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The Estée Lauder Companies, Inc. (EL)

Q2 2019 Earnings Call

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MANAGEMENT DISCUSSION SECTION

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

For opening remarks and introductions, I would now 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, goodwill and other intangible asset impairments, changes in contingent consideration, the finalization of provisional charges related to the U.S. tax law enacted at the end of calendar 2017 and the new accounting standard for revenue recognition. 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 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. Good morning, everyone. We delivered excellent results in our second quarter, as multiple engines of growth drove constant currency double-digit gains in sales and earnings per share, led by strong advances in our product categories, brands, countries and channels. We strategically invested in the most promising opportunities in our rich digital content engaged consumers, attracting them to our high-quality innovative products. Overall, net sales grew 11% and for the first time exceeded \$4 billion in a quarter. We achieved this milestone despite an extremely challenging and volatile environment, which included softness in two of our largest markets, the U.S. and the UK, and global trade tensions.

This is a testament to our strategic resource allocation, superb execution by our talented employees and improved capabilities throughout the organization. We leveraged our strengths where we had the greatest growth opportunities, including China and Travel Retail, and we further broadened and diversified our growth engines with strong results in the rest of Asia and Emerging Markets, in our fast-growing channels and in most brands. The benefits from our Leading Beauty Forward initiative allowed us to deliver savings and selectively increase our advertising spending, which in turn supported our strong top line growth and enabled us to leverage our cost structure. Diluted earnings per share rose 25% more than twice our sales pace.

Importantly, we accelerated our share growth in global Prestige Beauty in the quarter, which confirmed that our strategy has enabled us to gain share profitably. With an outstanding first half and ongoing confidence that we will continue to effectively execute our winning strategy we are raising our sales and EPS guidance for the year. We

now expect sales growth of 8% to 9% and EPS gains of 14% to 16% for fiscal 2019. In the recent quarter, we benefited from many growth engines throughout our business, supported by strong product innovation and effective marketing, which was informed by improved customer insights and data analytics. Our innovation program is getting stronger. We have developed more robust data and are using it to focus on top priority areas and create highly-desirable products.

The proof is evident in sales from new launches, which have reached an all-time high of nearly 30% of our business and we become even more sophisticated, marrying analytical insight with our innate creativity. We believe our innovation has the potential to reach new heights, also thanks to the improved speed-to-market. Over time, consumer demand for different kinds of beauty products fluctuates and Skin Care is currently the fastest-growing category globally. With agility we deployed more of our resources into this area. Our Skin Care sales grew sharply, while our Makeup and Hair Care categories also posted healthy gains. Our luxury and artisanal fragrance brands were stars in the fragrance area, but the category declined slightly because of some designer fragrances.

Estée Lauder Beautiful Belle was a popular new scent during holiday gifting season. Three of our largest brands grew globally, validating consumer loyalty to powerful, authentic, well-established brands especially when supported by compelling innovation and strong hero products. Momentum continued in our Estée Lauder brand, which climbed double-digit for the seventh consecutive quarter. The brand delivered double-digit increases in every region, and a stellar performance in both Skin Care and Makeup, led by its hero franchises. M·A·C gains were led by a strong international showing and it continues to pivot to fast-growing channels with greater penetration online and in specialty-multi.

La Mer continued its superior results. It gained share in every region in luxury skincare, fueled by growing consumer loyalty to its beloved products and effective digital campaigns that recruited many new consumers. Clinique continued to make good progress. Although its overall results were impacted by declines in North America brick and mortar department stores including the closure of Bon-Ton, nonetheless Clinique Skin Care sales rose globally on the strengths of several key franchises, and we are optimistic about its Skin Care growth in the coming quarters, reflecting expected strong performance from recently-launched innovations. Clinique new hydrating jelly is Dramatically Different moisturizer franchise achieved terrific results across the globe.

The brand's newness innovation, Clinique iD is a breakthrough [indiscernible] (00:07:38) that is custom-fit for consumer needs by offering 15 combinations of different moisturizer and treatments. It launched in the last week of the quarter and is off to a very encouraging start, exceeding our expectation in many markets. Clinique iD has the potential to become one of our company's most exciting launches and addresses consumer growing desire for more personalization. Looking at other brands in our diverse portfolio, our Tom Ford luxury brand resonated very well with consumers. In fragrance brands, Jo Malone London, Le Labo, Frederic Malle and By Kilian achieved double-digit growth.

Too Faced further expanded internationally; it remained highly ranked in the U.S. specialty-multichannel. A key strategy behind our brand success is creating a significant base of profitable repeat business from the go-to consumers while attracting new users with compelling innovations and marketing, and then, the quality of our products turn them into life-long fans. Many of our brands strived in a broad range of markets with diverse consumer needs, showing the power of their global appeal layered with locally relevant insights. We have developed robust analytics and are using the data to help inform our innovation and our communications. Together with compelling storytelling, macro influences and digital advertising, we can now better engage the consumers through our product offerings and marketing. Asia-Pacific continued strong growth at a double-digit rate. China led the advance. Hong Kong and Japan had solid gains and our sales in Korea accelerated.

