Thomas Travis

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

Thank you, Fabrizio, and good morning, everyone. First, I will review our fiscal 2019 first quarter financial results and then cover our expectations for the second quarter and for the full year. My commentary today excludes the impact of restructuring and other charges and adjustments, including those related to our Leading Beauty Forward initiative and the recent U.S. tax legislation.

All net sales growth numbers are in constant currency and comparable accounting methods unless otherwise stated. As a reminder, we adopted the new accounting standard for revenue recognition, ASC 606, this fiscal year on a modified retrospective basis. For the first quarter, the impact decreased our sales growth by two percentage points, our operating profit growth by five points and our EPS by \$0.06.

Net sales for the first quarter were up 11% with virtually all regions and product categories contributing to growth. From a geographic standpoint, our Asia/Pacific region led net sales growth this quarter. Sales rose 29% and most markets saw double digit increases. Sales in China and Hong Kong rose very strong double digits with broad-based growth across brands, categories and channels.

Prestige beauty growth in department stores in China continued to grow more than 20% and we gained share, while sales in specialty multi and online more than doubled. Our strong growth extended beyond China and Hong Kong. We also achieved excellent sales growth in Japan, where we experienced growth across all channels, including department stores, specialty multi and online. Taiwan and Malaysia were also up double digits and we had single-digit growth in Australia.

Net sales in our Europe, the Middle East and Africa region rose 16%, driven by strong double-digit increases in our global travel retail business and emerging markets in the region. All three geographic regions within travel retail grew, led by corridors across Asia. Strong like-door growth drove the majority of the increase and was supplemented by additional points of sale, particularly for our less distributed brands. Our emerging markets growth in the region was led by the Middle East, Turkey, Russia and India. The Middle East had significant net sales growth following the reset that we did last year, but the underlying retail trend continues to be challenging reflective of the area's economic situation.

In Western Europe, Italy remained a bright spot, while lower consumer sentiment in the UK pressured brick and mortar retailers. This was seen most acutely in House of Fraser, one of our largest department store customers in the UK, as they reorganize under new ownership. Debenhams is also experiencing some challenges as they announced last week, and we are prudently supporting them as the holiday season begins. Our online business in the UK continued to grow double digits. In other Western European markets, our business was relatively flat, in line with prestige beauty in the area.

Net sales in the Americas declined 2%. North America continued to achieve double-digit growth in specialty multi-retail and in online, all of online, which offsets declines in mid-tier department stores and freestanding stores. Excluding prior year sales to Bon-Ton, our sales in North America increased slightly, better reflecting the retail improvement Fabrizio mentioned. Latin American sales declined as the tough environment in Brazil and Mexico overshadowed strong growth in the Andean countries.

Skin care continued to lead product category growth this quarter. Net sales grew 21%, with strong contributions from the innovations previously mentioned within hero franchises in the Estée Lauder, Clinique and La Mer brands. Net sales in makeup grew 6%, led by strong innovations and launches in foundation and lip from Estée Lauder and M•A•C. Sales of fragrances rose 2% as gains in luxury and artisanal brands were partially offset by declines in designer fragrances and Estée Lauder.

Le Labo launched its [ph] City Exclusive fragrance set out line (20:57), continued its strong comp door growth and expanded its targeted consumer reach. Our hair care sales rose 7%, primarily driven by Aveda's strong innovation and its acceleration of online sales.

Our gross margin declined 160 basis points compared to the first quarter of last year, due primarily to the impact of new accounting standards, which negatively impacted our gross margin by 220 basis points through the reclassification of samples, testers, and collateral to cost of goods from operating expenses. This decline was partially offset by favorable skin care category mix and pricing of 100 basis points. Operating expenses as a percent of sales improved 250 basis points, largely due to the 180-basis-point impact of the new accounting standard for revenue recognition.

For the remainder of expenses, we continue to reallocate expenses smartly to drive the business with flexibility, fueled by savings from our Leading Beauty Forward initiative. Lower selling, general, and administrative expenses improved our expense margin by 210 basis points, allowing us to invest more in advertising behind strong innovation to fuel growth. We continue to optimize our marketing mix to maximize returns on investment across all areas. We have found that our increase in digital advertising broadly has been highly effective with a return on investment that is meaningfully higher than traditional media.

