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# The Estée Lauder Companies, Inc. (EL)

Q1 2020 Earnings Call

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### Fabrizio Freda

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### Tracey Thomas Travis

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Analyst, Morgan Stanley & Co. LLC

### Olivia Tong

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## MANAGEMENT DISCUSSION SECTION

**Operator:** Good day, everyone, and welcome to The Estée Lauder Companies Fiscal 2020 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 Senior Vice President of Investor Relations, Ms. Rainey Mancini.

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### 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 other reports filed with the SEC, where you will 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 and adjustments disclosed in our press release. All net sales growth numbers are in constant currency. 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 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.

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### Fabrizio Freda

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

Thank you, Rainey, good morning, everyone. We have started off our new fiscal year with terrific results. Our successful strategy, driven by the multiple engines of growth, helped us to deliver an extraordinary performance, especially in light of the volatile macro environment. Net sales grew 12% in constant currency, making our tenth consecutive quarter of double-digit growth. As a result, we gained share and strengthened our leading position in global prestige beauty.

We leveraged our strong sales increase with a disciplined focus on cost and adjusted diluted earning per share rose 20%. Our performance on both the top and the bottom lines was fueled by successful innovations, increased advertising and effective marketing across brands, categories, geographies and channels. With deeper consumer insights informed by improved data analytics, we expanded our growth engines activated additional ones and invested in the best opportunities worldwide, which fueled these strong results.

We remain mindful of global volatility risks. However, with the strong start and our confidence in continue to execute effectively, we are raising our net sales and EPS estimates for the year in constant currency. During the quarter, the external environment was challenging and we faced different issues in every region. Disruptions in Hong Kong affected commerce in that area. Continued uncertainty about Brexit impacted consumer spending in the UK and demand for makeup in North America softened it. However, by having numerous growth engines across all facets of our business, we were able to deliver and exceed our sales and earning expectations.

Most of the overachievements came from continued strength in China and travel retail. We also had better-than-expected improvements across Europe and our other emerging markets. Also, contributed to our continued growth is our company positions in the sweet spot of consumer goods.

Our brands generate superior consumer loyalty, evident in our strong repurchase rates. And while our high-quality products justify premium pricing, they are an affordable luxury, which we believe makes them more resilient to economic volatility than other luxury products.

During the quarter, each of our four largest brands grew globally, reflecting strong consumer demand for established brands and their proven desirable product and compelling innovations.

Estée Lauder and La Mer each advanced more than 20%. A key strategy is our focus on hero franchises, which are the high-repeat products in each brand. With greater innovation and resources around these hero product lines, our brands successfully attracted new consumers and reinforced their loyalty with existing ones.

Our Estée Lauder brand is a great example of this winning strategy. The brand introduced a new product in its largest franchise Advanced Night Repair. Sales of the concentrate exceeded our expectations, and it helped lift the entire franchise by double digits globally.

In Asia, buzz around Estée Lauder new Intense Reset Concentrate broadened the brand reach, about 70% of consumers who bought it were new to the brand, underscoring our strategic priority to attract new users with exciting innovations.

Estée Lauder was one of several of our brands that benefited from rapid growth in the skin care category worldwide. We are well-positioned to meet the growing demand for all types of skin care products. It is our largest category and grew sharply, accounting for nearly half of our global sales in the quarter.

We continue to invest in skin care. La Mer gained share in luxury skin care in Asia/Pacific and Clinique delivered its stronger global growth in several years, driven by well-received skin care innovations.

One of Clinique's newest products, the Smart Clinical Multi-Dimensional Moisturizer line, resonated strongly with ageless consumers, particularly in North America and the UK. In other developments, our Tom Ford beauty brand launched a luxury skin care collection to complement its successful fragrance and makeup offerings.

Our makeup sales grew globally, driven by a sharp uptick in Asia/Pacific and travel retail, as well as gains in the European region. The deceleration in prestige color cosmetics has been driven by Anglo market, but growth is still healthy in other geographies and global companies like ours are well positioned to grow in the category.

Using enhanced data analytics and consumer insight that signal new and fast-growing areas of demand, we invest in the promising subcategories as they emerge. For example, we knew the interest in foundations with skin care benefits was trending. With that insight, we develop new products around our hero foundations that offer hydrating and smoothing benefits. And our foundation business climbed 20% globally.

We innovated with great success in other subcategories, where we found granular opportunities. For example, M•A•C introduced Love Me Lipstick, a breakthrough weightless and moisturizing formula that offer lasting color. The product helped increase the brand lip business which climbed double-digits. Overall, our innovation was robust, a new product accounting for 30% of our makeup category this quarter.

Turning to our geographies. Our growth in China accelerated from the previous quarter, fueled by multiple engines. We had double-digit growth across all categories, all channels and nearly all brands. Our online business in China was strong. Our sales on Tmall doubled with growth across brands. We also successfully partnered with Tmall on special events, such as Jo Malone London, super brand day. Additionally, Glamglow launched on the platform in September.

