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# The Estée Lauder Companies, Inc. (EL)

Q3 2019 Earnings Call

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## MANAGEMENT DISCUSSION SECTION

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

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

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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 our reports filed with the SEC, where you'll find factors that could cause actual results to differ materially from those 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, the net gain on liquidation of an investment in a foreign subsidiary, 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, which benefited our results this quarter.

All net sales and EPS growth numbers are in constant currency and exclude the impact of the new revenue recognition accounting standard. 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.

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### Fabrizio Freda

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

Thank you, Rainey, and good morning, everyone. We delivered another quarter of outstanding results, thanks to strategic investment in our best opportunities, combined with activity and data driven insight that fueled our innovations.

Our double digit constant currency growth in both sales and earning per share came from being well diversified across categories, brands, geographies, and channels, our multiple engines of growth, all while staying 100% focused on Prestige Beauty, one of the fastest growing consumer areas worldwide.

Our net sales growth accelerated to 12%. We continued to gain global share. We invested some of the savings generated from our Leading Beauty Forward initiative into targeted advertising, which helped support our increased sales and leveraged our cost structure. Our diluted earnings per share rose 17%.

As you recall, when we reported last quarter, we were cautious in our outlook, as it related to several macroeconomic and geopolitical factors around the globe. These includes a prudent stance on the United States, given the industry slowdown in December. We also anticipated that the uncertainty surrounding Brexit would continue to dampen consumer spending in the UK.

Lastly, we factored in a gradual moderation of growth in China and Travel Retail, due to trade tensions and economy slowdown risks.

While some of these risk materialized, particularly, the softness in the U.S. and the UK markets, slower growth in China and Travel Retail did not happen, which contributed to our overachievement in the third quarter.

The key areas that have been driving our strong performance this year continue to be vibrant. They included the Asia-Pacific region, the Skin Care category, the Estée Lauder, La Mer, and Tom Ford beauty brands and several other brands, and the Travel Retail and Online channels. In addition, most emerging markets grew. In particular, we continue to attract and retain consumers in India and Russia with locally relevant products and compelling social media.

In total, our strategy is working and produced again exciting results. Skin Care continued to be our largest and best-performing category, which reflected global trends. With increasing demand for Skin Care around the world, we devoted more resources to this area. And our sales rose sharply.

Our Makeup business climbed solidly with strong results across many brands in our portfolio. And our fragrance sales were healthy, driven by our high-end artisanal and luxury brands.

Having confirmed the strength of our business this quarter, we are raising our full year sales and EPS guidance. We now expect sales growth of 10% to 11%, well above our long range goals and the industry, and EPS growth of 18% to 19% for fiscal year 2019.

During the quarter, three of our four largest brands grew globally, demonstrating the popularity of established loyalty driven brands, offering high quality products backed by decades of science and creativity. Our largest brands continue to enjoy strong repurchase rates for their hero products, while also attracting new and younger consumers with compelling innovations in digital storytelling.

But one of our stronger brands was our namesake Estée Lauder, which has now delivered eight consecutive quarters of double digit growth. This quarter increase was the strongest one yet. Estée Lauder sales rose in every region, and its Skin Care, Makeup, and Fragrance business each grew double digits globally.

Estée Lauder had terrific initial success with a new product, Micro Essence with Sakura Ferment (sic) [Micro Essence Skin Activating Treatment Lotion Fresh with Sakura Ferment] (6:12), which launched in Japan before rolling out globally. The idea for this innovation came from local insights and data analytics and was created as a watery lotion that provide a strong skin foundation for a translucent glow. The formula and benefits are locally relevant to the target Asian consumers.

In the lotion's first month on counter, sales of the Micro Essence franchise more than doubled and lifted the entire brand. Importantly, the lotion attracted younger consumers. We estimate over 30% of the new consumers buying the product in the first six weeks were millennials. It is now rolling out in the rest of Asia and in key traveling corridors.

Clinique overall sales declined slightly. However, its Skin Care category increased globally, driven largely by Clinique iD, an important innovation that has successfully attracted new consumers, younger and multi-ethnic consumers. And it has performed particularly well in the specialty multichannel, making it a big win.

Clinique iD's strengths, the brand Dramatically Different Moisturizing franchise, enabling users to customize a moisturizer with one of five treatments, creating a truly personalized experience. In addition, the brand's social media activity around the world won a Webby Award.

In Makeup, Clinique introduced a new foundation, Even Better Refresh, which incorporates repairing and hydrating Skin Care benefits. And in the U.S., it helped increased sales in its entire Even Better franchise, which is one of its core hero lines.

On M·A·C brand, our M·A·C brands grew globally on the strength of its international business, driven in part by terrific consumer response in Travel Retail, where it launched its first campaign specifically for the channel across all regions. M·A·C China sales soared. And it was the number one Prestige Makeup brand on Tmall. Several new pure play platforms in Europe, including ASOS or Lookfantastic, contributed to its strong e-commerce sales.

M·A·C also continued to make progress in Specialty-Multi and opened in Sephora in Canada, where it quickly became the number one lipstick brand.

Our fourth brand with annual sales over \$1 billion is La Mer, which grew rapidly and gained share in many markets, including France, Italy, or across total Asia.