Virtually every brand generated higher sales in the region, both net and retail, boosted by the hero product and successful locally relevant innovations. Luxury brands have been in high demand in China, and our sales mirrored that trend as they increased strongly. We continue to build share, as Prestige Beauty further accelerated in the market. Every brand, category and major channel grew double digits. Makeup has been gaining favor among Chinese consumers. It now represents nearly one-third of our mix of business there. Within Prestige Makeup, Estée Lauder, M·A·C and Tom Ford were especially popular, [ph] again (00:10:31) significant market share. Online has been growing sharply for many quarters. It now accounts for more than one-third of our sales in China.

We had superb results on Tmall. And with the growing interest in Makeup, M.A.C. was the number one Prestige Makeup brand on Tmall during the entire calendar 2018 and has become number two in Prestige Makeup in the total market. Demand for Prestige Beauty from Chinese consumer has remained strong, in spite of macro issues and potential risks to the economy, including higher tariffs [indiscernible] (00:11:12) and more oversight on Chinese travellers who buy goods offshore for resales domestically. So far, we have not seen an impact and remain optimistic about the long-term health and resilience of Prestige Beauty in China. The industry will be driven by favorable demographics, and we are confident that the large growing middle-class in China will remain passionate about high-quality beauty products.

We note also that other actions, such as the announced tax cuts have the potential to sustain consumer consumption over the next few years. Beyond China, our success in Asia was widespread as we further diversified our growth engines in the region. Our strategy in Japan is to broaden our target consumer reach beyond our primary department store channel. We made excellent progress, further penetrating specialty-multi and online and had rapid growth in those fast-growing channels. With strong fragrance growth in Korea, we gained share, led by our high-end brands, By Kilian, Tom Ford and Jo Malone. Our business advanced in the Europe, Middle East and Africa region, with good underlying momentum in most markets.

We had gains in most emerging markets with the large improvements in the Middle East and delivered increased sales in the group of developed western markets. Even though Prestige Beauty in North America was challenging during the last month of the holiday season, influenced also by the government shutdown and a [ph] weak store (00:12:59) market that impacted consumer sentiment, there were several bright spots in our business. Several brands expanded further in Ulta where we have seen strong growth, including Estée Lauder, M.A.C, Clinique and Bumble and bumble. Many of our brands' holiday sales were popular, including Estée Lauder Blockbuster, which sold through early on.

We saw strong retail sales on department store and specialty multi e-commerce sites as well on our own brand sites. Our global digital agenda is working well and is a key enabler of our company strategy. We continue to support our brands with compelling social media programs, technology advances and growing online initiatives. Across our e-commerce business, our orders [ph] at commercial (00:13:51) increased and the 125 million global visits to our brand sites during the quarter made them highly valuable media assets. Sales on our brand sites, retailer sites and third-party sites all grew double-digits. Several brands had record-breaking days online during the holiday period in North America, for example. Estée Lauder, La Mer and Aveda generated sales record on their sites on Black Friday.

And Clinique's Cyber Monday event was its largest ever. In China, single-day activations boosted many of our brands on Tmall. Sales on our brand stores on Tmall on that day in November rose nearly 80%. And Estée Lauder and M.A.C were among the top five performers in total Prestige Beauty. In Europe we experienced strong demand for our products on third-party sites, including ASOS in the UK and Zalando in several markets in Europe. Our Global Travel Retail business remained robust. Thirteen of our brands grew double-digits at retail. All

categories grew and like-door sales were strong. Our retail sales rose several times more than the pace of global passenger traffic growth, and we lifted our business with successful exclusive products.

La Mer, for example, leveraged the opportunity to reach travelers who arrived in the UK on new flights from China. As a result, its Travel Retail business in the UK sky rocketed. Traveling consumers are showing an increased interest in the convenience of ordering products online before departing on their trips. Our online Travel Retail business, known as pretail sales increased dramatically. It's starting to account for a meaningful share of our business where it is available and is increasing conversion of travelers into buyers. In addition, we are working with travel retail partners to develop alternative online selling models into the channel.

To build on these exciting opportunities, our brands are now developing digital campaigns specifically for Travel Retail. International passenger traffic is expected to continue to increase in the next two quarters, and we have plans to expand our brand presence in airports. For example, we plan to open more doors for our newness artisanal fragrance brands and our new millennial focused makeup brands like Too Faced and BECCA. In closing, we are very pleased with our progress this quarter and in the first six months of our fiscal year. Many of our key brands in countries delivered terrific growth. China remained very strong. The Middle East improved. And our momentum expanded in other emerging markets. Our two fastest-growing channels, Online and Travel Retail, kept up their rapid pace globally.

Our innovations were highly successful, and our hero franchises continued to support growth across the portfolio. We are proud of our financial results and share gains in global Prestige Beauty and are increasing our guidance, even while recognizing certain geopolitical and economic risks in the short term. At the same time, I want to emphasize that historically, Prestige Beauty has been less sensitive to economic downturns because it is an affordable luxury, driven by repeated purchases and loyalty.

Long term, our industry has strong fundamentals, including favorable demographics that should drive solid growth for years to come. In the next two quarters, we plan to invest more behind our innovation to further build our share. To continue fueling our innovation success, we expect to invest behind important new product launches such as Clinique iD, upcoming innovations and popular products and are leveraging our brands during Chinese New Year with robust advertising dollars in beautiful, dedicated products. We are also allocating additional resources to strengthen our capabilities throughout our business. Our strategy is to further build our global share and drive long-term profitable growth. We are very well-positioned to succeed.

