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The Estée Lauder Companies, Inc. (EL)

Q2 2020 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good day, everyone, and welcome to The Estée Lauder Companies Fiscal 2020 Second Quarter Conference Call. Today's call is being recorded and webcast. For opening remarks and introductions, I would like to turn the call over to Senior Vice President of Investor Relations, Ms. Rainey Mancini.

Laraine A. Mancini

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

Good morning. On today's call are Fabrizio Freda, President and Chief Executive Officer; and Tracey Travis, Executive Vice President and Chief Financial Officer. Since many of our remarks today contain forward-looking statements, let me refer you to our press release and other reports filed with the SEC, where you'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 and adjustments disclosed in our press release. All net sales growth numbers are in constant currency. You can find reconciliations between GAAP and non-GAAP figures in our press release and on the Investors section of our website. During the Q&A session, we ask that you please limit yourself to one question, so we can respond to all of you within the time scheduled for this call.

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

Fabrizio Freda

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

Thank you, Rainey, and good morning to everyone. We delivered exceptional results in the second quarter, which I will elaborate on shortly. But first I want to acknowledge how concerned we are for all the people, including our employee and consumers who are affected by the recent outbreak of the coronavirus in China and around the world. Our heart goes out to them, and I will discuss what steps our company is taking to support them in a few minutes.

In the second quarter, our prestige beauty portfolio resonated with consumer globally. Our successful strategy based on multiple engines of growth once again helped fuel our performance as we grew in all regions and all major categories. Skin care rose in every region, as did fragrance and hair care, while makeup grew international.

The company generated 16% constant currency sales growth, the highest organic growth rate in 20 years in the seasonally largest quarter of our fiscal year, allowing us to gain significant share in global prestige beauty. While our second quarter continues to be boosted by holiday, it now also includes another important event driver, Single Day (sic) [Singles Day] (02:39).

Our advanced planning for these events delivered strong growth across our business, led by Asia/Pacific region, the global online and Travel Retail channels in the skin care and fragrance categories, powered by the extraordinary performance of Estée Lauder, La Mer, and our luxury and our seasonal fragrance brands.

With disciplined expense management, we leveraged our sales growth into a 21% increase in adjusted diluted earnings per share. Our strong performance reflected smart and deliberate investments in the best opportunities worldwide, including focused product innovations, increased advertising, enhanced digital marketing, better use of data analytics, a greater local relevance. We attracted a broader group of consumers and continued to build strong repeat rates for our products driving greater loyalty.

During the quarter, we completed the acquisition of the Korean-based Have & Be Company after having taken a minority stake four years ago. Its Dr. Jart (sic) [Dr. Jart+] (03:54) skin care brand has grown rapidly with cutting-edge innovation and excellent speed to market capabilities. We are optimistic about our first acquisition in Asia, and we see many opportunities to further cultivate the brand globally as consumer interest in skin care continues to expand.

Our momentum continued in the first three weeks of January. But as you all know, the global environment has changed meaningfully following the outbreak of the coronavirus. Our thoughts are with individuals who had been diagnosed and those who mourn family and friends. The Chinese government has responded in a very serious manner, along with many other countries and organizations, and they are working [ph] entirely (04:44) to address and contain the outbreak and help those afflicted.

As a company, we are focused on the well-being of our employees in China and globally, and are taking appropriate measures to protect them based on guidance from local authorities and the World Health Organization. Our consumer and business partners in China and elsewhere are also top of mind, and we are actively [ph] engaging in ways (05:12) to support them. We are pledging RMB 5 million to support coronavirus relief efforts for needs across China and we are matching donations of US-based employees to assist with the outbreak. We are working on various support initiatives to support people and their recovery.

Over the past 10 years, in my role as CEO, I've made numerous trips to many regions of China. I met with our local employees, talked to consumers of all ages and conferred with our business partners. I've traveled all over

to learn more about this beautiful country, its wonderful people. My heart goes out to the citizens of China during this difficult time, and I look forward to my next trip there hopefully in the near future.