Operating income rose 13% and operating margin increased by 90 basis points. Excluding the impact of the new accounting standard, operating income rose 18% and operating margin increased 140 basis points. Our effective tax rate this quarter was 20.9%, primarily reflecting the lower U.S. statutory rate and favorable geographic mix of earnings.

Diluted EPS of \$1.41 increased 17% compared to the prior year and grew 19% in constant currency. Earnings per share for the quarter included \$0.02 of unfavorable currency translation. Diluted EPS excluding the impact of the accounting change was \$1.47, an increase of 22% compared to the prior year or 24% in constant currency. EPS was higher than expected due to the stronger sales growth and a favorable tax rate.

During the quarter, we utilized \$119 million in net cash flows from operating activities, which was below the prior year due primarily to timing differences in shipments and receivables, and we invested \$128 million in capital expenditures. We used \$530 million to repurchase 3.8 million shares of our stock and paid \$141 million in dividends. We also announced this morning a 13% increase in our quarterly dividend to \$0.43 per share and an increase in our share repurchase authorization by 40 million shares.

Now, let's turn to our outlook for next quarter and the full year. We've obviously had a solid start to the fiscal year, but we recognize that a variety of macro risks, including pre-Brexit sentiments and post-Brexit potential implications, political instability in many areas around the world, and soft economies in certain markets, create an ongoing level of uncertainty in many parts of our business.

As you know, we adopted the new revenue recognition accounting standard beginning this fiscal year and the guidance we are providing today reflects the impact of the new method, which reduces our sales and EPS growth due to deferral of recognition of certain revenue and associated profit related to some promotional activity. We have also bridged to the comparable growth expectations we have for the business for ease of comparable business performance.

For the year, we remain comfortable with our sales growth expectation of 7% to 8% in constant currency and excluding the impact of the new accounting standard. This does assume some moderation of growth in China and travel retail in the second half, reflecting the current geopolitical and economic risks.

It also reflects the previously-announced door closings of certain department store locations in the U.S. and the UK. Currency translation is expected to negatively affect reported sales growth by 2 percentage points, reflecting weighted average rates of \$1.17 for the euro, \$1.31 for the pound and [ph] ¥687 for the yuan (25:39) for the fiscal year. And the new accountings standard is expected to negatively affect reported growth by 1 percentage point. We now expect our effective tax rate to be approximately 23%.

We are raising our EPS expectations to a range of \$4.73 to \$4.82 before restructuring and other charges. This includes the impact of known tariffs globally, including the planned increase in China in January, as well as approximately \$0.20 of dilution from currency translation and \$0.02 dilution from the new accounting standard.

In constant currency and with comparable accounting, we expect EPS to rise by 10% to 12%. For the second quarter, net sales are expected to increase approximately 8% to 9% in constant currency and using comparable accounting. Currency translation and the accounting change are each expected to negatively impact growth by 2 percentage points. Therefore, we expect reported net sales to grow between 4% and 5%.

EPS is forecasted between \$1.47 and \$1.50 before restructuring charges. This includes about \$0.03 dilution from currency and \$0.11 dilution from the new accounting standard. With the strong start to the fiscal year and with our first quarter behind us, we are focused on delivering another successful full year of solid top-line growth, margin expansion and double-digit EPS increases thereby generating strong returns for our shareholders.

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

QUESTION AND ANSWER SECTION

Operator: The floor is now open for questions. [Operator Instructions] Our first question today comes from Dara Mohsenian, Morgan Stanley. Sir, your line is open.

Dara W. Mohsenian
Analyst, Morgan Stanley & Co. LLC

Q

Hey. Good morning, guys. Sorry about that.

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

A

Good morning.

Dara W. Mohsenian
Analyst, Morgan Stanley & Co. LLC

Q

So, Fabrizio, you were pretty clear that the fiscal 2019 guidance now assumes more onerous external assumptions in China and travel retail, given the external environment despite the internal momentum. I was hoping you could also take that out to more sort of a longer-term basis as you look out over the next few years. And, A, maybe just on a backwards-looking basis give us some historical context for how much of the top line momentum in these two areas have been driven by macros more recently in the last couple of years versus more enduring factors, just to help us conceptualize the macro risk.