Investing in emerging market remains a strategic priority because we anticipate a continuation of growing demand for prestige beauty from the expanding middle class. Excluding China, as a group, this market rose double digits and they recruited several new consumers. Standout included Russia, Mexico, Brazil and Southeast Asia and we saw improvements in retail in Middle East. Our business in Hong Kong was challenged. Our sales declined 20% in the quarter. And we have not seen sign of improvement to date. However, since the last downturn in the market, we have repositioned our business and increased sales with local consumers becoming less dependent on tourists, which was the most affected area.

Our sales decline in Hong Kong was offset by an acceleration in the rest of Asia, reflecting strong consumer demand for our prestige brands and desirable products. In Europe, the Middle East and Africa, every market grew, which added another growth driver and broadened our multiple engines. We were encouraged by strength in the large western European markets which advanced, as well as many emerging markets in the region, thanks in part to a strong reception of our brand's innovation across categories.

The North American market remained challenged by declining makeup sales, mainly in color cosmetics, as well as weak traffic in brick-and-mortar department store where we are the largest player. Although our business generally reflected these trends, there were several bright spots. Our skin care business rose; several brands had higher sales and we had grown in key subcategories such as eye treatments or mascara. Typically, skin care makeup growth fluctuates depending on trends and innovation and can accelerate at different rates at different times.

However, on average, over the last five years, both categories rose nearly 10% compounded annually in the US. We believe recent declines in color cosmetics in the US are due to several factors. Trends change and a more natural appearance is now involved, which requires fewer products that went contouring and other looks were popular. Also, the number of new product launches in makeup declined 20% in the last year, including from indie brands. In addition, Gen Z consumers are discovering the benefits of skin care, spurred by more social media activity in that category.

Our brands continue to innovate strongly in both makeup and skin care. Clinique recently launched a new lipstick collection, which matches the consumer foundation shade with 28 new lipstick color based on the brand shade match science. This continues Clinique customization of beauty product that began with its successful Clinique iD skin care launch.

Looking at our business by channel. travel retail and online globally again drove our performance. Travel retail upward trajectory continued, with strong double-digit sales growth, reflecting diversified growth engines across brands worldwide. Our products continue to resonate globally and like-door growth was robust.

Among our top eight brands in the channel, all but one grew double-digits at retail. Digital campaigns and pre-ordering aimed at travelers before they start their trip helped boost sales. We expanded distribution for our newer artisanal fragrance brands and there is still much distribution expansion remaining for many brands in our portfolio that are only available in a small percentage of airports.

Our online business also climbed strong double-digits. All types of online distribution grew substantially, led by third-party sites and retailer sites. Traffic was higher and mobile commerce accounted for more than half of our e-commerce sales. We increased our advertising investment faster than our sales growth and continued to focus our spending on digital advertising, which accounted for 75% of the total.

Our digital spending is mainly on advertising, social media communications and search engines. Our brands are using many digital tools and experimenting with emerging social media platform to connect with consumers. For example, M•A•C launched a tool that lets consumer test over 100 lipstick shades on their own pace by accessing the camera of their own phone and to simply research and purchasing. La Mer and Bobbi Brown launched voice search on their brand.com site in North America.

We are proud of our results this quarter and confident we have the right plans in place for the rest of the year. Our brands have created many exciting products and promotions for the holiday period in-store and online for Cyber Monday and 11.11 in Asia and we believe consumer will be attracted by our compelling offerings.

Looking ahead, we expect to further expand and magnify our multiple engine of growth across categories, brands, channels and geographies to better manage global volatility. We will continue to leverage our superb skin care growth and expect to gain even greater market share in that category.

We have the best diversified pure-play in global prestige beauty with talented global teams and have profound local expertise, which makes us well positioned to pursue the fastest-growing areas around the world for any kind of consumer. At the same time, we will continue to transform our business as we anticipate what lies ahead and strengthen our entrepreneurial and competitive spirits.

Now, I will turn the call over to Tracey.

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## Tracey Thomas Travis

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

Thank you, Fabrizio, and good morning everyone. As a reminder, my commentary today is adjusted for the items that Rainey mentioned at the beginning of the call and net sales growth numbers are in constant currency.

And now for the quarter results. Net sales for the first quarter rose 12%, driven by strong growth in our international regions and in our skin care category. Asia, travel retail and online continued to deliver strong growth and our European and Latin America market sales growth accelerated, while sales in North America remained challenged.

From a geographic standpoint, our Asia/Pacific region net sales rose 26%, with more than half of the markets contributing double-digit increases. Sales in Greater China rose strong double digits. Our sales in Mainland China continued to deliver broad-based growth across cities, brands, categories and channels as we gained share. And as anticipated, our sales in Hong Kong fell 20%.

Among developed markets in APAC, both Japan and Korea delivered double-digit sales growth this quarter. Our sales in Japan, which grew a solid 7% last fiscal year, accelerated even further within the quarter, in anticipation of an October 1 VAT increase in the country. In Korea, sales in specialty-multi and online distribution were robust and we gained share in department stores. And Southeast Asia grew double digits, led by Thailand, Indonesia and Vietnam.