Although it is difficult to anticipate the full impact of the coronavirus on our business, we expect the next couple of months will be very challenging. Chinese consumer in many big cities are staying home and retailers are closing stores or limiting hours in an effort to help contain the spread of the virus. Additionally, global travel is being restricted and the effect is being felt beyond China into major Travel Retail corridors and large tourist cities.

Given what we know now and our experience with past epidemics, we believe our business will gradually recover toward the end of the fiscal year. We stand ready to invest, to facilitate the recovery as soon as the market supports it, leveraging the flexibility of our resource allocation and our multiple growth drivers. We remain committed to China and to the Chinese consumers for the long-term and plan to increase our R&D investment in the market in order to drive both breakthrough prestige beauty innovations for China, the Asia/Pacific region and the rest of the world.

Reflecting China leadership in science, we will expand upon our existing in-market capability, build a new state-of-art innovation center complete with the latest technologies and tools. This facility will also highlight our passion and commitment to quality, sustainability and employee wellness.

Our enhanced capability and capacity will ensure we meet the needs of Chinese and Asian consumers with local relevancy and local trends as well as with creativity, agility and speed. This investment aims to sustain the long-term development of our company in China and around the world. We will continue working to advance this new development and look forward to sharing more details in the future.

Turning back to the second quarter results, The Estée Lauder brand was again a star in our portfolio. The brand grew strong double digits globally in both skin care and makeup and rose in every region, powered by its many hero franchises, including Advanced Night Repair as well as Re-Nutriv, Revitalizing Supreme (sic) [Revitalizing Supreme+] (08:31), Micro Essence and Double Wear.

This is a beautiful example of our multiple engines not only winning across many brands but also within a big brand. Re-Nutriv, Estée Lauder luxury skin care line, delivered superb results supported by targeted marketing with the luxury consumer, enhanced merchandizing and desirable innovation.

Looking now at our geography results, sales advanced in every region with strength across categories. In Asia/Pacific, virtually every market grew led by China, which accelerated generating strong double-digit growth as all our brands, category and channels advanced.

We had terrific growth from smaller cities in China, which are becoming a greater part of our business and a promising long-term growth driver. We expanded into two new cities, bringing our total to 123. Our online business in China more than doubled, elevated by well-integrated online and offline campaigns for Single Day (sic) [Singles Day] (09:44). The Estée Lauder brand was among Tmall best performers for the event, while M·A·C, La Mer and Jo Malone London each excelled in their respective categories.

Our brand expansion strategy on Tmall was a distinct advantage. As an example, following Tom Ford Beauty launch on Tmall in 2019, the brand executed its first Single Day (sic) [Singles Day] (10:10) to tremendous success in both fragrance and makeup. Its performance was twice that of its Tmall launch day, which was our biggest launch ever on the platform.

Chinese consumer interest in prestige fragrance category is rising, and we are nicely positioned with our wide portfolio of luxury fragrances. Jo Malone London and Tom Ford Beauty excelled in the quarter, helping to further diversify our business in China. We plan to launch additional luxury fragrance there later this year.

We delivered strong growth in our other emerging market outside of China, led by terrific results in Russia, India, Thailand and Brazil. In the quarter, we continued to invest for growth and attract new consumers. For example, Brazil is the fourth largest market globally for hair care, and we launched Aveda, our 10th brand there. We are showcasing the brand historical committed to sustainability, the environment and botanically-based product with a salon in São Paulo that includes sustainable elements.

Across Europe, the Middle East & Africa, Estée Lauder, M A C, Clinique and La Mer, our four biggest brands prospered, demonstrating the appeal of established brands that have broad exposure to multiple subcategories and compelling innovation.

Every category advanced in the region. Our skin care brands led the growth with sought after newness from La Mer, Darphin and Origins.

In the UK grew modestly for the second consecutive quarter in a difficult environment and several of our brands gained share. Our growth strategy are showing promise amid macro industry-specific headwinds.