Recent innovations and engaging social media programs recruited new and younger consumers. As an example, La Mer relaunched one of its core products, called The Concentrate. During the first four weeks in China, sales of The Concentrate grew by 60%. And more than half of the consumers were new to the brand, drawn in by successful digital marketing.

La Mer also enjoys one of the highest repurchase rates. And that trend continued with large base of loyal consumers who are devoted to the brand and to its products.

Our two fastest growing channels continue to rapidly expand. Travel Retail delivered outstanding results. And its growth drivers were well diversified. We had a double digit net sales gain from each one of our top five brands, the two largest geography region within the channels, and the Skin Care and Makeup categories, which strengthened our leading position in Prestige Beauty in Travel Retail.

We developed many activities with focused products that capitalized on higher traffic during the Chinese New Year. Our Estée Lauder brand, for example, opened pop-up locations in key airports, even outside of Asia, to reach traveling Chinese consumers.

Our retail sales growth during the quarter was far ahead of passenger traffic growth, a trend we expect to continue as we bring more brands into more airports, increase conversion, leverage our increased brand investment in local markets.

Our sales were also boosted through our accelerating Online retailing business, which more than doubled.

Another fast growing channel, our global e-commerce business, continued to thrive. And for the first time, half of our sales came from mobile devices, with the highest penetration in Asia-Pacific.

Tmall continued to be a large contributor to our Online sales in China. And we recently successfully launched Tom Ford on Tmall, now our 10th brand on that platform and our strongest launch on Tmall so far.

We see terrific runway ahead of our Online business expand, with many more brands to roll out in dozens of countries. M·A·C, for example, became our first brand Online in Vietnam, launching on Lazada with a store-in-store Online model, followed recently by Clinique.

Looking in our geographies. Asia-Pacific continued to be the major contributor to growth. Nearly all countries grew, led by China, Hong Kong, and Japan, as well as Southeast Asia, particularly in emerging markets. This performance strengthened our number one position in Prestige Beauty in the region.

Skin Care, Makeup, and Fragrance all grew more than 20%. Our net sales in China rose sharply with across the board gains in categories and channels, and virtually all brands grew by double digits. Retail sales also increased strongly.

In total, our emerging markets grew double digits. India, while still small, had excellent growth. We strengthened our number one position in Prestige Beauty also there.

Recent launches of our Aveda brands and Makeup collections from Tom Ford contributed to the country's growth. Clinique and Estée Lauder assigned Indian brand ambassador, as they make a bigger push in the market. Clinique new spokesperson, a Bollywood actress, will promote the brand globally.

We continued advancing our strategy in North America, which includes increasing our presence in fastest growing channels. And our retail sales rose in Specialty-Multi and Online. The Estée Lauder brand's retail sales improved, helped also by a successful gift with purchase program at Macy's. The brand sales rose sharply during the event, even with fewer doors than in the past years, reflecting strong desirability and social media engagement.

M·A·C retail trend is improving. It continue expanding in Specialty-Multi, as mentioned.

Our innovation continued to resonate strongly, with a greater focus on strengthening our most important brand franchises. This fiscal year, sales from our new innovations tied to our hero product comprised nearly 40% of our total innovation, up over last year. Our innovation toolbox includes data analysis, rich insights about global and local consumers, and a long history of scientific discovery and creativity that we combine to capitalize on big, fast growing, and new opportunities.

Our strategy to create fewer, bigger launches is working beautifully. The average size of our top 30 product launches is 30% higher than last year.

In addition, our speed to market is faster. In the third quarter, we had 17% more products in Skin Care and Makeup launched under 12 months than in the previous year quarter. Products launched with the last year are expected to account for 30% of our sales in fiscal year 2019, a new record.

Among our latest innovations launching now is Clinique Moisture Surge Eye Concentrate (sic) [Clinique Moisture Surge Eye 96-Hour Hydro-Filler Concentrate] (15:21), which expands one of the brand's large hero franchises.

In Makeup, M·A·C is extending the shade range of its new Powder Kiss lip collection that was created by using analytics to understand consumer needs, combined with creativity for the brand's makeup artist and runway

trends. The result is a unique formula, a moisturizing lipstick with a matte texture that we are supporting with advertising.

And in a new development, consumer can now buy these lipsticks and other M-A-C products directly from the brand's Instagram's post. M-A-C is our first brand to use this technology, which simplifies shopping through social media.

During our Investor Day, we spoke about the importance of our social input and charitable activities. And today I want to highlight the incredible work of our M-A-C brand. This is the 25th anniversary of its Viva Glam campaign, which has raised nearly \$0.5 billion to help people affected by HIV and AIDS in more than 100 countries. Every penny of every Viva Glam lipstick sold goes to the cause, which is a vital part of the brand DNA and actively supported by its makeup artists and consumers alike.

In the last nine months, we achieved outstanding results, while continue to transform our business to adapt to a changing global landscape and competitive beauty environment and to be always well-positioned to leverage the biggest future opportunities.

Without losing our advantages or scale and scope, we are instilling a more entrepreneurial mind-set to ensure we stay agile and act decisively. This gives us the best qualities of a well-financed, structured organization with the challenger spirit of a start-up. This is unique positioning and is just one of the many characteristics that makes our company distinctive.