Net sales in our Europe, the Middle East and Africa region rose 19%, with every market contributing to growth. Our global travel retail business rose strong double digits, led by quarters across Asia. Strong like-door growth drove the majority of the increase in travel retail and was supplemented by the rapid development of online pre-ordering. Our emerging markets in the region grew high single digit, led by a double-digit increase in Russia and the Middle East.

Western markets grew mid-single digits, led by Switzerland and Greece. Our sales in the UK grew modestly this quarter, despite continued challenges in, brick-and-mortar retail. Some retailers bought extra stock this quarter ahead of the anticipated hard Brexit. And our online business in the UK continued to grow double digits. Net sales in the Americas declined 6%.

Brick-and-mortar retail remained difficult, especially in department stores. As you know, the makeup category in North America has been declining and we are the leading prestige company in the category. We continued to invest where we saw the best opportunities for growth. Skin care showed good growth, driven by Estée Lauder, Clinique and La Mer in their hero franchises. Within makeup, we saw solid growth with some key subcategories such as Mascara. And while our Fragrance business was particularly soft this quarter, it is expected to pick up in the holiday quarter.

Looking at the region by channel, North America sales rose in both brand and retailer online as well as in freestanding retail stores. Our sales in the specialty-multi channel also grew at retail.

Our Estée Lauder brand and most luxury brands grew in North America this quarter. In addition, sales in Latin America grew double digits in all major markets. From a category standpoint, skin care led growth this quarter. Net sales accelerated to 25%, with strong contributions from Estée Lauder, La Mer and Clinique. Innovations, such as Estée Lauder Advanced Night Repair Intense Reset Concentrate, LA Mer, The Regenerating Serum and Clinique Smart Clinical Multi-Dimensional line, contributed incremental sales and supported hero franchises.

And the historical strength of Origins and natural skin care helped drive the brand's double-digit gains. Net sales in makeup grew 4%, with strong double-digit growth in Asia and travel retail, led by strong innovations and support behind foundation and lip products from Estée Lauder, M•A•C, La Mer and Tom Ford Beauty.

Sales of fragrances declined 1%, as sales in luxury and artisanal brands were offset by declines in designer fragrances, Clinique and Estée Lauder which had a tough comparison to the prior year launch of Beautiful Belle. Innovations this quarter included Poppy & Barley from Jo Malone, Metallique from Tom Ford and new city exclusives from Le Labo. Fragrance sales grew in all international regions, but were soft in the Americas region as I mentioned earlier. Our hair care sales declined 4%, driven by a tough comparison to the prior-year launch of Cherry Almond Shampoo and conditioner from Aveda, as well as lower sales from Bumble and bumble in North America.

Our gross margin declined 10 basis points compared to the first quarter last year. Higher obsolescence and sourcing costs were mostly offset by pricing and favorable skin care category mix. Operating expenses as a percent of sales improved 120 basis points. Continued leverage of our cost base due to greater efficiencies in our selling model and store operating costs more than covered higher advertising investments to build awareness in critical growth markets and support our innovations globally.

Operating income rose 17% and operating margin increased by 110 basis points. Diluted EPS of \$1.67 increased 19% compared to the prior year and grew 20% in constant currency. EPS was higher than expected due to the stronger sales growth with greater operating leverage and a slightly favorable tax rate.

During the quarter, we utilized \$170 million in net cash flows from operating activities, which was below the prior year, due primarily to timing differences in accounts payable and we invested \$125 million in capital expenditures. We used \$313 million to repurchase 1.6 million shares of our stock and paid \$156 million in dividends. We also announced this morning a 12% increase in our quarterly dividend to \$0.48 per share.

Now let's turn to our outlook for next quarter and for the full year. We are pleased obviously with the strong start to our fiscal year, but we recognize that a variety of macro risks such as ongoing trade tensions, Brexit and continued challenges in Hong Kong's retail environment could impact our fiscal 2020 results. Nonetheless, we believe our multiple engines of growth strategy will continue to deliver strong global results. For the year, we are raising our sales growth expectation by one point to 8% to 9% in constant currency. This still assumes a moderation of growth in China in travel retail in the back half of the year.

Despite the market conditions in place today, we expect our North America business to gradually improve, fueled by innovations in skin care and foundations, better fragrance performance during holiday and strong growth online. Currency translation is expected to negatively affect reported sales growth by 1 percentage point, reflecting weighted average rates of \$1.09 for the euro, \$1.23 for the pound and \$7.12 for the won for the fiscal year. EPS is expected to range between \$5.85 and \$5.93 before restructuring and other charges. This includes approximately \$0.05 of dilution from currency translation.

As you are most likely aware, currency rates have moved about 3% to 4% since our last guidance, which was based on rates as of June 30, the spot rate. The won, euro and pound have all weakened relative to the US dollar and created a currency swing of approximately \$0.10 on our annual expectations for EPS. So the currency impact previously was a plus \$0.05 that we were expecting for the year and we are now expecting a minus \$0.05 EPS impact based on the September 30 spot rates.