In North America, we made good progress towards stabilization of the business. We learned – we leaned into our multiple engines of growth, leveraging our successful skin care and fragrance franchises during the holiday season in light of industry challenges in makeup. There were several bright spots, brand representing about half of our sales grew and we had gains in the specialty-multi and online channels.

In fact, La Mer delivered record Black Friday sales on its own site, driven by a unique product assortment and influencer-led holiday campaign. As we work to rejuvenate the makeup business in North America, we are creating products that leverage consumer insight from our enhanced data analytics.

For example, we learned consumers want product that combines skin care benefits with makeup. In response, The Estée Lauder brand just launched Futurist Hydra Rescue, a new moisturizing foundation combining the positioning of our winning Futurist franchise in China with consumer needs in North America. The launch is off to a very strong start with high ratings and reviews.

Looking now at the channels, our global online business delivered stellar results. Our brand sites, third-party sites and retailer sites all grew double digit with broad-based strength across regions. Our online business was vibrant globally around Cyber Monday as our brands offered well-received products and set in the important holiday gifting giving season.

We continue to invest in our excellent growth prospects online. We launched our brands on more third-party sites, which are rising in popularity, deployed new digital payment technologies across several of our brand sites in the US and expanded our loyalty programs. We reached and engaged content with increased time consumer spent on our brand sites and traffic has grown, increasing the inherent media value these sites provide.

Travel Retail also continued its momentum. Our top eight brands grew double digits at retail, with strength in skin care and our luxury and our seasonal fragrance brands grew strongly, aided by expanded distribution in the channel. Innovative pre-retail campaign, unique retailer's activation and assertive advertising all contributed to fantastic results.

The pretail segment of Travel Retail excelled in the quarter, and it's becoming an increasingly important part of our business. Pretail enables us to engage with consumers before they travel, build brand equity and desirability and drive conversion. When tourist and travel resume following containment of the coronavirus, we anticipate that pretail will continue to expand.

Another important highlight this quarter was the publication of our 2019 Citizenship and Sustainability Report. Last March, we announced new goals and the report details our vision and progress. One of our goals is to promote ingredient transparency across our brands, and Aveda led the way with the ingredient glossary on its website. Other brands will soon follow.

Innovation is the core of our company, once again helped drive our performance, accounting for over 25% of sales. We have exciting innovation from our four biggest brands coming in the second half of our fiscal year, many in their hero franchises. We believe these launches will be well received by consumers globally and these important franchises have high loyalty.

We are pleased by our strong start in the first half. We're now focused on managing effectively throughout the coronavirus outbreak. We are determined to serve our consumers in the best ways possible. We believe that the efforts of the China's government along with leadership from around the world to contain the outbreak will prove effective.

I want to thank our employees worldwide to their extraordinary efforts working through this challenging time, while supporting each other, our consumers, the communities where we work and our business. Their grace and agility are a testament to our company culture.

Now, I will turn the call over to Tracey.

Tracey Thomas Travis

Executive Vice President-Finance & Chief Financial Officer, The Estée Lauder Companies, Inc.

Thank you, Fabrizio, and good morning, everyone. Certainly, our thoughts and best wishes are with everyone managing through a very difficult situation in China and globally. We are committed to supporting our employees and other stakeholders, while we also manage the business impact as best we can during this time. As a reminder, my commentary today is adjusted for the items that Rainey mentioned at the beginning of the call and net sales growth numbers are in constant currency.

We acquired Have & Be, the owner of the Dr. Jart (sic) [Dr. Jart+] (17:42) brand towards the end of December. The results for the new brand will be recorded in future periods on a one-month lag, so you can expect operating results from Dr. Jart (sic) [Dr. Jart+] (17:52) to be reflected in our fiscal third quarter for the first time, including the impact of purchase accounting and the interest expense on the debt we issued largely to fund this acquisition.

So starting with the quarter results, net sales for the second quarter rose 16%, driven by strong growth in our international regions and improvement in North America. Sales growth in Asia, Travel Retail and online continued to exceed our expectations.