Over the last few years, we have streamlined our organization to better capitalize on global opportunities. We have unleashed savings from Leading Beauty Forward and other programs that we plan to invest in the most exciting opportunities to strengthen our leadership and to continue driving profitably. We operate our business with a long-term view and are upbeat in our outlook, thanks to our diverse brand portfolio, wide global reach and talented employees who are successfully executing our winning strategy. We believe that fiscal year 2019 will be another year of exciting sales gain and double-digit EPS growth.

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 second quarter financial results, and then cover our expectations for the third quarter and for the full year. As a reminder, my commentary today includes the adjustments that were mentioned at the beginning of the call by Rainey. All net sales growth numbers I will discuss are in constant currency and comparable accounting methods, unless otherwise stated.

Also, as a reminder, we adopted the new accounting standard for revenue recognition ASC 606, this fiscal year on a modified retrospective basis. For the quarter, the impact decreased our sales growth by 2 percentage points, our operating profit growth by 7 points and our diluted EPS by \$0.11.

And now, for the quarter results; net sales for the second quarter rose 11%, with broad-based growth across most regions and product categories. From a geographic standpoint, our Asia-Pacific region had robust net sales growth this quarter. Net sales overall rose 20%, with many markets experiencing double-digit increases. Sales in China and Hong Kong grew very strong double-digits with most brands, categories and channels contributing to growth. Our sales in department stores in China continued to grow strong double digits, and other channels, especially online, rose even faster. We also achieved excellent mid-single digit sales growth in Japan and Korea, with growth across all channels, including department stores, specialty, multi, and online.

And other markets such as Taiwan, Thailand, Malaysia and Indonesia also contributed to the region's growth with our sales in Australia declining slightly. Net sales in our Europe, the Middle East and Africa region rose 16%, driven by strong double-digit increases in both our Global Travel Retail sector and our Emerging Markets in the region. Double-digit like-door growth across most brands drove the majority of the increase in Travel Retail, and expanded consumer reach for brands such as Jo Malone London, Tom Ford and M·A·C, also contributed to growth. Outside of Travel Retail, the Middle East, Turkey and Russia led our Emerging Markets growth in the EMEA region. Western European growth was mixed, with Greece and Italy particularly strong and Germany more challenged.

Our UK business declined 2%, as macro issues dampened consumer spending, including the uncertainty over Brexit, with the greatest impact felt across brick-and-mortar distribution. The online business remained a brighter spot, as consumers continued to shift their spending to online. In online, we had solid growth across most retailer and third-party sites. House of Fraser, one of our largest department store customers in the UK, has been reorganizing under new ownership, and we therefore reestablished trading with them in November. Net sales in the Americas declined 3%. Excluding \$22 million in prior-year sales to Bon-Ton, the region sales would have declined 1%. North America continued to achieve solid growth online with strength across both retailer and brand sites, while much of brick-and-mortar sales in North America softened in December, net sales in the specialty-multichannel continued to grow particularly in Ulta.

Latin America sales were flat overall as growth in Mexico, Brazil and Argentina was offset by a decline in Venezuela. Skin Care again led product category growth this quarter. Net sales grew 22% with very strong global contributions from the Estée Lauder and La Mer brands. Both brands had successful new products as well as growth in existing franchises. Our Origins brand also delivered a terrific performance in Asia and Travel Retail reflecting increasing demand for the brand's key product lines. Net sales in Makeup grew 6% led by strong demand for Double Wear Foundation in Asia and Travel Retail as well as a greater focus on Makeup in our U.S. holiday offerings. M·A·C and Tom Ford continued to resonate with Chinese consumers and BECCA saw double-digit gains from its holiday program and other new products.

Net sales of fragrances declined 1% as declines in designer and Estée Lauder fragrances offset gains in luxury and artisanal brands. Our Hair Care net sales rose 6% primarily driven by Aveda's recent launches and strong online sales. Our gross margin declined 250 basis points compared to the second quarter last year due entirely to the impact of the new accounting standards, which negatively impacted our gross margin by 240 basis points through the reclassification of samples, testers and collateral to cost of goods from operating expenses. Additionally, favorable mix impacts of 85 basis points were mostly offset by adverse foreign currency and obsolescence. Operating expenses as a percent of sales improved 280 basis points.

Major drivers of the improvement include 180 basis points related to the new Accounting Standard for Revenue Recognition, 130 basis points from lower selling cost and 90 basis points of savings in general and administrative cost. We reinvested 120 basis points more in A&P to drive the business and still realized expense rate improvement. Operating income rose 8% and operating margin increased by 20 basis points. Excluding the impact of the new Accounting Standard operating income rose 15% and operating margin increased 120 basis points. Diluted EPS of \$1.74 increased 14% compared to the prior-year and grew 18% in constant currency.

Earnings per share for the quarter included \$0.05 of unfavorable currency translation. Diluted EPS, excluding the impact of the accounting change, was \$1.86, an increase of 22% compared to the prior-year or 25% in constant currency. For the six months we generated \$1.27 billion in net cash flows from operating activities, which was slightly below the prior-year due primarily to investment in inventory to support our international growth and some timing differences in payables and receivables. We invested \$292 million in capital expenditures and we returned significant cash to shareholders. We used \$1.13 billion to repurchase 8.2 million shares of our stock, and we paid \$297 million in dividends, essentially doubling the value of stockholder distributions this year compared to the first six months of last year.