We are proud of our performance this quarter and fiscal year and confident we are well positioned in the biggest and best opportunities to keep advancing our strategy winning model. We have an amazing portfolio, diverse and desirable brands. We are the Prestige Beauty leader in two of the fastest growing channels, Travel Retail and Online. And our wide geographic footprints enable us to invest where we see the greatest rewards.

Our innovation has never been more robust. And our hero franchises instill high loyalty and attract new global consumers. All of this is made possible by our talented employees, led by our exceptional leadership team, who many of you met during the Investor Day. Our results this quarter prove once again their ability to execute so effectively. The diversity among our leaders and the breadth of their ability make them the best in the industry. And they are essential to our success.

As we wrap up fiscal year 2019, we are mindful of ongoing geopolitical risk, yet confident in our ability to continue executing with excellence across brands, countries, and channels, and we have demonstrated throughout the year.

In closing, long term, Prestige Beauty has strong fundamentals, backed by positive demographic trends. Even if an economy slows, we believe that our industry will be less affected than most consumer goods businesses, as we have shown in the past.

Prestige Beauty is an affordable luxury. And our aspirational brands have high consumer loyalty and invaluable pricing power, putting us in a unique position as the best diversified pure play to deliver long term sustainable and profitable growth.

Now Tracey will discuss our financials.

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## 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 third quarter financial results. And then I will discuss our expectations for the balance of the year.

As a reminder, my commentary today is adjusted for the items that Rainey mentioned at the beginning of this call. All net sales growth numbers that I will discuss are in constant currency and using 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 increased our sales growth by 3 percentage points, our operating profit growth by 21 points, and our diluted EPS by \$0.27. I would encourage all of you to look at the bridges that we've included in the press release this morning, as we do have a lot of adjustments. But I will talk to the adjusted numbers as I go through the quarter results.

Net sales for the third quarter rose 12% with growth in our international regions and all product categories.

From a geographic standpoint, our Asia-Pacific region had robust net sales growth this quarter. Net sales rose 27%, with all major categories rising double digit. More than half of the markets in the region saw double digit growth, led by a sharp increase in China, reflecting the continued strength of Prestige Beauty. Nearly every one of our brands rose strong double digits in China, as did all distribution channels.

Among the larger markets in the region, Hong Kong rose double digit, Japan grew high single digit, and both Korea and Australia delivered solid mid-single digit increases.

Net sales in our Europe, the Middle East, and Africa region rose 20%, led by strong double digit increase in our global Travel Retail business, which Fabrizio just described.

The EMEA region also benefited from growth in emerging markets, led by India and Russia. Growth in Western European markets was mixed. Modest increases in markets like Italy, Greece, and Switzerland were essentially offset by modest declines in France, Benelux, and the UK.

Net sales in the Americas declined 6%, reflecting a deceleration in Prestige Beauty and brick and mortar retail in North America. We continue to achieve solid growth Online across both retailer.com and brand.com sites.

Latin America sales declined overall, as growth in Brazil and Mexico was offset by declines in other markets like Chile and Venezuela.

Skin Care again led product category growth this quarter. Net sales were 21% with very strong contributions from the Estée Lauder and La Mer brand internationally. Estée Lauder sales were driven by continued success in hero franchises, notably Advanced Night Repair, Nutritious, and Revitalizing Supreme, as well as preliminary sales from the launch of its Micro Essence with Sakura Ferment (sic) [Micro Essence Skin Activating Treatment Lotion Fresh with Sakura Ferment] (22:41) in Japan.

La Mer saw success from its Arrive Hydrated travel campaign and its New Year holiday program in Asia. Our Origins brand also delivered terrific results in Asia and Travel Retail, reflecting the strong performance of its Dr. Weil Mega-Mushroom franchise.

Net sales in Makeup grew 7%, led by strong demand in Asia and Travel Retail. Key drivers of the growth included Estée Lauder's Double Wear and Pure Color franchises, La Mer's Luminous Cushion (sic) [Luminous Lifting Cushion] (23:13) foundation, Tom Ford's Beauty lip and eye makeup and M·A·C's locally relevant activation, Strike of Kings and Tmall Super Brand Day in China.

Fragrance net sales rose 5%. Higher net sales of Estée Lauder, Tom Ford, Jo Malone, and Le Labo fragrances were partially offset by declines in certain designer brand fragrances.

Our Hair Care net sales rose 1%. Higher net sales from Aveda's recent launches in Asia and targeted expansion in EMEA were partially offset by soft sales from Bumble and bumble.

Our gross margin declined 160 basis points compared to the third quarter last year. The new accounting standard negatively impacted our gross margin by 135 basis points. Favorable mix impacts and pricing were offset by higher obsolescence, negative currency, and tariffs.

Operating expenses as a percent of sales improved 410 basis points, or 70 basis points excluding the impact of the new accounting standard and currency translation.

Increases in digital advertising to support innovation were more than offset by savings in selling and other expense areas.

Operating income rose 28% and operating margin increased by 260 basis points. Excluding the impact of the new accounting standard, operating income rose 6% and operating margin contracted 30 basis points, entirely driven by negative currency.