From a geographic standpoint, our Asia/Pacific region net sales rose 30% with broad-based growth across the region. Sales in Greater China accelerated, rising very strong double digits. Our sales in Mainland China continued to deliver broad-based growth across cities, brands, categories and channels, and our brands saw record results on Singles Day.

As expected, sales in Hong Kong declined more than 20%. Among developed markets in APAC, we again delivered double-digit sales growth in Korea this quarter. Our sales in Japan rose mid-single digits despite the October 1 VAT increase last year that contributed to double-digit growth last quarter.

And emerging markets in Southeast Asia grew high-single digits led by Thailand. Net sales in our Europe, the Middle East & Africa region rose 18% with most markets contributing to growth. Our global Travel Retail business rose strong double digits, driven largely by light door growth, the continued rapid development of online preordering and the successful introduction of newer brands like Le Labo and Kilian.

Emerging markets in the region grew double digits led by India and Russia. Western European markets grew low to mid-single digits led by Italy, Iberia and Germany. Net sales in the Americas rose 1%, a significant improvement from last quarter.

Skin care and fragrance showed good growth, driven by Estée Lauder, Origins and La Mer as well as strong holiday performances from Jo Malone and Tom Ford. Initial shipments of Estée Lauder's new Futurist Hydra Rescue Moisturizing Makeup launch helped to partially offset the overall continued weakness in the makeup category.

In North America, sales rose high-single digits across all of our online channels. Our sales in the specialty-multi channel grew double digits, while the brick-and-mortar department store business remained challenged.

From a category standpoint, skin care once again led growth this quarter. Net sales accelerated to 28% growth with strong contributions from Estée Lauder, La Mer, Origins and Clinique. Innovations such as Estée Lauder Advanced Night Repair Intense Reset Concentrate, La Mer The Regenerating Serum and Clinique iD BB-Gel contributed incremental sales and supported their hero franchises.

Net sales in makeup grew 7% led by Estée Lauder, Tom Ford and Bobbi Brown. Solid innovation and support in foundation and lip products as well as special holiday sets and products drove growth in the category. Sales of fragrances grew 9%, driven by strong holiday activations at Jo Malone London and the launch of Métallique from Tom Ford. Fragrance sales grew across all regions but were strongest in the Americas and in Asia.

Our hair care sales rose 5% driven by the launch of the Nutriplenish line of products from Aveda, and improvement at Bumble and bumble. Our gross margin increased 20 basis points compared to the second quarter last year. Favorable pricing and mix was partially offset by the impact of the incremental tariffs and higher obsolescence costs.

Operating expenses as a percentage of sales improved 130 basis points. We continued to leverage higher sales and greater efficiencies in our selling model and store operating cost to fund advertising and strategic investments in technology and other capabilities.

Operating income rose 23%, and operating margin increased by 150 basis points. Adjusted diluted EPS of \$2.11 increased 21% compared to the prior year, and the currency translation impact was negligible. EPS was higher than expected due to the stronger sales growth as well as disciplined expense management and was partially offset by a slightly higher tax rate.

During the quarter, we acquired the remaining stake in Have & Be, the Korean-based skin care company. The transaction resulted in a one-time gain of \$576 million primarily related to the re-measurement of our previously

held minority equity investment fair value. We also recorded \$777 million of impairment charges related to three of our four makeup brands, a reflection of the continued challenges in the makeup category that have been most prevalent in North America.

While the market momentum for makeup has slowed in the near term, as we have previously discussed, the growth opportunities and the strategic value of these brands remains compelling as evidenced by our increased share and capability in specialty-multi retail, the enhanced social media expertise of the brands and an increased consumer base of Gen Z and millennials.

Turning now to cash flow. For the six months, we generated \$1.26 billion in net cash flows from operating activities, which was roughly flat with the prior year. Higher earnings were offset primarily by the timing and level of accounts payable. We invested \$291 million in capital expenditures with cash and \$1.04 billion to acquire the remaining equity interest in Have & Be, which was funded with debt. We also continued to return cash to stockholders by utilizing \$813 million to repurchase 4.3 million shares of our stock and \$330 million to pay dividends.