And, B, going forward, can you talk a little bit about how you can practically manage or adapt your strategies in those two areas, or even maybe at the corporate level, elsewhere in the organization, if the macro pressure materialized, particularly given the inventory swings in China and travel retail historically which can often exacerbate a retail sales slowdown? So again, that's sort of beyond fiscal 2019 as you look longer term. Thanks.

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

A

Yeah, that is a long question. Let me start from the 2019 part of your question, which was the first part, and then I'll address the long term. So, we have recognized that given the external environment, there is a risk the China TR moderate growth and there is a risk of tariffs. So we have frankly already recognized that risk in the August

guidance. However, we have prudently growth the protection of our estimate from that risk this time because obviously, we didn't pass all the [indiscernible] (29:50) on, which increased our protection of this risk to materialize. If this risk does not materialize, obviously, we have the opportunity to do better. And that's the way we look at it.

And we have also internal flexibility to answer more directly your question to move funds and resources to the most appropriate growth opportunity, depending on what we see. And we have, with our leadership team organized ourselves to be ready to allocate resources, depending on the situation externally and depending on the rate of return of our innovation and our initiatives. So that's the way we are organized.

In terms of the long term is we frankly believe that the China market will continue to be a market that will grow at double digit over the long-term. And this is going to be driven, as I said in my prepared remarks, by many external factors, meaning demographics, growth of middle class, women work, young generation, purchasing powers and the amazing, amazing interest for luxury beauty in the Chinese consumers. That will not change. It will not be changing because of economic trends. Maybe variable or volatile because of economic trends in the short term or because of tariff implication or any other aspect, but will not change in our opinion for the long term. So, we are assuming that a double-digit growth of China and travel retail will be part of our long-term potential in terms of growth.

But also, we have demonstrated in this quarter that to reach a 6% to 8% growth for the long-term, we do not need an over-delivery of China travel retail. We are just implying travel retail and China to continue what we design a normalized long-term growth. And we will be able to deliver our long-term 6% to 8%. And the many other engines of growth are also helping that. Last data point, if you take our EMEA results and you exclude UK short-term issues for Brexit, as Tracey underlined, if you exclude the TR positive impact, you are left with plus 7% growth, which is exactly in the middle of our long-term 6% to 8%, just to make the point.

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Operator: Our next question comes from Lauren Lieberman, Barclays.

Lauren R. Lieberman

Analyst, Barclays Capital, Inc.

Q

Thanks. Good morning.

Tracey Thomas Travis

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

A

Good morning.

Lauren R. Lieberman

Analyst, Barclays Capital, Inc.

Q

I was hoping you could talk a little bit about M•A•C. So M•A•C being called out for double digit performance – I know, Middle East was a big part of it, so some are probably reselling, you know, sort of, the reset that you've done in the Middle East in the route to market. Can you just talk about performance for M•A•C in the U.S., both online, separate from major department stores? What you're seeing in terms of – you've talked about hero products, bigger innovation? What is it strategically that's driving some change in that business? Thanks.

Fabrizio Freda

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

A

Yeah, no. Thank you. M•A•C is improving sequentially its performance. This definitely in the quarter in the short term has the positive implication to restock in the Middle East and to the improvements of this trend in the Middle East. Therefore, M•A•C is very important.

But now also to speak about the negatives, I will say there's also – there is the negative that Brazil is another important market for M•A•C which it was not very active in this quarter. So, there are positive and negative also internationally.

The drivers start becoming many, many. China continue to be a great driver. Asia in total continue to be a great driver. TR continue to be a good driver, and many other emerging markets, and markets in Europe – Italy, for example, that we have mentioned as for the overall business is one of the best performing markets for M•A•C. And to your question, we continue to see...

[audio gap] (34:08 – 34:18)

Operator: There will be a slight delay in today's conference. Please hold.

[audio gap] (34:22 – 35:43)

Laraine A. Mancini

Senior Vice President-Investor Relations, The Estée Lauder Companies, Inc.