For the second quarter, net sales are expected to increase approximately 8% to 9% in constant currency. Currency translation is expected to negatively impact growth by 1 percentage point, therefore we expect reported net sales to grow between 7% and 8%. EPS is forecast between \$1.83 and \$1.86 before restructuring charges. This includes about \$0.02 dilution from currency. With a strong start to the fiscal year, we are optimistic about our ability to execute our plans to deliver another year of top line growth, margin expansion and double-digit EPS improvement.

And with that, 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 question comes from Lauren Lieberman with Barclays. Please go ahead.

Lauren R. Lieberman  
*Analyst, Barclays Capital, Inc.*

Q

Great. Thanks so much. I wanted to ask a little bit about US and distribution footprint because the commentary we all know of course that the specialty-multi channel has slowed a bit. And Tracey, your comment I think was pretty specific that you still saw growth in the channel at retail. So I guess one, can you talk about any inventory destocking that might be going on in that channel? And two, what might be happening there in terms of foot traffic and takeaway because that might tell a slightly better story in terms of the health of the channel versus I think what we're all worried about in terms of maybe like a structural slowdown of the channel? Thanks.

Fabrizio Freda

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

A

Let me start answering this question. I think the key point is I don't think stocks – the key point here is that the color makeup market has softened. And there are certain companies like us and certain retailers which are more exposed to makeup than others. And this has fluctuations. And so in that quarter, that was the new news that we have managed around. And so the key idea is that when we see trends, we are able to anticipate and react to those trends. That's why we've moderated the impact of this fluctuation on makeup, pushing more obviously our skin care business and continue building our distribution in the way that we want to focus it in the long term, meaning swinging the distribution toward high-traffic, high-performance channels and retailers gradually over time. So the strategy continues.

On top in North America, we have really improved our team, our capabilities, our ability to manage the market granularly exactly to anticipate and react to these trends very fast. We have better consumer inside, more local relevance and we have dramatically improved the ability to work online and our online business have been very solid.

So we are committed to improve the North America trends, in the course of this fiscal year obviously even more in the long term. And this quarter was mainly, as I explained, a softer than expected color makeup business.

Lauren R. Lieberman  
*Analyst, Barclays Capital, Inc.*

Q

Okay. That's great. Thank you. In that regard, Fabrizio, you're pointing out some of the changes that you've already started to make in the US and that you had actually talked about – and I think some of the things that Chris Good highlighted at your Analyst Day in the spring were really interesting, so [indiscernible] (28:09) the type of segmentation. So when do we start to see – or do you think we'd start to see that impact performance? Is that kind of why you're speaking to the forecasted improvement from here? It's less about the makeup category and getting healthier and more about some of the Estée Lauder-specific proactive hyper segmentation coming into play? Is that fair?

Fabrizio Freda

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

A

Yeah. That's fair. It is going to be more proactive segmentation. Also it's going to be innovation focused on this proactive segmentation. That's why in my prepared remark I explained that our innovation, for example, the Clinique innovation on makeup is more customized exactly to the opportunity we had identified.

I also explained that frankly, when you don't look to the last quarter or the last six months, but you look to the last five years, the categories, makeup, skin care or even the subcategories like color cosmetic versus the foundation or moisturizer versus anti-aging had different situation and different trends. On average over the years, this category all been growing pretty well. In this moment, there is a softness in color makeup for a specific consumer-driven reason. I personally believe this will come back. It has always come back up and down over time.

Tracey Thomas Travis

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

A

I would also add more in that we did have an unusual anniversary of a very strong launch period last quarter from a fragrance standpoint last year with Estée Lauder Beautiful Belle and some of our other designer fragrances and we are comfortable and quite encouraged by our holiday programs for the second quarter.

Fabrizio Freda

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

A

Yeah. And also I want to clarify [indiscernible] (29:50) maybe this is not completely coming out from the fragrance number that our high-end fragrances, so Jo Malone, Tom Ford continues to grow very strongly also in North America globally and in North America. So the fragrance number is 100% influenced by the base period of the launch of Estée Lauder in the past and scent designer fragrance performance. But our high-end fragrance has continued to be strong performance, continue to become a bigger percentage of our business and we are at the moment, are tilting the proportion.

Lauren R. Lieberman

*Analyst, Barclays Capital, Inc.*

Q

Okay, great. Thank you so much. I'll pass it on and try to get back in.

**Operator:** The next question is from Dara Mohsenian with Morgan Stanley. Please go ahead.

Dara W. Mohsenian

*Analyst, Morgan Stanley & Co. LLC*

Q

Hey. Good morning.

Fabrizio Freda

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

A

Good morning.

Tracey Thomas Travis

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

A

Good morning.