Diluted EPS of \$1.55 increased 33% compared to the prior year and grew 40% in constant currency. Earnings per share for the quarter included \$0.09 of unfavorable currency translation.

Diluted EPS excluding the impact of the accounting change was \$1.28, an increase of 10% compared to the prior year or 17% in constant currency.

During the quarter, we liquidated investments held in a foreign subsidiary and realized a net gain of \$71 million before tax, which was reported in other income in our GAAP financial statement. This equates to approximately \$0.15 of EPS.

Also in the third quarter, we recorded additional impairment charges of \$52 million for goodwill and other intangible assets related to the Smashbox brand. This reflects the continued softness in the brand's Makeup sales, driven by slower than expected growth in key retail channels for the brand.

For the nine months, we generated \$1.76 billion in net cash flows from operating activity, below the prior year, due primarily to higher inventory levels to support international growth and the timing of payables and receivables.

We invested \$441 million in capital expenditures. And we generated \$1.22 billion from the liquidation of investments discussed a moment ago.

We continue to return substantial cash to shareholders, as we repurchased \$1.34 billion, or 9.7 million shares, of our stock. And we paid \$453 million in dividend. We are obviously pleased with our third quarter results.

Now let me turn to our outlook for the fourth quarter and for the full fiscal year.

Global Prestige Beauty is a vibrant category that is currently growing above historical rate. With the outstanding performance we've seen year to date, we are again raising our full year guidance. However, we are mindful of a number of macro risks that remain concerning. These include uncertainties caused by political tensions and instability as well as soft economies in certain markets.

Given the strong performance to date, we are raising our expectation for full year net sales growth to 10% to 11% 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 \$1.14 for the euro, \$1.297 for the pound, and CNY 6.808 [to \$1] for the yuan for the fiscal year.

We expect the full year 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 \$5.15 to \$5.19, before restructuring and other charges. This reflects approximately \$0.22 of dilution from currency translation and \$0.06 accretion from the new accounting standard. In constant currency and with comparable accounting, this reflects EPS growth of 18% to 19%.

For the fourth quarter, our sales are expected to rise by approximately 9% to 10% in constant currency and using comparable accounting. Currency translation is estimated to dilute sales growth by approximately 2 percentage point. And the accounting change is forecasted to dilute an additional point. Therefore, we expect reported net sales to grow between 6% and 7%.

We expect to increase investment substantially behind advertising and promotion to leverage our strong momentum and support our successful new product launches, as well as to increase investment behind recruitment in the U.S. This investment should also provide us with a strong start to our fiscal 2020.

EPS is forecast to be between \$0.45 and \$0.49 before restructuring charges. This includes an approximate \$0.04 dilution from currency and \$0.04 from the new accounting standard.

With two months left in the fiscal year, we remain encouraged by the momentum in global Prestige Beauty and our ability to effectively execute our strategy to generate profitable growth. Our outstanding performance represents continued investment behind the greatest opportunities in our business as well as our commitment to long term sustainable growth.

The additional financial flexibility we have gained through our Leading Beauty Forward program, the increasing strength of our operating cash flow, and the greater returns we are achieving from our advertising investments position us well for continued success.

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 Erinn Murphy with Piper Jaffray.

Erinn E. Murphy

*Analyst, Piper Jaffray & Co.*

Q

Great. Thanks. Good morning. I guess I was hoping to understand a little bit more about what you've been seeing in the North American market. I mean the downtick was worse than I think a lot of us were expecting, so maybe you could unpack some of the drivers? Whether you're still seeing Bon-Ton. Maybe it was the pressure of government shutdown?

And then relatedly, could you talk a little bit more about what specifically you're seeing in the Specialty-Multi channel here in North America? And then where your investment, as you think about Q4, kind of being driven? Thank you.

Tracey Thomas Travis

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

A

Okay. Erinn, let me start as it relates to the Americas and really the U.S. Prestige Beauty market. So the Prestige Beauty was soft in the quarter. Actually the share results that we get suggest that it was actually down in the quarter.

So and I think it's a combination of the things that you mentioned. Obviously, we're anniversary-ing the tax rebate. There was a lower level of promotion, which we believe is healthy. But clearly affects sales growth in the quarter.

And we saw a bit of – from our business, we saw a bit of destocking. But our business really trended with the market in terms of the performance in the market.

Specialty-Multi globally was up about 6%. And so we are still seeing good growth from that channel.

Fabrizio Freda

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

A

Yeah.

Tracey Thomas Travis

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

A

Fabrizio, do you want to add anything?

Fabrizio Freda

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

A

I just want to add, as you mentioned also Bon-Ton was still in our number, [ph] the PUC (31:43), so that's still one probably last quarter in which we have an input of Bon-Ton.

What I want to add is that at the end, the market was really down, the major market. There could be some part of the market, particularly in Makeup, that was in the non-major market. But at the end, the major market and particularly brick and mortar was a tough quarter.

Now we are pretty confident of our improvement plan in North America. And in fact, in quarter four we are going to invest behind some exciting innovation that we believe will attract new fresh traffic.

We are going to continue expanding in the fast growing channels, Specialty and Online particularly. We have just completed the sales restructuring that will improve our ability to go to market. And we will start executing with excellence the new consumer targeting and granularity of marketing that we presented in the Investor Day.