So we ended the first six months of the fiscal year with strong net sales growth of 14% in constant currency and adjusted EPS growth of 21%, a tremendous reflection of the hard work of our teams as well as strong consumer momentum that we have in our markets. So now let's turn to our outlook for the balance of this year.

The strong performance in the first half of our fiscal year, our multiple engines of growth strategy and the greater financial flexibility and agility we have built into our operating model is expected to help us to effectively manage through the short-term disruption caused by the coronavirus outbreak.

Due to the rapid escalation and the fluidity of the situation, it is both complex and difficult to predict the timing and the corresponding impact on our business. Therefore, we are not giving explicit guidance for the third quarter. We also remain mindful that a variety of macro risks, such as ongoing trade tensions and continued challenges in Hong Kong's retail environment could impact our second half result.

For the year – for the fiscal year, we now strive to achieve net sales growth of at least 6% to 8% in constant currency. This range is before the impact of 1 point of growth from the inclusion of sales from Have & Be. Currency translation is expected to negatively affect reported sales growth by 1 percentage point, reflecting weighted average rates of \$1.10 for the euro, \$1.27 for the pound and [ph] 7.03 for the Yuan (25:58) for the fiscal year.

With this sales guidance, EPS is expected to range between \$5.60 and \$5.70 before restructuring and other charges. This includes approximately \$0.05 of dilution from currency translation and \$0.18 dilution from the Have & Be acquisition. In constant currency, we expect EPS growth of 6% to 8%. Excluding the dilution from Have & Be, EPS growth is expected to be at least 9% to 11%, which remains in line with our long-term objectives.

For the second half, net sales are expected to increase approximately 1% to 2% in constant currency. Currency translation is expected to negatively impact growth by 1 percentage point and the inclusion of Have & Be is expected to add 2 percentage points. In terms of cadence, throughout the second half, we have anticipated the greatest negative sales impact from the coronavirus to be in the third quarter followed by a gradual recovery in the fourth quarter.

We are severely curtailing discretionary costs, while continuing to support critical areas of growth. Leading Beauty Forward has reduced our percentage of fixed cost in our operations, which gives us greater agility to manage

more effectively with slowing sales. We expect the belt tightening to have the maximum benefit in the fourth quarter.

EPS is forecast between \$1.86 and \$1.91 (sic) [\$1.82 and \$1.91] (27:34) before restructuring charges. This includes approximately \$0.03 dilution from currency and \$0.17 dilution from Have & Be, which includes some impact from the coronavirus outbreak, purchase accounting and interest expense on the debt issuance as I mentioned previously.

While our outlook for the balance of this year is uncertain, we do remain quite optimistic about the long-term growth opportunities for the company. We believe we can manage through this difficult health crisis, while maintaining the agility to invest as needed and regain our momentum once the recovery is established.

On behalf of the entire Estée Lauder Companies we extend our deepest well wishes to those who have been affected and thank everyone for their extraordinary efforts to manage during this period, particularly our incredibly hard working and wonderful team in China.

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

QUESTION AND ANSWER SECTION

Operator: The floor is now open for questions. [Operator Instructions] Our first question today comes from Dara Mohsenian with Morgan Stanley. Please go ahead.

Dara W. Mohsenian

Analyst, Morgan Stanley & Co. LLC

Hi. Good morning, guys.

Q

Fabrizio Freda

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

Good morning.

A

Dara W. Mohsenian

Analyst, Morgan Stanley & Co. LLC

So just was hoping for a bit more clarity on the coronavirus and how you guys are thinking about the potential impact longer term. I guess, what we've seen with past epidemics is usually beauty demands come back pretty quickly after a couple quarters. I know there's not a lot of visibility here and the duration of the illness is obviously still a big wild card, but just, Fabrizio, any initial thoughts or context on if you think this could be an issue that impairs longer term growth as we look out over the next few years? You talked about a gradual recovery through fiscal year-end. Should we expect things to sort of ramp up pretty quickly after that or how are you thinking about it in terms of longevity of impact? Thanks.