Dara W. Mohsenian

*Analyst, Morgan Stanley & Co. LLC*

Q

So I would to flesh out a bit more the lower global prestige beauty category revenue growth guidance you gave in your release versus last quarter. Can you give us a sense of which geographies and product categories are driving that lower growth expectation? Is it just mainly US makeup or are there other areas? And then obviously you raised your own internal sales forecast. So, just help us understand the context of greater confidence in Estée market share trends within that lower prestige category growth?

Fabrizio Freda

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

A

Yeah. First of all, I want to say our estimate of the market is still very, very strong. And the 5% to 6% is at the top of the historical averages. So to be clear, we continue to believe that this – the prestige beauty is going to be one of the fastest-growing market in consumer goods and that will continue to be in this moment on top of the historical averages. So this is a great moment of growth overall. We have taken this point down in reflecting the reality of the softening of the color makeup, particularly in the Anglo market, specifically North America, UK, Australia and to reflect our assumption to a moderation of growth, in China and travel retail that however, to be clear, we have not yet seen happening, but just to be consistent with our future forecast. And that's what we're seeing. But again, this is the most robust consumer market in the numbers and this robustness will continue in our estimate.

Tracey Thomas Travis

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

A

And obviously taking up the year certainly reflects the performance that we saw in the first quarter.

Dara W. Mohsenian

*Analyst, Morgan Stanley & Co. LLC*

Q

Great. Thanks.

**Operator:** The next question is from Olivia Tong with Bank of America. Please go ahead.

Olivia Tong

*Analyst, Bank of America Merrill Lynch*

Q

Great. Thanks. Just sort of following up a little bit on that. Can you talk about your expectation for market share gains, particularly given that a key competitor's luxury division at least this quarter outpaced your growth? Now clearly Asia continues to be fantastic. Is there more coming there to drive even greater improvement, more in terms of the US rebound? You talked a little bit about that in the prepared remarks, even more doors, even better innovation? And maybe if you could just sort of, if possible, on the category growth, just sort of talk through the prestige growth where it's more --where your expectation is going in makeup? Thanks.

Tracey Thomas Travis

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

A

So I'll start and then Fabrizio will continue. So, Olivia, we're seeing strong growth in Asia. We're seeing very strong growth as we've called out previously in travel retail. We're seeing also an acceleration in EMEA as well. So, some of the things that give us confidence in terms of gaining market share, it's less about North America at the moment although we clearly expect to see – as I said in my prepared remarks, modest improvements in North America throughout the course of the year. But from a share standpoint, we really expect to gain share outside of North America in our international markets as well as good growth in online as well.

Fabrizio Freda

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

A

Yeah. And on top of what Tracey explained, obviously is the trends of this quarter – the trends of the last two years shows that we are growing clearly ahead of market. So we are gaining market share. So it's not that we plan to do anything different.

We continue to gain market share in a very good way, we are growing market share today. Our strategy for growing market share is not to spend aggressively in stable markets to fight market share in a zero-sum gain.

Our strategy to grow market share is dictated by our Compass, where we anticipate where growth will come from and we build market share at the beginning of the growth trend. For example, in this moment, we are gaining significant market share in China. We are gaining significant market share in every single of the emerging markets of the world. We are gaining, again, market share in Europe, in Western Europe. We are gaining market share in most of the categories in the UK because of the softness on the market.

And so we grow market share where we are taking the opportunity to really anticipate growth in areas that then in the future will increase dramatically so that our market share is also a reflection of mix where our high market share markets will become over time bigger and grow our global market share. So it's a very long-term-oriented game. And because of this, it's very efficient and our rate of return on the investment of our market share growth are excellent and I monitor it every day.

The other big driver of market share growth is innovation. As we said, we had a robust innovation; very, very good results in the success of our innovation. In the last years, we have improved it dramatically. Our speed of our innovation is improving; in this moment, we had about 70% of the innovation that we had developed from idea to market in 12 months and many other particularly makeup within six months. This was not possible in the past and this has reinforced our ability to grow market share via innovation in every market of the world.

And then finally, our Leading Beauty Forward activities have created more flexibility for us to invest in advertising and advertising invested in the current way is the other increasing tool and increasing strength for us to grow market share globally.

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**Operator:** The next question is from Ali Dibadj with Bernstein. Please go ahead.

Ali Dibadj

*Analyst, Sanford C. Bernstein & Co. LLC*

Q

Thanks. Hey guys. Fabrizio, that's a very good segue to my question actually and recognizing very much the share gains that you've developed and you're not growing the beauty category even as it slows the gap in fact as to your point continue to expand as you continue to outgrow even further the category.

And I guess my question is what levers do you have at your disposal if the top line of the category slows even more. What levers do you have at your disposal to keep growing top line, keep growing margins if it really gets tougher from here, would you just continue to invest more in advertising and innovation like you just described, would you acquire more, would you lever the balance sheet more and buy back stock more?

Are there new expansion and geographies that you take advantage of? Could you cut costs a lot further? I guess I'm trying to get a better sense of what's the contingency plan if the world gets much tougher from here?