So there are a lot of opportunity to first stabilize and then bring back to growth, also the U.S. market in the future.

**Operator:** Our next question comes from the line of Michael Binetti with Credit Suisse.

**Michael Binetti**

*Analyst, Credit Suisse Securities (USA) LLC*

Q

Hey, guys, congrats and thanks for all the detail here today. Let me follow Erinn's question I guess a little bit with, it looks like in the Americas, the operating income in the quarter, it looks like the negative number was almost fully explained by the Smashbox decision you made on the impairment. Could you maybe give us a little bit more of your thinking on Smashbox?

And you've obviously taken some accounting to that to try to right-size the brand and the financials here. But what do you think the brand needs going forward? And are we getting to a point where it can stop being as much of a drag to those U.S. numbers? It looked like they were quite a bit better when we exclude that.

And then separately, I was wondering if you might be able to give us a little bit more behind your comment that – I know you said you've got some new innovation coming that drives recruitment. Can I take that to mean that in the U.S. within the negative 6%, the new customers – the new customer acquisition numbers have slowed as well. Any idea what the diagnosis looking backwards is there? And what the epiphany is that you think you can spend back against to help reverse those trends in the fourth quarter?

**Fabrizio Freda**

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

A

Yeah, I'll start answering the second question. And then we'll clarify the Smashbox thing.

Is, no, actually the consumer acquisition is, while we are bringing back up, particularly young consumers and millennials. And we are making progress on most of the brands in acquiring new millennials and Gen Z consumers in the United States as well.

As Tracey mentioned, in this last quarter there was a less promotionality on average and an overall lower market, meaning there was just less traffic in the stores. But in term of our brands acquisition, is pretty – is improving. And as all my comments about our intention in quarter four and next year is actually to accelerate that.

And we have a lot of tool, the granularity of targeting, the new innovation, the better exposed to growth channels, and all the other elements we are putting – including extra investment in advertising that we are putting in our

United States turnaround trend – plan. So we are pretty positive on the mid-long term impact of those activities also in consumer acquisitions.

On Smashbox, I want to clarify that Smashbox is not the main reason for the decline. Smashbox is a relatively small brand in our total portfolio.

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**Tracey Thomas Travis**

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

From a sales perspective, right.

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**Fabrizio Freda**

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

Yeah.

A

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**Tracey Thomas Travis**

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

From a profit perspective, you're right, that the impairment certainly did impact the profitability of the Americas segment. But from a sales perspective, as Fabrizio mentioned, it's not the main driver.

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**Operator:** Our next question comes from the line of Bonnie Herzog with Wells Fargo.

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**Bonnie Lee Herzog**

*Analyst, Wells Fargo Securities LLC*

Thank you. Good morning. I actually wanted to touch on your Skin Care margins in the quarter, which were still very strong. So hoping you guys could bucket maybe some of the key drivers for us in a bit more detail. And then help us understand what the contribution might have been from the fast growth in certain geographies such as Asia, versus maybe improvements you're seeing in the product mix from some of your innovation. Thanks.

Q

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**Tracey Thomas Travis**

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

So let me start. Again, the margins on Skin Care are so strong, I would say first because the Skin Care category was up 25% in constant currency. So when you've got that kind of growth in the category, we see tremendous leverage across the board. That would be the first driver.

A

Clearly, we're seeing great success, as we called out, in A-Pac and Travel Retail. And leveraging that success in those regions certainly helps from a margin standpoint as well.

But it really – when we got a category growing at 25%, that certainly justifies the kind of margin expansion that we're seeing in the Skin Care category.

We've also had some terrific new innovations in the Skin Care category this year that we're quite excited about. So our innovation has continued to step up every year. And this year in Estée Lauder and La Mer and Clinique, we've had terrific, terrific innovation, and Origins as well. So all of our Skin Care brands are doing quite well globally. And certainly the strongest impact being in the Asia-Pac and Travel Retail regions.

Fabrizio Freda

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

A

And the only thing I want to add is that our improved focus on hero products, meaning on the main product, the main SKUs on every brand, is also driving profitability over the medium and long term, because creates bigger products that can be better leveraged and better optimized. And this trend will continue.

**Operator:** Our next question comes from the line of Robert Ottenstein with Evercore ISI.

Javier Escalante

*Analyst, Evercore Group LLC*

Q

Hi. This is Javier. The question has to do again with North America. If you can help us understand the channel mix now in the U.S., with all the brands that you bought that tilt toward the Specialty channel. So basically if you can help us understand how important department stores is? What was the impact of Bon-Ton in the U.S.? Whether you can give us a sense of what was the growth in U.S. department stores ex-Bon-Ton? And also basically, how you are doing in the Specialty channel. What is the exposure? What is the growth rate? That would be helpful. Thank you.

Fabrizio Freda

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

A

Any other questions?

Tracey Thomas Travis

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

A

So, Javier, department stores are still about half of the business in the U.S. And obviously, the growth that we're seeing is primarily in Online and in Specialty. But about half of the business is still in department stores, a little over half of the business still in department stores in the U.S. So it's still an important channel of distribution for us.