Hello.

A

Operator: Ms. Mancini, you may proceed.

Laraine A. Mancini

Senior Vice President-Investor Relations, The Estée Lauder Companies, Inc.

Okay. Lauren?

A

Lauren R. Lieberman

Analyst, Barclays Capital, Inc.

Yes.

Q

Laraine A. Mancini

Senior Vice President-Investor Relations, The Estée Lauder Companies, Inc.

Okay.

A

Fabrizio Freda

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

Yeah. Hi.

A

Lauren R. Lieberman

Analyst, Barclays Capital, Inc.

Yeah. You talked about Brazil, right, emerging markets, Italy...

Q

Fabrizio Freda

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

A

Yeah. I was speaking about – so you dropped when I was speaking that there was the positive of the Middle East that you highlighted, but there was also some negative, like Brazil is not yet back, but obviously because of our external environmental situation.

But I was also mentioning the positives for M•A•C. There were China, TR, every single Asia market, Italy. And I was speaking about the improvements in the U.S. in specialty-multi, in online, and I was saying that these improvements are also generated by a more focused innovation plan with fewer initiatives, bigger, and focus on the key drivers. And I made the example of lipstick, but we have also big example in foundation and an exciting innovation plan in front of us. So, M•A•C is on improvement trend in the U.S. and continues its solid performance overall internationally.

Operator: Our next question comes from Michael Binetti, Credit Suisse.

Michael Binetti

Analyst, Credit Suisse Securities (USA) LLC

Q

Hey, guys. Thanks. Great quarter. Let me add my congrats.

Fabrizio Freda

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

A

Thank you.

Tracey Thomas Travis

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

A

Thank you.

Michael Binetti

Analyst, Credit Suisse Securities (USA) LLC

Q

Tracey, would you mind adding any, kind of – is there any kind of numbers you could add around how much you guys adjusted guidance related to the tariffs and the more conservative assumption around China and travel global?

Tracey Thomas Travis

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

A

Basically, when we gave guidance in August we included the known announced guidance at that time that we knew were going to be impacting us. And so that was tariff related to the EU and some preliminary tariffs in China. Subsequently, it has become more certain at least that – or at least we believe that we may experience higher tariffs in January.

So, some of the – embedded in the guidance in the second half from an EPS standpoint is the inclusion of that increase in tariffs. We do as we said on the last call 30% of our product in China comes from the U.S. The balance comes from our factories around the rest of the globe. So, that's generally what the exposure is. We also export products out of China, primarily raw materials and components. And so, we do get a duty drawback on that.

Michael Binetti

Analyst, Credit Suisse Securities (USA) LLC

Q

Okay. Just following up then. I think some of your competitors have mentioned seeing the category, the beauty category accelerate globally. And then, there has been some comments on strengthening trends behind premiumization. As I look through your guidance, I know you guys always try to make sure you're on the conservative side of where you see the category headed, but it seems like those two dynamics, in particular, with the global growth accelerating and then premiumization would – could potentially be an outsized benefit for you given your exposure. Can you speak to anything you're seeing related to – I guess, you kept your outlook for the category the same, but I didn't really hear any commentary on premiumization, how you see those two trends.

Fabrizio Freda

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

A

So, I'll take this one. And premiumization, absolutely we see that. As you see in our – but, again, your question is about guidance. So, the guidance – I'll comment to the guidance in a second. But in terms of the results we see today, we see the market of beauty remaining very strong. Our estimate is 5% to 6% for the year, which assume in this 5% to 6% a little slowdown in the second semester, but the current growth is very strong. And we do see premiumization, meaning prestige is growing much faster than mass in all the markets that we had data about.

And most importantly, we see consumer continue to trading up and going toward luxury skin care, basically towards quality products and quality experiences. And we see the overall luxury experience, which includes service and customization, to be more and more preferred by consumer, and we believe this is a long-term trend and the fact that we are a company completely focused on prestige we believe is a strong competitive advantage for the long-term because in all our brand, we are delivering the premiumization benefits that the consumer is looking for.