Q

Fabrizio Freda

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

So, obviously, we don't know about the specific medical health recovery timing, which is the unknown at this point. But we are in agreement with your assumption, which is basically this will have a impact in the short term and

A

definition of short term is what is unknown today. But then, after this period, there will be a recovery, and people will come gradually back to normal habits. And so we do expect to recover our momentum at the end of the health crisis and in term of our assumption today are in line what you said, we assume the two quarters to be affected by the impact, and we expect a normalization in fiscal year 2021. That's our assumption today.

The other important thing is that we are ready to stay close to the current mitigation of the issue and resolution of the health crisis as we are doing, supporting our China team and all the activities that the government is putting in place in China today, and we also will stand ready to support the recovery when the recovery will be happening and to invest behind the recovery as required by the market opportunity but most importantly by the needs of rebuilding the right consumption of Chinese consumers in the name of the economical development of China.

Dara W. Mohsenian

Analyst, Morgan Stanley & Co. LLC

Q

Great. That's helpful. Thank you.

Operator: The next question will come from Lauren Lieberman with Barclays. Please go ahead.

Lauren R. Lieberman

Analyst, Barclays Capital, Inc.

Q

Great. Thanks. Good morning. I was [indiscernible] (31:41) talk actually a little bit about the Americas because the strength this quarter, the inflection was very notable. So I was wondering if you could talk a bit more about how much you think this is tied to just being really proactive in promoting – in getting behind, I should say, excuse me, fragrance and skin and holiday being the key to this, or are you starting to see other lift that you think can carry through past holiday? And then in part with that, of course, you've had the news about incremental Macy's door closures this week, so if you can just comment on the outlook for the rest of the year in the Americas? Thanks.

Fabrizio Freda

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

A

So, first of all, in – as we said, this quarter has contributed to the stabilization of our North America business, and this has been in line with the strategy we communicated in Investor Day and we remain commitment to continue the work of stabilization in the next months. So what happened this quarter is first of all we have used as anticipated much more granular insight in the market to activate our plans and much more local relevance in the activation.

The other thing that happened we have recognized the softness of the overall makeup market, and that's why we've accelerated our activity in skin care and particularly fragrances during the holiday season. They were well fitting the situation and we got great results. So, we had, if you want, adjusted our engines of growth in a way that they contributed to the good results.

Our innovation pipeline, as anticipated has been strong and the impact of innovation has improved. And so all of these have been a positive impact. We will continue to operate in that direction. We do have still to be confront some of the headwinds. To be clear, the makeup softness, particularly the color makeup softness is continuing. As you mentioned, the closures of certain retailing stores where we do have high market share will continue, although we completely share the Macy's strategy of focusing on the high performance doors and on gradually stopping the smaller and lower performance doors with – as I said we support this strategy but obviously we will need to operate with strategy with making sure that we retain the consumer in the brands and this will be difficult but we will do our best to do that. So we need to take under account our extraordinary efforts to improve our

model that are working but also take under account there will continue to be headwinds. So our strategy remains at this point stabilization.

Lauren R. Lieberman

Analyst, Barclays Capital, Inc.

Q

Great. And just as a follow-up, how are you thinking about the impact of Chinese travelers not really visiting the US over the next several months just in terms of the outlook?

Fabrizio Freda

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

A

That's actually a good point. We assume that there will be obviously an important reduction of Chinese travelers not visiting the US in the next at least two, three months and this will have a negative impact, obviously on the sales to Chinese tourists.

Frankly, in this moment, we are assuming in our guidance also a slowdown on any travel population. To be clear, in this moment, because of the coronavirus global concern, tourist in general is being reduced temporary. So we have taken these temporary assumption – sorry, the assumption of this temporary reduction under account in our guidance.