The segment would have been negative without Bon-Ton. Bon-Ton was about \$16 million of revenue in the quarter last year. And obviously no sales this year. So that's the situation in the U.S., as it relates to the sales growth.

Fabrizio Freda

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

A

Yeah. And I just want to add that today we have 75% of our business outside of the United States. And we are super well diversified by channel, category, brands.

And another thing I want to clarify, because I think we are definitely looking at markets like the United States and the UK, China. And we have a segmentation by geography. But if you look at our results this quarter by channel, globally, every single channel has been growing. So you were asking about Specialty-Multi. Specialty-Multi we grew 6%, 7%. Department store globally we are growing 2%, and the TR and Online and the freestanding store, and the way we look at, which is direct to consumer, which is a mix of brand.com and freestanding store, all growing double digit at a very strong double digit.

If we look by categories, we have been growing every single category, Skin Care, Makeup, Fragrance, Hair Care. And within Skin Care, as the previous question, every single category of Skin Care, like moisturizers, serums, everything is growing double digit.

In terms of by brands, 80% of our brand – the exception is Smashbox and GLAMGLOW. But all our brands are growing more than double digit, the large majority of them.

So there is a lot of different engines of growth going on in our business in this moment, segmenting the business, the way we segment it, also the way we operate it.

**Operator:** Our next question comes from the line of Lauren Lieberman with Barclays Capital.

Lauren R. Lieberman

*Analyst, Barclays Capital, Inc.*

Great. Thanks. Good morning.

Q

Tracey Thomas Travis

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

Morning.

A

Lauren R. Lieberman

*Analyst, Barclays Capital, Inc.*

One of the things I wanted to ask – I'm sorry, because I know, Fabrizio, you're just now emphasizing that U.S. is 25% of the business today. But I was still curious, I'm sorry, about channel mix.

Q

Because the mention of the sales restructuring struck a chord with me. I think for a few years I've sort of been thinking about your investments in the U.S. as being to sort of fully support traditional brick and mortar, being both your freestanding stores and department stores, while at the same time investing well ahead of the revenue build in kind of Specialty-Multi and Online in totality.

And with mentioning the sales restructuring today, it suggests to me that all these kind of, call it, newer channels have reached scale to where you can perhaps start reallocating resources in the U.S. in a way that better suits the future growth.

So I wanted to just I guess ask, one, is that a reasonable way about thinking where we are in terms of long term channel mix shift? And then secondly, brand performance in the U.S. within those faster growing channels, versus the channels where the traffic isn't. Where – what's your feeling on market share performance for your brands in those faster growth channels, versus the more struggling parts of the market? Thanks.

Fabrizio Freda

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

No, you're welcome. First of all, just thinking about channel mix. As I said, Tracey just mentioned, we have 50% today we are in department stores and the remaining is in the fast growing channels. So we are tilting on a better balance of diversified by channel also in the United States. That's our strategy. This will continue to be.

A

We are now better penetrating Specialty. We are very strong Online across the front, both in retail.com and in brand.com. Our freestanding store are a significant channel in the United States. And obviously, department store

continue to be an important part of our business. And in some areas, we are growing. And some department store are making some significant progress on the business.

The real difference is brick and mortar versus Online. So the brick and mortar are [ph] not growing (43:12), and the Online is growing, even Online in department store, Online in retail.com. So all the Online is continue to accelerate. And that for us is very positive, because we see a good market share in this area. Our brands are very successful in this area.

So your other question was, are your brands successful in these new channels? Absolutely. I would say that our brands are even more successful in the new channels. By the way, that's true in the United States, but that's true globally. I think in Investor Day we demonstrated our success in new channels like Online globally, Tmall, Travel Retail, Specialty-Multi globally is really happening. And we are definitely capable to drive these brands.

Now we have a very big portfolio brands, so some brands are better tailored to win in Specialty. Other brands are better tailored to a typical more department store environment. And finally, some brands are more prone to win Online. And we manage this portfolio artfully also to make sure that we always match the right brand with the right channel and with the right consumer target. And that's an art. There is not [ph] another natural (44:23) behavior. It's really a segmented way in which we manage our portfolio brands. And that's why portfolio brands is a big [ph] competitor of brands (44:31).

Last comment, your comment of our field sales force restructuring. Absolutely. It was time to restructure our investment in field in order to match and to go in parallel with the new distribution strategy and with the new balance of the different channels. And absolutely, this is – as part of this plan, we are increasing the resources and the focus and importantly the skills on the new channels in order to make our performance also in the new channels as strong as our historical performance is and has been in department stores.

**Operator:** Our next question comes from the line of Steph Wissink with Jefferies.

Stephanie Wissink

*Analyst, Jefferies LLC*



Thanks. Good morning, everyone. Fabrizio, I just had a question for you on your comment on trailing 12-month launches are 30% of sales, which I think you mentioned was the highest level. Can you give us some context of how that number has trended over the last few years? And then how that connects to the advertising spend that you're doing, kind of fewer, bigger launches with more focused advertising? Thank you.

Fabrizio Freda

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



Yeah, this is a great strength that we have evolved in the last years. And it's the fact that we have now multiple brands. And every brand has its own innovation program. And the fact that we innovate in Skin Care and Makeup and Hair Care and Fragrances. And within every of this category, like Skin Care, we have very clear innovation programs by subcategory, example, moisturizer rather than masks, et cetera.