Your second part of the question was more specifically in the guidance. No, on the contrary in the guidance, as you have seen, we do not assume the market to accelerate – the premiumization to accelerate in the second semester. Actually, we assume a moderation of this phenomenon for the next short term for the January-June period, not necessary for the long term but that's in the assumption and again we explain why we are taking prudently this assumption at this point in time.

Operator: Our next question comes from Bonnie Herzog with Wells Fargo.

Bonnie L. Herzog

Analyst, Wells Fargo Securities LLC

Q

Thank you. Good morning.

Fabrizio Freda

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

A

Good morning.

Bonnie L. Herzog

Analyst, Wells Fargo Securities LLC

Q

Good morning. I had a question on your Makeup business. Operating income declined as did margins, so you called out stepped-up spending behind Too Faced. So, I was hoping you could drill down a little further on this to give us a sense of, I guess, where you're at with the spending and then maybe how much your Makeup business

would be performing excluding the spending. And then, hoping to get a sense of how much longer the spending levels might be or stay elevated behind Too Faced. And then finally, more importantly, what kind of lift you're seeing right now if any or really what your expectations are? Thanks.

Tracey Thomas Travis

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

A

Yeah. So, regarding Makeup, we did have – we called out as well some declines in our Smashbox business. But the Too Faced investment – the Too Faced had quite a few large launches this quarter. They launched their Born This Way Foundation with extended shades, Born This Way Concealer. Their Tutti Frutti line as well launched this quarter.

So, they had – quarter-to-quarter, it's very difficult to look at our results from a spending standpoint because we are so launch and innovation driven. And if it's a bigger launch one quarter than the next, you'll see perhaps outsized spending and depending on when that spending happens in the quarter. So I would expect that our Makeup operating margins will improve throughout the balance of the year, and you'll see more normalization there.

Bonnie L. Herzog

Analyst, Wells Fargo Securities LLC

Q

Thanks.

Operator: Our next question is from Robert Ottenstein, Evercore ISI.

Robert Ottenstein

Analyst, Evercore Group LLC

Q

Great. Thank you very much and terrific quarter. You're obviously doing a really nice job on some of the larger well-established brands and I know this is a tricky question, it's very hard to dissect, but I was wondering if you could give us a sense of the contribution of innovation to those brands and e-commerce and if it's possible, obviously they're connected, but I was wondering if it's possible to kind of tease out the impact of both of those factors? Thank you.

Fabrizio Freda

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

A

Yeah, so first of all, on all these brands, and frankly on every brand that the impact of e-commerce is very positive. As we explained, we have brand sites, retail.com and overall platforms like Tmall. We are growing in each one of these three segments very strongly, double-digits, and particularly on platform at very strong double-digits, and also in retail.com at very strong double-digits.

And we expect this strong trend to continue because also we are creating great experiences online in all these platforms and the consumer is more and more interested. We are very strong, and we have been investing for years in this area, so we consider our e-commerce business a strength and something we can continue to leverage and be at the forefront of the industry with it.

In terms of the contribution of innovation, as I touched in my prepared remarks, we are really taking innovation to the next level. Our innovation today is much more focused on the right opportunities, on the right consumer targets, on the right benefits, thanks to a major work we have done in the last couple of years on adding analytics

and more sophisticated analytics to our way to determine how to innovate and to focus our marketing plan after we have produced the innovation, and we see the results of this.

Personally, I believe that a big part of our acceleration on the big brands is driven by the quality of our innovation and by the ability to focus innovation on the areas of biggest return. Finally, we are really focused on product quality. That's why at the end, we speak about prestige. Premiumization is about quality in my opinion and the consumer are going more and more towards high quality products. Our products are superb quality as we see from the repurchase rates of our consumers.

So innovation needs to be pushed with trial, but after the trial what really makes the innovation successful is how many consumers come back more and more to buy the product, that we measure with our repurchase rates. And we have extraordinary strong repurchase rates and obviously profitability is driven by repurchase. Investments are driven by trial. So we always keep in mind this difference.