During December, we took impairment charges of \$38 million for goodwill and other intangible assets related to the Smashbox brand. This action reflects a slowdown in the brand's Makeup sales driven by increased competitive activity and slower than expected growth in key retail channels for the brand. The charges represent less than 20% of the carrying value of Smashbox's goodwill and other intangible assets. Now let's turn to our outlook for the third quarter and for the full fiscal year. We've had an outstanding first half which should reinforce confidence in our full year guidance; however, there are still a number of macro risks and opportunities encompassed in our outlook for the second-half. These include uncertainties caused by political instability and soft economies in certain markets, including the UK and Europe, with the Brexit deadline impending shortly.

Soft January retail trends in some areas of the U.S. also influenced by the government shutdown, strong but somewhat moderating growth in China and Travel Retail, the impact of expected additional tariffs in China and comps in the U.S. easing, as the impact of Bon-Ton sales in the prior-year declined in our second-half. As Fabrizio mentioned, given the strong first half performance, we are raising our expectation for full year net sales growth to 8% to 9% in constant currency, excluding the impact of the new accounting standard. Currency translation is expected to negatively affect reported sales growth by 3 percentage points, reflecting rates of \$1.147 for the euro, \$1.283 for the pound, and ¥6.874 for the yuan for the full fiscal year. We now expect the impact of the new accounting standard to be immaterial to net sales growth for the full year.

We are raising our EPS expectations to a range of \$4.92 to \$5.00, before restructuring and other charges. This reflects a slightly-lower effective tax rate estimate of 22%, approximately \$0.22 of dilution from currency translation, and \$0.01 dilution from the new accounting standard. In constant currency and with comparable accounting, we expect EPS to rise by 14% to 16%. For the third quarter, net sales are expected to increase approximately 8% to 9% in constant currency and using comparable accounting. Currency translation is expected to negatively impact growth by 5 percentage points and the accounting change is forecasted to add 2 points to growth.

Therefore, we expect reported net sales to grow between 5% and 6%. EPS is forecasted between \$1.26 and \$1.28 before restructuring charges. This includes approximately \$0.09 of dilution from currency and an \$0.18 benefit from the new accounting standard. With a strong first half of the fiscal year behind us, we are focused on investing further behind key launches, digital outreach and brand expansion to support future growth in North America and continued strength in other markets. We have the flexibility to make these investments in our

second-half, while delivering another successful full year of solid top line growth, margin expansion and double-digit EPS growth, as reflected in our increased guidance for the year.

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 the line of Olivia Tong with Bank of America.

Olivia Tong

Analyst, Bank of America Merrill Lynch

Q

Thanks. Good morning. Wanted to start on China because the growth there obviously continues to be fairly impressive. First, if you could talk about the overall environment because some of your luxury peers are also saying that they haven't seen a slowdown yet. But in terms of your outperformance, how much do you think is the environment has held up better than a feared versus the actions you're taking; growing market share, positioning yourself in faster-growing channels, launching more brands, more online initiatives, all these things. And can you give us a sense of where your comp growth is versus what's come from new brand launches into either the market or also online? Thanks.

Fabrizio Freda

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

A

Okay. So the environment of Prestige Beauty – I want to be clear is strong. Actually, as we said in our prepared remarks, the Prestige Beauty market in the quarter has further accelerated growth. And our performance within that market is very, very strong because we continue to build market share even in an accelerating market. So to answer directly your question, our program is working very well and we are very satisfied, so there is a lot of our specific activity which is working; that's why we are growing market share. But the market also remains solid.

This is the Prestige Beauty market. It's not necessarily the total economy, which is different, which shows that Prestige Beauty is particularly resilient in China versus the total market, and this comes from the passion of consumer for the category, for the growth of the middle-class and very importantly, from the role of young people in the overall Chinese consumer base. China is a very special market, where the young generation is consuming more than their parents in many areas, but particularly in Prestige Beauty, where the market share of prestige and luxury in the young generation is bigger than the market share in prestige and luxury in the more adult consumer. That's why Prestige Beauty in this moment is doing well and is also, in general, more resilient than other categories in China.

Operator: Your next question comes from Ali Dibadj with Bernstein.

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC

Q

Hey, guys. So wanted to better understand and maybe help quantify what is actually in the expectation or in your guidance, particularly along three dimensions? One is North America. Can you talk a little bit about that by channel? It looked like specialty-multi slowed a little bit. I want to get a sense of the growth there by channel. Two is, again, just on China. Tracey, I think you mentioned "somewhat moderating" – of solid but somewhat

moderating in China. I just want to understand what you put into your guidance there. And then, any more you can give us about the return on those investments you're making in the second half? Just try to help us understand the expectations you're setting on guidance. Thank you.

Tracey Thomas Travis

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

A

Okay. So I'll start in terms of the Americas in the second half. In general, we are expecting slightly improved performance in the second half from the Americas region and in particular in the U.S. for a couple of reasons. One, obviously, as we mentioned, we are not anniversary-ing the Bon-Ton shipments from the first half of last year, so that will represent some improvement. At the same time, we're cognizant of the fact that January, as we mentioned in our prepared remarks, Ali, has been quite soft.