So our granularity or our granular ability to look at opportunities make us now innovating across all these multiple global segments. That has increased the percentage of successful sales that we do via innovation.

This strategy, combined with hero product strategy, meaning bigger innovations and fewer innovation and leveraging our historical franchises like Advanced Night Repair or [ph] the Hello (46:37) Clinique, the combination

of those strategy is making our innovation stronger, more abundant, and at the same time more profitable and efficient. And that's what I'm trying to say is the magic of our new innovation program.

How does this link – by the way, how it was in the past? Last year was 20%, this year will be 30%, and when we started our strategy nine years ago, we were around 10%. So we have tripled our innovation power in the last nine years.

How this – by the way, this is indicated also by our results I believe. And how this is linked to our advertising investment is, we – the advertising, what has changed with the arrival of a lot more digital advertising is that in the past, we had few advertised brands. Clinique, [Estée] Lauder, some Fragrances, and that was it. The other brands will live out of word of mouth and other activities.

Tracey Thomas Travis

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

A

And in-store.

Fabrizio Freda

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

A

And in-store, and obviously a lot of in-store activation.

Today, every single brand is advertised. That's what is creating also the acceleration. And so our advertised brands, our advertising investment today touch all our brands. And all our brands are reaching scale and levels to justify a part of the budget in advertising. And that is a – obviously is a topline accelerator, particularly when combined with innovation.

And last, which is probably behind your question, yes, a lot of our advertising is focused on our innovation.

**Operator:** Our next question comes from the line of Dara Mohsenian from Morgan Stanley.

Dara W. Mohsenian

*Analyst, Morgan Stanley & Co. LLC*

Q

Hey. Good morning, guys.

Tracey Thomas Travis

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

A

Morning.

Dara W. Mohsenian

*Analyst, Morgan Stanley & Co. LLC*

Q

So, Fabrizio, it's rare to see this level of corporate topline growth that you're expected to post this year. It's even rarer to see it continue in subsequent years when you cycle more difficult comparisons.

So I'd love to hear your viewpoint on the sustainability of the strong topline growth as we look out to next year. And specifically, are there any signs of a potential slowdown in some of the key momentum areas that have been driving your business?

And then also, just from a longer term perspective, can you talk about how you've managed the business this fiscal year to sort of take advantage of the topline growth and use it to propel longer term growth as you look beyond this year? Thanks.

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**Fabrizio Freda**

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

A

Yeah. Our – the idea of growing ahead of market is definitely sustainable. We believe we will continue to grow ahead of market and continue to build global market share.

And the reason why this is a sustainable, long term view for us is accepted, many would think I was explaining, is because we are exposing our business to the fastest growth currents of the world. Thanks to Leading Beauty Forward, we have changed a lot in fixed cost and created valuable OpEx. And these variable expenses we can tailor them where the biggest opportunity are at the speed of light. This was not possible in the past.

So the first thing that make us sustainable is that we can invest and allocate resources very fast with a lot of agility, wherever the opportunity is. And so even in a world which is more volatile and where the opportunity changes faster than in the past, we have now had the agility to react at the same speed. And so this ability to match resources to opportunities is our strength.

In this moment, the biggest opportunity, China, we are able and willing to invest in China in a great way. If this has to change over there, there will be other opportunity, as we have demonstrated in the past, where we will invest more.

In this moment, our priority, turn around the United States. We are going to invest in the United States. And within the United States on the biggest opportunity, which are in the channel by category, by channel, and by consumer segment.

So this ability to granularly look at the opportunity and invest, allocate resources on them, is a sustainable, long term capability that we built in our business, that I believe will continue to drive our business ahead of market for many years to come. In term – you want to add anything, Tracey?

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**Tracey Thomas Travis**

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

A

No, I mean, the only couple of things that I would add there, is clearly if you look at our history over the past few years, you see that the fourth quarter is our lowest operating margin quarter. And it is somewhat related to the timing of some of our big innovation.

And also related to, once we have seen how innovations perform during the course of the year, we take the opportunity to invest more behind them. And that provides us – has historically, at least in our experience, provided us with a strong start to the next fiscal year.

As Fabrizio said, we do expect that we will continue to grow ahead of market. The market last year, based on our information, grew around 7%. As we communicated at Investor Day, we do expect that the market will settle down at some point in the 5% to 6% range.

So we do expect that our – the growth that we've seen, the double digit growth over the last few years, in the next few years would slow as we expect that the market would slow. But we, in all cases, believe that we will continue to grow ahead of the market.

**Operator:** Our next question comes from the line of Dana Telsey with Telsey Advisory Group.

Dana Lauren Telsey

*Analyst, Telsey Advisory Group LLC*

Q

Good morning, everyone, and congratulations on the terrific results.

Fabrizio Freda

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

A

Thank you.

Tracey Thomas Travis

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

A

Thank you.

Dana Lauren Telsey

*Analyst, Telsey Advisory Group LLC*

Q

As you think about your categories and just the Makeup category, can you talk a little bit about how you see that progressing on the Makeup side? What would change the direction of operating income there? Is there anything, whether it's products, whether it's channels, geographies, where there's a differentiation in how it's performing? Thank you.