Tracey Thomas Travis

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

A

And the only thing I'll add to this and this doesn't directly address your question, but just a reminder that for our overall company, our increase from pricing and distribution has been roughly the same in the 2% to 3% for distribution, 2% pricing. Everything else is innovation and comp store sales. So the big acceleration that we've seen, which certainly includes the performance in China and travel retail but also online, has been really in that category, which is very, very strong and very healthy for us.

Robert Ottenstein

Analyst, Evercore Group LLC

Q

So it sounds like you've got a very nice, for lack of a better word, formula working that has had this gaining traction, and it seems to be gaining some traction in Clinique. Would that be fair? And do you see – and how would you look at the mix between the innovation in e-commerce in terms of getting Clinique even to a higher sales trajectory?

Fabrizio Freda

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

A

Thank you for this question. Actually, yes, we do expect Clinique to get a lot of acceleration, definite from online. That's already happening and will continue to happen more, but as I mentioned particularly from innovation. I believe Clinique is one of the best innovation programs in this moment in front of us, and I said there will be a new launch of Clinique, which is very important in December which is very exciting in the area of Skin Care. And there is more innovation to come.

Plus the ingredient story of Clinique has been taken to the next level, and this also is having an initial encouraging impact on consumers. So we are in a situation where three of our biggest brands are already growing double-digits, in which M•A•C is gradually improving [indiscernible] (48:09) which has been U.S. and UK. And in a situation where Clinique, we believe has the potential for the total fiscal year to go back to growth as well. And so our ambition is to finish this fiscal year with all our top-four brands on a growth trajectory.

Operator: Our next question comes from Wendy Nicholson, Citi.

Wendy C. Nicholson

Analyst, Citigroup Global Markets, Inc.

Q

Hi. Could you talk about the trends in the specialty-multi business in the U.S.? I think for the last few quarters, we've heard you talk about strong double-digit growth, and it has clearly slowed a little bit in this quarter. Is that just a function of Smashbox weakness?

And can you update us on kind of where you are? I know you don't want to tell us exactly how many ULTA doors M•A•C is in, but kind of where you are maybe inning-wise? Are you in the third inning of distribution expansion for M•A•C into ULTA doors? Or just how much more run-way is there for new door expansion in specialty-multi? Thanks.

Fabrizio Freda

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

A

Yeah, you're welcome. And so we are doing well in specialty-multi. We continue to grow. And this has continued to be one of our key drivers. And we are at the point already, we communicated that last quarter, where the benefit of specialty-multi start to being substantial, so having a significant impact on our growth in the quarter. That's very positive.

Now there's been some slowdown on Smashbox for sure, as you mentioned, and that's obviously a slowdown of the results of growth. But the other brands really in specialty-multi did very, very well, and there is no other sign of slowdown. Actually, I would say, most of them are on a clear accelerating trend. And there is more potential for distribution.

Yes, on M•A•C in Ulta, there is more potential for more doors. That is not only about M•A•C. There is more potential for many of our small and medium-sized brands that have the opportunity to further accelerate distribution in this area. And as you know, we had also some distribution in online and flagship doors of brands like Jo Malone and La Mer, which are also performing very well on the high-end consumers that shop in this channel. So overall, we are positive and we believe this story can continue to build over time.

Operator: Our next question is from Nik Modi, RBC Capital Markets.

Nik Modi

Analyst, RBC Capital Markets LLC

Q

Yeah, thank you. Good morning, everyone. So I just wanted to stick on the topic of innovation. Fabrizio, maybe you can just talk about some of these new product launches you referenced in terms of the personalized skin care product and just some context around if you've tested it, what kind of demographics does it appeal to? And then maybe you can also talk about the Clinique 72-hour moisturizer and kind of how you think about that product relative to how it's maybe tested or your hopes and desires for that franchise? Thank you.

Fabrizio Freda

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

A

Yeah, so on the innovation on Clinique, which is customized to every consumer, I prefer not to comment more. We are in the process of announcing it to the various retailers around the world, and so we'll be soon official and will be launched in December. But basically is the kind of innovation our analytics are giving us, meaning innovation that is not only a great product quality that provide interesting and relevant benefits. But is also proposing to the consumer a new customization idea and so there is responding to new desires, doing it in a way which is unexpected and different. And that's the quality of innovation I'm speaking about.