And everything from weather-related issues to obviously the government shutdown, I think, has impacted consumer sentiment in the U.S. in the third quarter. We also have very strong innovations that, as I mentioned, we are supporting globally Clinique iD being one of them and really focused on our largest brands, some of which will be announced later. And that, well, also we expect those to do quite well and we are investing incremental advertising in the second half in North America behind those programs. So, from a channel standpoint, we expect some improvement in department stores, some – continued good performance in specialty-multi, in particular, with the traction we've seen in Ulta and Shoppers Drug Mart in Canada and a few others and online. Online continues to grow nicely across all of the channels of distribution, retailer.com, as well as our own brand.com sites.

In terms of the return on the investments that we're seeing in the second half, we, obviously, have tremendous amount of experience and Fabrizio suggested in his prepared remarks the improvements that we've made internally in terms of our data analytics. So, we have lots of information to inform not only the new products that we're launching in the second half of the year but how to communicate and what to invest behind in terms of marketing those products and what generates the highest return. So, that is a continual area of increasing improvement for us. And, obviously, as we have seen in the first half, we showed that we actually have good return on the investments that we've made in that area.

Operator: Your next question comes from Wendy Nicholson with Citi.

Wendy C. Nicholson

Analyst, Citigroup Global Markets, Inc.

Q

Hi. Good morning.

Fabrizio Freda

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

A

Good morning.

Wendy C. Nicholson

Analyst, Citigroup Global Markets, Inc.

Q

Can you talk about the margin on Skin Care? I mean, it's phenomenal and I guess if you can unpack that a little bit. Is it more driven by channel? Is there less promotion in that? Is that a function of Leading Beauty Forward? Is it the growth in China? And you just have to spend less to support the brands there. Just trying to get a sense for a 30-plus-percent operating margin in Skin Care. How sustainable is that going to be going forward? Thank you.

Tracey Thomas Travis

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

A

So, I'll start and Fabrizio may add to it, Wendy, but thanks for the question. So Skin Care grew at 22% in the quarter, and that's a combination of great innovation. The investment that we put behind Skin Care in all markets, but in particular where we saw the greatest momentum which was in Asia as well as in Travel Retail, and we saw the benefit from those results, so that really is the predominant driver of the better margin in Skin Care. Skin Care is also benefiting from the investments in Leading Beauty Forward both in terms of lower-cost as well as some of the investments we've made in digital and social capability internally that's allowed us to market the Skin Care products in a better way, so I mean, those are all contributing factors to Skin Care.

Fabrizio Freda

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

A

Yeah, and just to add that the profitability is also improving in Skin Care because of the strong growth is leveraging our cost base in an amazing way, and the strong growth is generated by our much more accurate ability via the user data to identify target groups and ways to reach the target group be it a channel or an investment in advertising and digitalization. So the new model we are developing which is more databased is making the growth stronger and the stronger growth is leveraging our cost structure better.

The other thing is – the second point is Leading Beauty Forward is really transforming our P&L structure and taking money from fixed-cost to advertising, and within advertising and promotion to be clear, the entire increase is advertising. Promotions are flat despite our strong business growth. With that dynamic, advertising is much more flexible. Advertising is the resource that you can move from a working initiative from taking down initiative which is not working very fast from a market which has a good momentum, or out of a market that doesn't have a good momentum, so we had basically made our resources much easier to allocate with speed to the biggest opportunity around the globe, and this improved agility is increasing return of our resources and this is very evident in this moment, particularly on Skin Care.

Operator: Your next question comes from Steve Powers with Deutsche Bank.

Steve Powers

Analyst, Deutsche Bank Securities, Inc.

Q

Yes. Hi. Can you hear me okay?

Tracey Thomas Travis

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

A

Yes.

Steve Powers

Analyst, Deutsche Bank Securities, Inc.

Q

Okay, great. Thanks. So I actually wanted to follow-up on Fabrizio's comments there, surrounding Leading Beauty Forward. Both for an update on the benefits you're achieving, as well as – as for more perspective on the costs of achieving them. I think if my math is correct, and my records are correct, since the start of the year, you've raised your anticipated restructuring cost now by about 50% at the midpoint. So again, just hoping you could elaborate on what initiatives are driving that increase? What portion of those costs are cash? And whether we should view this as you pulling forward program cost and benefits or whether this is in effect – an increase in the overall program, both in terms of the costs to achieve but also hopefully the benefits also? Thanks.

Tracey Thomas Travis

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

A

So I'll start and then Fabrizio might add to this. We did raise the expected benefits as well as costs of the program at the beginning of the year, so we're now expecting the full program cost to be \$900 million to \$950 million, and the benefits to be \$350 million to \$450 million once the program is complete, the full annualized benefits from the program, so yes, you are seeing higher charges this year related to that increase. The increase is driven by adding more programs to Leading Beauty Forward. We launched it in 2016. This is the last year of charges for Leading Beauty Forward, and then we realized the benefits from the ongoing programs execution.

So that's the reason why you're seeing higher costs from the program. In terms of the elements of the program, we have a number of Supply Chain initiatives in the program to increase agility and reduce inventory levels and speed-to-market. We have supported an accelerated transformation in our digital and social capability through the Leading Beauty Forward initiative and have incurred restructuring charges related to that. We've established shared service operations in the organization and that has allowed us to leverage growth which you saw certainly this quarter in our sales, much more effectively and flow more dollars to the bottom line.