Tracey Thomas Travis

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

A

So let me start, Dana. Obviously, the makeup category is impacted by some of the challenges that we discussed with Smashbox. We are seeing the M·A·C brand pick up. But obviously, the M·A·C brand had been slow in the last year or so. So that has impacted the profitability of the Makeup category.

And fundamentally, again, when you think about the architecture of our P&L, growth drives a lot of margin expansion. So to the extent that we see the Makeup category growing globally, which we are growing relatively in line with the Makeup category. But to the extent that we see that category pick up, certainly we'll see operating margin pick up.

We expect operating margin will pick up anyway, given some of the innovation that we've got planned for some of our Makeup brands like Too Faced, like M·A·C, and some of our other brands as well, BECCA, et cetera, in the next few quarters. So we do expect that that will be an improvement. But we do have some brands struggling in the category that's dragging the operating margin down.

Fabrizio Freda

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

A

Yeah. And our strong brand where there is growth of demand, the operating margin is very, very attractive. And so it's a matter mix of brands that we will correct over time.

But also want to clarify, the market on Makeup is, we go up and down. I mean now is the Skin Care moment. But two years ago was the Makeup moment. And by the way, this is different by region.

In the U.S., clearly, Makeup is not a growing segment in this moment. But in Asia is the fastest growing segment. Just to be clear, Makeup in China in the last quarter grew faster than Skin Care. And not – I'm not speaking about our business only, I'm speaking about the market.

And so Makeup is a very strong category with a lot of future. And when reached certain level of growth, will have the same positive impact, allowing us to leverage our cost structure that Skin Care has.

**Operator:** Our next question comes from the line of Mark Astrachan with Stifel.

Mark Stiefel Astrachan

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

Thanks and morning, everybody.

Q

Fabrizio Freda

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

Morning.

A

Mark Stiefel Astrachan

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

I wanted to revisit the U.S. again. And maybe ask the question in kind of a bit of a different way.

Q

How do you think about the brands and the channel mix today? Obviously, department store is still half the business. Do you think you have what it takes to improve performance as it is? Is this just a – you mentioned increasing spend, but is that enough? Do you think you need to do more selectively if available to go into different brands, channels, M&A, that would buy things that could help you in that? Do you think maybe expanding into more active areas, things that may be a bit more on trend from a consumer standpoint? And then just more broadly, when do you anticipate the U.S. gets back to growth?

Fabrizio Freda

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

Yeah. As we said on that, but we believe we have a great plan as I said. The plan is about continuing exposing different brands to the right channels, the right target group. As you said by brand, certain brands are really playing well in Specialty, and they're playing well with the Specialty customers.

A

Other brands our perfect for department stores. It will continue to be exposed in the majority of the department stores, which are very important channels. All of these brands are doing fantastic Online. And we are continue building their specific targeting Online.

The innovation and the new exciting innovation that attract consumers is going to be a key driver, continue to be a key driver of acceleration. And the other will be segmentation, the ability to speak in a granular way to different segments of consumer, including multiethnic consumers around the U.S. is our plan.

And we believe this mix of distribution, activation, innovation, and granularity of marketing, and the new era of segmentation, combined with a better field sales force, better focus by channel, is our answer to restart growth.

Obviously, we need to assume that the market overall will start growing back again. And that's what we also expect, that the market we go back to growth. And when this will happen, which we believe next fiscal year, we do have the potential to go back to growth.

The last thing, sorry, I wanted to say, I want also to clarify that even if that happen, the impact in the short term on the overall trend of the total company is not very big. The real total in the significant input of the company is not in that turnaround from slightly decline to slight growth.

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**Operator:** Our final question comes from the line of Olivia Tong with Bank of America.

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Olivia Tong

*Analyst, Bank of America Merrill Lynch*

Q

Thanks. Good morning. Wanted to talk a little bit about the operating expense, because excluding the change of the accounting impact, there was quite a nice movement there.

Did Leading Beauty Forward hit an inflection point? Because now historically, you've reinvested a significant portion of that. So maybe it's just timing. But normally you don't flow that much of it through, so just trying to understand that a little bit better. Thank you.

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Tracey Thomas Travis

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

A

No, we did have a great quarter of leverage, Olivia, in the third quarter. You're right. And Leading Beauty Forward absolutely contributed to that.

So as we had announced previously, we actually have increased our expectations for the program, given the number of programs that have been added to Leading Beauty Forward. And it is giving us more flexibility in our expense base. So we did see more leverage in some of the areas outside of advertising and promotion than what we had expected. And so yes, we have more flexibility.

We're still investing though a good portion of the savings of Leading Beauty Forward. Fabrizio mentioned digital advertising. The digital capabilities in order to be able to do digital advertising. So the talent, the technology that we are investing in, to be able to both create the digital advertising as well as investing a lot more in our analytics capability as well.

So we are using some of the savings to reinvest back in the business to build capabilities that we need to have continued growth over the next few years. And that's working out well for us in the short term and we believe in the long term as well.

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**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 p.m. Eastern time today through May 15.

To hear a recording of the call, please dial 855-859-2056. Passcode number 6869966. 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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