We always had to make quality products. We always had the ability to create interesting benefits. But we are now learning how to do it in a way which is much more customized, more differentiated and anticipate new consumer desires in a world where the consumers is more at the center of the attention and leading the process.

In terms of the other innovation, yeah, the Moisture Surge, which is the Clinique 72-hours benefit product you had mentioned is doing very, very well. It's one of the key driver of the success in skin care of Clinique, and it's the results of a extraordinary technical innovation, where the level of moisturization is extremely strong and very appreciated by the consumer, included into a formula with a very special texture that we know has high level of appreciation by the consumer around the world. So, it's strong, it's doing well, and we believe there is potential to do even better in the future. We'll continue to drive it.

Another example is the launch of jelly, which I mentioned, which is basically taking the core franchise of moisturization of Clinique and giving it a different form and this jelly form, by the way, our analytics show that there was absolutely preferred by a certain group of consumers, particularly young consumers. And so, with the goal of rejuvenating, of making younger, that historical franchise of Clinique, we have chosen a form, a texture, and a model of benefit that we knew was preferred by this group of consumers. And, in fact, the results are coming. So, it's about applying our historical innovation strengths to better analytical understanding of the opportunities and thanks to this, creating much higher rate of returns of our innovation scheme.

Operator: Our next question is from Linda Bolton Weiser, D.A. Davidson.

Linda Bolton Weiser

Analyst, D.A. Davidson & Co.

Q

Thank you. So, when we talked to investors about your strong trends in growth and innovation and everything, you've been talking about, one of the pushbacks we get is that we are getting potentially close to the end of the cycle. And some investors actually think we will get a recession in the next 18 to 24 months. So, can you talk about – in the past, you had invested quite heavily through the cycle and especially in the downturn you continued to invest behind your brands. Can you talk about – is there anything different in the structure of your business or the mix of your business, this cycle that would potentially mute the decline in your earnings that we saw in past downturns? Thanks.

Tracey Thomas Travis

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

A

Yeah, so, I'll start. One of the big differences quite honestly is Leading Beauty Forward. And so, the efforts that we have taken to take more fixed cost out of the business to structure ourselves differently, to invest behind faster growing areas, we actually have more flexibility in our cost base, which you hear us talk about quite often. And in terms of investing behind when markets are strong and when innovation is strong, but also pulling back when there is a downturn or to your point if a recession were to occur.

So, I think structurally the company is much, much stronger today than it was a few years ago, because of all of the work that we've done in programs like Leading Beauty Forward to really reorganize our expense base and invest behind areas that really drive the growth of the business.

Fabrizio Freda

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

A

So, to that point of Tracey, basically, we have higher variable costs and lower fixed costs, and we are more flexible, and we have great cash. And so, the ability to go through recessions with cash assuming this had to

happen. But I want also to touch on the part from the consumer. To be clear, we have a portfolio of brands, they really go from the entry price point of prestige to the luxury. And so, we have seen during recession our abilities also to push more the brands which are at the entry price point and to leverage them. And today, we are much more capable of doing that and we have a much richer portfolio across the several price points.

The other thing which has changed is – please, let's not forget that prestige cosmetics are affordable luxury. And the famous thing that Leonard Lauder said many years ago about the lipstick index, which is when there is a recession, women buy more lipsticks, not less, for the simple thing that it is affordable luxury in a moment where maybe other luxuries is not the right priority for families or for people. And so, we believe that we can leverage much better than in the past the concept of the lipstick index.

Operator: Our next question comes from Mark Astrachan, Stifel.

Mark Stiefel Astrachan

Analyst, Stifel, Nicolaus & Co., Inc.

Q

Thanks, and good morning, everybody. One housekeeping question, one follow-up on the Clinique line. One, just Tracey, is there any benefit anticipated in the second quarter guidance from selling ahead of the tariffs? And then just on Clinique broadly, I guess maybe to put the question in a different way, why has the brand not resonated with consumers in recent years? And, I guess, the question is, innovation sounds pretty exciting, but from a brand standpoint, how much of it is the brand itself where there's a lot more competition for a dermatologically correct skin care makeup brand today versus maybe 10 or 15 years ago? And then how do you think about spend or innovation around kind of modernizing it versus just running the business kind of as it is with lesser growth than you have seen in recent years versus history?