We have investments and savings from our procurement programs, and that has allowed us to achieve more savings in our indirect procurement spending, which we expect to continue going forward. So there are many different areas under Leading Beauty Forward that we've invested behind in the program over the last two-and-a-half, almost three years now that we've been managing the program in order to drive the kind of results that we're seeing now and expect to see in the future.

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Operator: Your next question comes from Erinn Murphy with Piper Jaffray.

Erinn E. Murphy

Analyst, Piper Jaffray & Co.

Q

Great. Thanks. Good morning. I guess my question, Fabrizio, is for you on the comments you made on pretail Travel Retail sales. It sounds like that's become more of a sizable portion of the overall business. Can you just share a little bit more about that? And how do you think about the expansion plan for pretail? And then I guess any comments on what you're seeing from a customer base with Clinique iD? Is it reactivating a lapsed consumer or bringing in a new customer? Thanks.

Fabrizio Freda

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

A

Yeah, so pretail is, as I explained in my prepared remarks is basically the possibility when you have a ticket, you're making a journey. You could instead of buying in the airport, you could buy online before coming to the airport and then you will get the products at the airport; in some cases on the chair of your aeroplane. And that today is mainly in Korea. And I would say is only significant in Korea, so is the beginning of the learning about this area, but in Korea where this has started is becoming a significant part of the business.

We believe it is a pretty good idea. First of all it's a good service to the consumers that can decide to shop while traveling even without investing the time to go to the stores, et cetera. So it's a good convenience process for the consumer. But interestingly, as an input in improving conversion because we know that we estimate between 10% and 15% of the travelers buy anything. Obviously, if you had the possibility more conveniently to buy early online and taking your time to choose, this can increase the amount of conversion. So this can be over time another booster of the overall market potential in Travel Retail in our opinion because it can be a conversion

booster over time. But to be very clear, for the moment is a Korean, mainly a Korean reality. Second question is Clinique iD.

Erinn E. Murphy

Analyst, Piper Jaffray & Co.

Q

Yes.

Fabrizio Freda

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

A

We see very, very promising initial results from Clinique iD. The consumers are very interested. They're trying the product and by the way, the advertising spending behind the brand is just starting and we will see more in the next months. And the large majority actually will be in quarter four, so there is a lot of great programs that in the next six, eight months will then hopefully bring Clinique iD to the levels that we believe has the potential to go. As I explained in my initial comments, is that the idea of personalization and – is very much appreciated by the consumer. And the personalization opportunity together with the high-touch services that Clinique provides in every touch point with the consumer together with the data and information that we have, what are the concerns that people have and our ability to focus the personalization on the most promising concerns that Clinique can address. The combination of these factors, we believe, has strong potential.

Erinn E. Murphy

Analyst, Piper Jaffray & Co.

Q

Thank you.

Operator: Your next question comes from Nik Modi with RBC Capital Markets.

Nik Modi

Analyst, RBC Capital Markets LLC

Q

Yeah, thanks. So just a quick housekeeping and then the real question. Just on the cash flow, I see for the first half of the year, cash flow has been lagging, operating profit growth. So just wanted to get some context around that. And then the broader question is when you really think about how much your channel mix has been diversifying, I'm just curious if you're finding opportunities on the sampling line. My understanding is that that's a decent size nugget in the P&L, and so I'm just curious if you're finding opportunities to save money in that area. Thanks.

Tracey Thomas Travis

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

A

All right, Nik. So on the cash flow, as I mentioned in the prepared remarks, that our cash flow was a bit less than last year, really primarily related to working capital. Given the strong growth that we've had two-years running now, we certainly are staging quite a bit of inventory to support growth going forward, so that combined with we had some very aggressive programs last year as it relates to payables. We're still seeing improvement in payables and receivables, but less improvement than we saw last year, which was as you recall a record year for us in terms of cash flow growth. So that's really what's happening in the cash flow, still quite strong as it relates to cash generation, strong enough that obviously, we repurchased a fair amount of our own stock in the first half with the excess cash that we had.

Fabrizio Freda

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

A

Sampling.

Tracey Thomas Travis

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

A

Yes. So sampling, in terms of the channel mix and the samples – with the growth of online, that does require some sampling in certain markets, so certainly in venues in Asia and in Tmall in particular, we do have a lot of samples in that venue. Less so in Travel Retail and a bit more mix in specialty-multi but certainly as we see the shift out of department stores, I would say samples in general, the cost has come down, but certain channels do require more samples than others, but overall, sample cost is coming down.

Fabrizio Freda

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

A

And the only thing I want to add is that we have done some great work in the cost-per-sample, but the idea is to invest more in more samples in the future, because trial is when you have high-quality products with the kind of repurchase rate that we have – being able to create early trial with the proper sampling is a great, great opportunity. And so we will continue to invest in the number of samples particularly on our new upcoming and very promising innovations, but we are reducing the cost-per-sample.

Tracey Thomas Travis

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

A

And are being more targeted in terms of the products that we're offering samples in.

Operator: Your next question comes from Rosie Edwards with Berenberg.