## Fabrizio Freda

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

A

The contingency plan is the diversification of our business in the sense that we believe that the total beauty business globally will continue to grow healthy, as I just explained in the previous question. So we can argue, if this 5% to 6% or 6% to 7%, but those are the recent numbers.

And this is sustainable in the long term as we have explained in our Analyst Day. So that being the base, however as we have demonstrated in this moment, that could be in a given market, a given category, which is softer in this moment, [indiscernible] (38:50) in the United States as an example. And then what we do is that we are able to continue to try to improve in this category and using the softness also to build some market share.

But most importantly, we are going to diversify our investment, our innovation, our marketing activation, our consumer repeat purchase activations and CRMs on where there is growth. And today we have the agility to move investment from maybe temporary soft markets or categories to very, very high-growth market and categories. This agility has improved, thanks to the increase of variable cost and reduction of fixed costs that Leading Beauty Forward provide and our flexibility to invest in advertising when needed.

So basically the answer – the overall strategic answer to your question, the flexibility that we have is part of our multiple engine or growth strategy and the ability to continuously invest on where there is growth or where the return of our investment will be the highest not only financially, but also in term of growth in market share.

Then going more in specific of the flexibility. We have take this quarter – I think this quarter, you can read it in many different way, but for us, it's a terrific demonstration of our multiple engine of growth. We are delivering a 12% market – growth globally and despite color makeup had one of the softer trends in Anglo markets in the last years. Hong Kong has been difficult. And North America business in total had a softer market than expected. Why?

Because we have accelerated [indiscernible] (40:36) market share and deployed innovation in skin care in a terrific way across the globe in every single market because this quarter, 94% of our brands grew; basically all our portfolio is growing because Asia has further accelerated. China has further accelerated. TR has been super strong. Online continued to grow at the same [audio gap] (41:07) for some years. In every single online channel, one data point which is interesting, our direct-to-consumer part of online, meaning where we have direct-to-consumer which include our brand.com and Tmall, has been growing at 40% plus. So we continue achieving more direct content with the consumers via that.

And we have been able, despite this area of softness, to focus also on the area of strengths, adding total to beat our growth forecast. That I think is the key sign that we are trying to explain is the secret is not never having something in the world that doesn't work. With such a big category, something will go wrong somewhere. But now we have the flexibility to move in order to always try our best to deliver the total and progress the total in term of growth, EPS and market share.

**Operator:** The next question is from Rob Ottenstein with Evercore. Please go ahead.

## Robert Ottenstein

*Analyst, Evercore Group LLC*

Q

Great. Thank you very much. I'd like to drill down a little bit more into China and specifically a number of things. First, you noted that China had accelerated. Was that your business and your market share or was it the market as a whole?

Second, as you've looked at and related – as you've looked at the Chinese market over the last 12 months, had there been any changes that you've seen or any adjustments that you've done to give us a little bit better sense of what's going on in the ground?

And then finally, our read of the media that's coming out of China, is that the pre-sales for 11.11 are off to a record start. I mean, really phenomenal presales. Is that correct and has that continued? Thank you.

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**Fabrizio Freda**

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

**A**

So let's start to the core of your question. China market continued to grow, the beauty market above 20%. So the market is super solid. We grew much more than that and we built significant market share. In the quarter, we built almost two full points of market share, so significant market share in the market.

And so both the market and our market share gains are working together in that sense. What is driving that? First of all, we are in China for the long term. We have a local organization which is terrific and understand the local relevance of the market. We are able to invest in all the area of growth. In this moment in China, there is a lot of growth that is coming also not only for Tier 1 and Tier 2 cities, which has been true for some time, but Tier 4 and – Tier 3 sorry and Tier 4 city are accelerating significantly, which is what is reflected in the acceleration of Tmall that you are referring to.

Let me explain what the dynamic here. Historically in China, there was no national advertising. We could invest where we had distribution. So if you had stores in Shanghai, you could invest in print in Shanghai. With the advent of social media, social media is national. And because of this, there is the possibility of creating demand nationally even if distribution for the moment is – our most distributed brand is in total 121 cities while in reality, there is social media impact and demand created in over 600 cities.

So there are hundred of cities with million inhabitants with growing middle class that for the moment do not have access to physical distribution. And obviously, the two drivers of their consumption is TR and Tmall and online brand.com site like ours. So obviously, over time, distribution will increase and physical distribution will make more inroads into these cities. But for the time being, online is basically the way in which demand gets satisfied.

And with that dynamic is a long-term dynamic and will continue for some time independently from temporary or not, softness or economic variations. But this long-term is driven by middle class demographics and by the passion for beauty of the Chinese population and frankly for the Asian population as a whole. So this is the trend and I believe that our position is strong and the forecast for the market in the long term remains as strong as possible.

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**Operator:** The next question is from Wendy Nicholson with Citi. Please go ahead.