Tracey Thomas Travis

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

A

So let me start on the tariff question. We are seeing obviously incredibly strong growth in China, so we have not been building up related to the tariffs. We've really been flowing inventory as we have it to support the slow or the very fast sales trends. So we don't have a big inventory buildup in China where that would cause the moderation or the slowdown that we're speaking about in the second half.

As it relates to Clinique, and I'll let Fabrizio add on to this as well, one of the things that we mentioned in the last call that I would just remind you of is, Clinique has been one of the brands that's been disproportionately affected by some of the retailer dislocation that's happened, particularly in North America – in Canada and in the U.S. because they were so strong in those businesses, so. And the same in the UK as well, we're seeing that impact with Clinique. So they have been disproportionately affected by that.

The innovation in recent years has been quite strong, and certainly there's been a lot more competition in the space. I always say great brands attract great competition and certainly our brand portfolio has done that. So the innovation, as Fabrizio mentioned that Clinique is coming out with, is informed by insights, the competitive environment, what consumers are looking for today, and being done in a Clinique way. And so we are very encouraged by early signs that we've seen on some of the product launched starting with Moisture Surge and certainly the jelly that Fabrizio spoke about and the upcoming innovation that will begin to be phased out in December on the new product line which is quite exciting.

Fabrizio Freda

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

A

And I just want to add that the Clinique team, which is probably listening to the call, will be very happy about your question because they could not agree more that they are working very hard on the modernization of the brand. They have modernized the allergy-tested, fragrance free position of the brand with the new purity statement. They're modernizing their stores. They're modernizing their packaging. We spoke already about innovation.

There's been a lot of progress on Clinique and frankly, you would see already more of this progress into the number if it was not for the fact that, for example, Bon-Ton closure is the large majority impacting Clinique, the House of Fraser softness in the UK is for the large majority impacting Clinique. So Clinique has been the most impacted not necessarily by the consumer not liking the brand, but really from the dislocation of the distribution reality around the world. And the work they are doing on modernization of the brand starts working well, and we believe will give soon better and better results.

Operator: Our next question is from Erinn Murphy, Piper Jaffray.

Erinn E. Murphy

Analyst, Piper Jaffray & Co.

Q

Great. Thanks. Good morning. And let me add my congratulations. Maybe just a segue from a lot of the comments on Clinique, but when you take a step back and just think about the natural beauty trend, how much of your portfolio today really lends itself to this macro trend? And then going forward, how are you weighing the opportunity to invest behind this trend in your existing portfolio today versus looking at M&A?

Fabrizio Freda

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

A

Yeah, in our portfolio, first of all, the purity concept is actually the Clinique concept. As I said, today it is called in many different ways. It's called clean, natural, et cetera but – so the brand that is now stepping up to leverage this trend in a unique Clinique way is actually Clinique. The other brands are obviously Origins, which is, as I said in my prepared remarks, exactly in the middle of that and in fact is having exciting results. And exciting results because it's leveraging the strength and because it's doing great innovation exactly on that trend, like the very recent launch of Origins lipstick line in the U.S., which is a super exciting flower-based line that leverage even in lipstick the natural trends that personally, I believe, will be very, very interesting for the consumer worldwide.

And then we have Aveda. Aveda is in the middle of this since always, since ever. Not only Aveda adds to the natural element to be leveraged, the sustainability element as well that is a very strong preferred Millennials point of view today. So Clinique, Origins, Aveda are the obvious question that we are using these brands to further leverage these trends.

And on your question on M&A, we always look at the M&A possibilities around the world, and if there will be opportunity in these areas, obviously we will consider them.

Operator: That concludes today's question-and-answer session. If you were unable to join for the entire call, a playback will be available at 1:00 PM Eastern Time today through November 14. To hear a recording of the call, please dial 855-859-2056, passcode number 4946739. That concludes today's Estée Lauder Conference Call. I would like to thank you all for your participation, and wish you all a good day.

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