Rosie Edwards

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

Q

Yes. Good morning. Just a quick follow up on China. You emphasized Prestige a number of times when describing the market conditions. Do you think that there the share gains of Prestige versus other channels in China have increased, largely the mass market here? And then just very quickly, no mention of France at all. Am I right in thinking therefore there was no disruption from the Yellow Vest riots that we saw in Q4? Thanks.

Tracey Thomas Travis

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

A

So I'll take the second question in terms of France. We did see growth in France, obviously a bit slower given some of the protests as you mentioned, but we did see growth in France. So I talked about Western Europe had mixed performance, but France was one of the markets that actually did grow.

Fabrizio Freda

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

A

Yeah, no, France was good, and your first question on China, yeah, what we mean is that again, the phenomenon of the young people in China and the middle-class in general to [ph] trade out (00:51:19) to high-quality products is continuing, and is actually accelerating. So our view of the market is that high-quality is paying out and the trade-up to quality is continuing, even in a situation where there are more economical concerns than in the past.

Operator: Your next question comes from Dara Mohsenian with Morgan Stanley.

Dara W. Mohsenian

Analyst, Morgan Stanley & Co. LLC

Hey, guys. So the comments on North America...

Q

Tracey Thomas Travis

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

Hi, Dara.

A

Dara W. Mohsenian

Analyst, Morgan Stanley & Co. LLC

Hey, how are you?

Q

Tracey Thomas Travis

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

Good.

A

Dara W. Mohsenian

Analyst, Morgan Stanley & Co. LLC

So the comments on North America were helpful in terms of we called a season and obviously the January issues, but Fabrizio, I was hoping for more of a longer-term perspective sort of setting aside January and moving past that. Do you think North America can get back to consistent growth going forward as you look out to next fiscal year and beyond, particularly with the growth in Specialty and Online, and maybe just preempt tonight's speech a bit, and give your own State of the Union on North America and thoughts there? And then also, on the margin side, obviously we've seen some large compression over the last few years, so can that reverse at some point going forward? Or do you expect to see continued investment there? Thanks.

Q

Fabrizio Freda

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

Yeah, so on, I'll start with the trend in North America. Absolutely, we believe – we are on the process of turning around our North America business and we believe that we will go back to growth in North America. To put again more perspective on the last quarter, the quarter was pretty solid in November included and December has been a very soft mark. And then as Tracey explained, also the beginning of January continued the trend. We attribute at least part of that to the government shutdown to the overall consumer sentiment. It was not an easy moment to spend a lot of money in December, but our performance in November was very positive.

A

So, when we look at the quarter results in the U.S., particularly, the market was flat. Now the market before was growing 5%, 7%. So, all the difference that we see in our performance in the U.S. in the quarter is frankly is the market is not what we are doing in the market for the long term. So, our agenda for the long term is unchanged. And what is it? First of all, we are investing more money. We will have more advertising power on the right priorities in the U.S. and we will see some of it taking place in the next six months, particularly in quarter four behind some great innovation that, with the help of data, has been tailored to the American consumers even more than the past in many aspects.

Our analytical efforts are also helping our U.S. team to have a much more granular analysis of what are the opportunities by group. For example, we are focusing our existing hero products more on the Hispanic target group, where we didn't have sufficient market share as an example. And our field restructuring that will be fully in place by the end of this fiscal year, will allow us to execute this further tailoring by American region and groups in a much more accurate way than we ever been able to do in the past. And then, to your point, the expansion in the fast-growing channels is accelerating and we are going to be in a situation where the majority of our business will be in fast-growing channels and the percentage will further increase and obviously this will help the pivot.

And I want to underline, we are still working very collaborative with our department store partners to restart growth in department store, which we believe is absolutely a possibility also thanks to the very encouraging results that in e-commerce happening in our department store partner – with our department store partners. So, it's a combination of factors that we believe will bring U.S. again to growth in the future. And then, when this will start impacting will also depend from the overall market in the U.S. and how the overall market situation will evolve and how the overall consumer sentiment in the U.S. will evolve. But for the long-term, we are absolutely focused on that. On margin?

Tracey Thomas Travis

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

A

Yeah, Dara, and then on margin, just a reminder that our Americas sector does include a portion of our corporate expenses. So, in terms of what happened in the quarter, the Smashbox impairment that we mentioned was charged against the Americas segment. The revenue recognition impact from a profit standpoint was \$21 million as it states in our press release. And then, we had some of the investments that we made in IT and a few other areas that also impacted the Americas segment.

We certainly expect that when the Americas segment returns to growth that we will start to see the impact from a margin standpoint. The Americas region itself is strong from a margin standpoint. But because we have some of these other items in here, it does suppress, as it always has, some of the margin results. And, certainly, as the sales growth has softened in the Americas, we're seeing that impact in the quarterly results currently.

Operator: Your next question comes from Caroline Levy with Macquarie.

Caroline Levy

Analyst, Macquarie Capital (USA), Inc.

Q

Thanks so much, and good morning. I'm going to pivot back to China and just ask you, for your perspective on the changes that might happen amongst daigou, the resellers who buy in Travel Retail, who, I think, are now required to have a tax ID to resell in China. So just to talk about whether you think there is an impact, has been an impact, will be an impact. And then you mentioned tariffs, and we also know that there's some lower import taxes, I believe, in the Beauty segment. So putting all these different things together, how do you think each of them play out?