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**Wendy C. Nicholson**

*Analyst, Citigroup Global Markets, Inc.*

**Q**

Hi. Two questions if I can. First on the balance sheet. Your cash balance just continues to grow on – and I assume you're in the market or will be soon supporting the stock and buying back more. But just generally, you're

kind of – it seems like you're sort of – there's an aversion to acquisitions these days. But can you talk about, sort of, your interest in doing something more aggressive on the repurchase side? What's your philosophy with that growing cash balance?

And then just secondly, can you remind us – the gross margin has been under pressure now for several years and it just continues to surprise me because skin care I thought was your highest gross margin business. And with that outsized growth, I would have thought gross margin would revert to going back up at some point. So that – a little bit of color there would be great too. Thanks.

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Wendy C. Nicholson

*Analyst, Citigroup Global Markets, Inc.*

Q

Okay. So let me start with your second question, Wendy. In terms of the gross margin, there are many factors that impact gross margin, obviously and clearly, skin care is a benefit from a gross margin standpoint. Certain channels are a benefit from a gross margin standpoint as well. As we've called out, we have given where growth is coming from for us a lot in Asian markets and you're aware of our footprint. We do have more supply chain expenses related to supporting some of the terrific double-digit growth that we've had and certainly that growth being in the Eastern part of the world has increased both inventory levels as well as transit costs.

The tariffs, we've also spoken about the fact that we do have and have included some of the higher tariffs that have been called out in our gross margin as well. So we are seeing some shifts upside related to category mix and some geographic mix, offset by some of those other factors related to freight as well as obsolescence. And some of the supply chain costs related to tariffs, et cetera.

In terms of the balance sheet, our general philosophy as it relates to free cash flow is to return free cash flow to shareholders if in fact we don't have any acquisitions that we are contemplating. We are always in the market looking for the right strategic acquisitions that will represent white space opportunity for us and incremental sales and profit growth. We also have minority investments that we have a path to purchase as well.

So, we definitely consider acquisitions as an important strategic growth opportunity for us, the right acquisitions that again represent a good fit within our portfolio. If we have no acquisitions that are at the right price and represent those white space opportunities, then generally – and we have this discussion every year with our board, we return 100% of free cash flow to shareholders via dividends and share repurchase activity. And you're aware as well, we have also increased our CapEx this year to reinvest back in the business again to support long-term growth.

So I think our capital deployment in terms of the cash, even though you're seeing a little bit extra on the balance sheet is, in the highest return areas in terms of how we strategically allocated for our purposes as well as for shareholder purposes.

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**Operator:** The next question is from Mark Astrachan with Stifel. Please go ahead.

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Mark Stiefel Astrachan

*Analyst, Stifel, Nicolaus & Co., Inc.*

Q

Thanks and good morning everybody.

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Fabrizio Freda

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

A

Good morning.

Mark Stiefel Astrachan

*Analyst, Stifel, Nicolaus & Co., Inc.*

Q

Good morning. A couple of clarifications please. So the VAT benefit in Japan, how much was the benefit? Was it material in the quarter? Is there any expectation that that comes out of the December quarter? And then, your category growth expectation; I was under the impression that you had anticipated a moderation at some point in time in China, when you gave it originally. And so, your comment in addition to North America weakness was, I guess, somewhat surprising or maybe I just misinterpret it.

So, maybe if you could talk about kind of the confluence of those expecting China to already decelerate and yet taking your global growth rate down. And kind of related to the last one, how do you think about North America over the balance of the year? You had talked about it, anticipated to stabilize; is that still the expectation and what does stabilize kind of mean?

Tracey Thomas Travis

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

A

Okay. Let me start. I'll start with your question on Japan. So, as I'm sure you're aware, the Japan market had a VAT increase starting on October 1. So typically – and we have this experience from the last time, there was a VAT increase in the market.

We do see some acceleration of purchases into the month prior to the increase, which is expected. It typically normalizes out during the course of the year. So the reason I commented on the fact that we're coming off of a 7% growth last year from Japan. We certainly expect Japan for the year will normalize out to the levels of very strong growth that we've seen and we're very pleased with the pickup that we've seen in Japan over the last couple of years, really a testament to the great team that we have in Japan and what they've been doing in the market.

As it relates to North America, we did say and I did say in my prepared remarks, we expect gradual improvement. We did talk about the fact that we have seen further deceleration in North America. Fabrizio talked about the color makeup challenges that we, along with others, have spoken about in the market. So depending on your definition of stabilization, we certainly expect to see improvement from the results that we saw in the first quarter. And again, we had some unusual anniversary items in the first quarter as well. But – so we expect to see gradual improvement from the first quarter results throughout the balance of the year for North America.

Fabrizio Freda

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

A

And I think the other part you referred to China. We said, no, our market point of view is that 5% to 6% growth is a super strong growth that will continue at the high end as explained of the historical range, but we have reflected the softening of the make-up, North American market in our global estimate. And then we continue to assume that there could be a softening of the China market in the future. But as I said, we have not seen it yet. I just commented that actually we see an acceleration in this moment. But we believe this is a prudent assumption in the current global economic situation.