Fabrizio Freda

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

A

So comment on the daigou phenomenon. First of all, our Travel Retail business has not seen the impact from strict enforcement through January. So we don't see the impact so far. It is also important, however, to remember that we at Estée Lauder companies have a long-standing policy that limits the numbers of products that a single consumer can buy at any counter in our Travel Retail globally – since ever. So we were never benefiting from a

lot of the daigou business because of our strict policies to avoid any phenomenon like this and, obviously, to limit any risk of gray market around the world.

So this policy that has been restricting us in the past is turning probably to be an advantage today, because we see less of the difference, and we believe we will see less of the difference – whatever will be the implication of this new legislation. To be clear, for the moment we do not see an impact. And the other important thing is that that we believe that, in general, the items of Prestige Beauty are at the end affordable luxuries. So people can still buy, given the new regulation, something which is lower price and still makes purchase again within our policy. And so this will continue being more actionable on low cost items than on very expensive items. And so I believe there will be also this differentiating factor over time.

And then we continue to focus our efforts also on the drivers of our Travel Retail business for the long term independently from the daigou issues. So we continue to target to the international passengers and to the rising middle-class working on our corridors. We continue really increase the distribution of our new brands. We continue the conversion of travelers into shoppers, as I explained before, also helped by the potential in the long term of the pretail system. We continue to deliver more services and exclusivity to the channels also in terms of exclusive products. So all these great actions that we're doing in the Travel Retail for the long term, I believe have the potential to more than offset whatever will be the limitation created by that phenomenon. So that's the [indiscernible] (01:01:00). Sorry...

Tracey Thomas Travis

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

A

And then, Caroline, as it relates to China, as we mentioned, any expected tariffs that have been discussed we've included within our guidance. So that's certainly in our second half expectations, both as it relates to margin and expenses. And as it relates to the import duties, yes, certainly over the last few years now, there has been a steady increase in import duties. As we've stated previously, we have passed those savings on to consumers. We do believe that, that has stimulated some of the growth in China, for sure, for all of the Prestige Beauty players who have done the same. And in addition to that, with some of the tax cuts that Fabrizio mentioned in our prepared remarks that are expected to benefit Chinese consumers this year, income tax cuts. That also is another stimulus that we think will support continued growth in Prestige Beauty.

Fabrizio Freda

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

A

And the last thing I wanted to add is on Travel Retail particularly, is that the impact of our increased advertising investment in the key countries where the big populations that travel [ph] are origin (01:02:24) is frankly the biggest driver of Travel Retail. The Travel Retail business is driven by our ability to create demand and aspiration for our brands and our great products in the country of origin of the travelers. The Travel Retail business without these investments, without these great brands that we're proud of, obviously, will not flourish just because of whatever system and whatever promotion or whatever price or duty discounts, so the key idea is that what we are seeing in our Travel Retail business is also the results at the end of what we discussed before, meaning the Leading Beauty Forward system, liberating more resources, our ability to invest these resources in advertising in the key markets and improved innovation programs that goes with it, all of this is the main driver of Travel Retail and we should not forget that.

Tracey Thomas Travis

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

A

And that's the main driver in China. We've seen the same in Russia, Brazil and other markets that have large traveling consumers purchasing.

Operator: Your next question comes from Lauren Lieberman with Barclays.

Lauren R. Lieberman

Analyst, Barclays Capital, Inc.

Thanks. Good morning.

Q

Fabrizio Freda

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

Hi, Lauren.

A

Lauren R. Lieberman

Analyst, Barclays Capital, Inc.

Hi. I just wanted to ask something about the Middle East. So that's a business that you called out is very strong, I know it's been super choppy to say the least given distributor route-to-market, so if you could just kind of give us an update on any changes you've made in the route-to-market, anything you've been able to do, or maybe not, to kind of smooth out shipments versus demand and manage that business differently than maybe had been the case two-years ago?

Q

Fabrizio Freda

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

Yeah, I have to say, what we are seeing today is just the beginning of the plan we have to reinforce the Middle East in many aspects, because what we are seeing today is more of a readjustment of the stock. You remember when there was the big slowdown, all of a sudden we have two high stocks in the market and when because of the sudden slowdown, the stocks were very high. In the long chain that you just described, what happens is that people don't buy the new products fast enough because they have stocks of the old products, and this slowdown, even the ability to create more consumer interest, so we have been breaking this negative cycle.

A

We have gone back to have a more reasonable level of stocks, which means more orders of the new and more ability to involve the consumers which is at the end what really counts on the power of our innovation and the power of our brands, and doing that, we have seen an improvement of trend, so that's the current situation. In the future, we will make further improvements. We have brands that have very high-potential, that can be further leveraged. We have regions in the Middle East which have high-potential that can be further leveraged, and we have obviously the ability to invest more in advertising on the new innovation, but to be clear, this is not yet in the results we have published so far, but has the potential to be in the next couple of years in the Middle East.

Lauren R. Lieberman

Analyst, Barclays Capital, Inc.

Thanks so much.

Q

Fabrizio Freda

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

You're welcome.

A

Operator: That concludes today's question-and-answer session. If you were unable to join the entire call, a playback will be available at 1:00 PM Eastern Time today through February 19. To hear a recording of the call, please dial 855-859-2056, the passcode is 8459666. 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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