**Operator:** The next question is from Fulvio Cazzol with Berenberg. Please go ahead.

Fulvio Cazzol

*Analyst, Joh. Berenberg, Gossler & Co. KG (United Kingdom)*

Q

Yes. Good morning and thank you for taking my questions. Just on that last comment that you made, Fabrizio, about the potential of a slowdown in China. I mean given the comments that you've also made during this call about the contingencies, the diversification of your business, the ability to quickly react and adapt and go after new pockets of growth, how should we then read that in reference to the guidance that you've given? Because I guess if you think about what you've delivered, what you expect to deliver in the second quarter, your full-year guidance implies just over 5% organic growth in the second half. I'm just sort of trying to understand why you couldn't use all the tools that you've got available now to offset potentially some of that China slowdown if and when it comes in the second half to still generate a high level of growth? Thank you.

Tracey Thomas Travis

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

A

So I think – this is Tracey and then Fabrizio will respond. In the second half, we're – I think your numbers are a little soft. If you do the math, it's more in the 6% to 7% range in terms of what we're expecting in the second half of the year with the moderation that we spoke about in – as it relates to China and travel retail. And again, given the global backdrop and the global environment, it has nothing to do with our business. It is really a point of view with respect to what could happen to global markets given the fact that there are global macro slowdowns, even though we haven't in fact seen it in China and haven't seen it affect our Asia business in general, which is quite strong. But it certainly could happen. And so as we plan our business, plan our resources in the second half of the year, clearly if it doesn't happen, then we'll continue to have the kind of results that we had in the first quarter. But we think it's responsible for us to expect what many economists are projecting in terms of a slowdown in the second half of the year.

Fabrizio Freda

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

A

Yes. And by the way, to go to your point, I've explained all our great strengths, strategic strengths, the flexibility, the agility, the ability to leverage all channel. That's why we believe that even if there was a slowdown, we will continue to build market share and we'll continue to be ahead of the market. That's the strengths we've built. And if there will be no slowdown, we will over-deliver and that's what happened this quarter. And it happened frankly even in case there was one element, it actually was worse than our expectation. There was the makeup color market in the US. So even in presence of one element, that was actually a surprise. We still over-deliver because all the other elements, first of all, the strategic execution that I commented on and second, the overall trend of the market in Asia is now slow down and our strategy execution is excellent and so we have over-delivered. And that's the situation.

In this moment, as you see also, currencies have impacted in a way which were different than our guidance just few months ago. So there are many variable that we are trying to take under account, but the strength of our model and the ability to navigate good times and bad times, growing market share, doing better than market, that I believe is by now really proven.

Tracey Thomas Travis

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

A

Thank you for recognizing the fact that we are operating quite well in a very difficult market.

Fabrizio Freda

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

A

Yes.

**Operator:** And we do have time for one final question. That question will come from Linda Bolton with D.A. Davidson. Please go ahead.

Linda Bolton Weiser

*Analyst, D. A. Davidson & Co.*

Q

Hi. So I was wondering if you could comment on this concept of your hero products, which drive your core franchises so successfully. I think in the past, you had commented that some of the indie brands in North America may be weren't so good at that. Have you detected any increased capability on their part to develop these hero products, which could be further threatening to your market share? Can you just comment on that? And also the idea that your costs to attract attention on first trial is rising over time, can you comment on that trend and whether there's been any change there? Thanks.

Fabrizio Freda

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

A

Yes. Interesting question. So as I explained also in my prepared remark, what we define hero products in our portfolio is actually products with high repeat rates and a decent purchase frequency, meaning products that have not only the power to make the consumer loyal, but also they have to bring the consumer to the repurchase return that create traffic in stores for our partners and for ourselves. So these products are very precious in the portfolio and to build product like that, marketing is not enough. You need superior quality and great performance because I know many people, including myself, that is tempted to try new stuff one time to try new things, but I don't know any person that buys these things the second time if this product didn't perform in line with expectation. And that's what we mean.

We invest into high-quality R&D, high-quality manufacturing, safety, clinical test, product that really work and not only they work in term of performance and they have the kind of texture and usage experience that made the consumer delighted about what design and that investments that at the end is the essence of our premium pricing strategy. That investment creates repeat purchase.

This is still a very big differentiator between on average our portfolio and the portfolio of indie brands. If you look at the numbers, the difference in repeat are still significant because also the difference of repeat are driven by quality, innovation and by the ability to delight the consumer over the long term. So we believe this is a strength which is not being mitigated.

In your question, you speak about new threat. Frankly, on that topic, I don't see new threat. Actually, I see new strengths and it is from new strengths for our brands, not for the inde brands. And to prove that, is that this is the first quarter in some time where each one of our big brands is growing globally and the total of them is growing faster than any combination of our indie brands. And so it's really an extraordinary, if you want, proof of the point that repeat purchase is the biggest driver of prestige beauty.

**Operator:** That concludes today's question-and-answer session. If you were unable to join for the entire call, the 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 7996338. 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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