Lauren R. Lieberman

Analyst, Barclays Capital, Inc.

Q

Okay. Great. Thanks so much.

Tracey Thomas Travis

Executive Vice President-Finance & Chief Financial Officer, The Estée Lauder Companies, Inc.

A

And I just want to add as it relates to our guidance. I mentioned the range of \$1.82 to \$1.91, which is within our press release. I think I've mentioned a different number in our guidance for the second half.

Operator: The next question is from Michael Binetti with Credit Suisse. Please go ahead.

Michael Binetti

Analyst, Credit Suisse Securities (USA) LLC

Q

Hey, guys, thanks for taking our question and congrats on a really good quarter. So, I want to ask you...

Fabrizio Freda

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

A

Thank you.

Michael Binetti

Analyst, Credit Suisse Securities (USA) LLC

Q

Thanks. On the Dr. Jart's (sic) [Dr. Jart+'s] (36:08) dilution, could you walk us through how much the \$0.18 – we're trying to think forward I guess over the four quarters of integrating that business. How much of that is one-time in nature and when you see that starting to wear off or even possibly turn to an accretive position?

And then I just – I want to ask you, as you think through the US number a little bit, so do you think the retailers that you worked with on the holiday strategy to get more skin care and fragrance out there, they really seemed to

want to keep pushing on makeup even as the warning signs were showing up over the last year or two? Do you think they've gone through the psychological change yet that skin care is going to be the driver for the medium term? And are they accepting that they have to pull back more on makeup in a structural way I guess or the gains you saw in skin care and fragrance, would you characterize those as sticky and shelf space gains that are going to remain dedicated to those categories as we look into calendar 2020?

Tracey Thomas Travis

Executive Vice President-Finance & Chief Financial Officer, The Estée Lauder Companies, Inc.

A

Yeah. So, starting with the Have & Be dilution, we obviously have the step up in inventory which is [indiscernible] (37:07) depends on how you're treating the interest expense which is also in that number. What I would say Michael is that we expect that Have & Be will be, if you think forward, relatively flat including purchase accounting. So eliminating those one-time items next year and accretive the following year.

Michael Binetti

Analyst, Credit Suisse Securities (USA) LLC

Q

Okay.

Tracey Thomas Travis

Executive Vice President-Finance & Chief Financial Officer, The Estée Lauder Companies, Inc.

A

The makeup question is the second question?

Fabrizio Freda

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

A

Yeah. Sorry. Could you repeat? [indiscernible] (37:37)

Michael Binetti

Analyst, Credit Suisse Securities (USA) LLC

Q

Yeah. Well, it sounds like it was a pretty meaningful acceleration obviously in North America – or in America we can see your numbers, but it sounds like the number that you got from specialty-multi, which was a great growth channel for you guys over the last few years but slowed recently, sounds like it improved a lot this quarter and it sounds like you worked with them on skin care and I'm just wondering if you feel like that channel – they feel like they've gone through the mental change of saying look skin care is going to be the bigger driver and we're going to give them – give that category more shelf space that sticks around in calendar 2020?

Fabrizio Freda

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

A

Frankly, yes. I think everyone realized the power of skin care in this moment, and we are all working together to leverage the power of skin care. Also because skin care for instant results and skin care product combined with makeup is on a growth. So, yeah – you speak about shelf space, which obviously has been more gradual in the way it changes, but definitely innovation programs are reflecting a lot of this. So there is more activity, more social media, more advertising in skin care than before and this is a reflection on the results.

By the way, makeup is a big category. The makeup for face, meaning foundation, for example, is still doing very, very well. The place which is softer is color. And importantly, what we are doing to contribute not only to leverage skin care, fragrances better but to reinstate growth in makeup in the future, is we are accelerating the innovation

in the makeup category, contributing to the future results of our retail partners also in this category. So, to be clear, we're not giving up at all on makeup, we're just...

Michael Binetti

Analyst, Credit Suisse Securities (USA) LLC

Q

Right.

Fabrizio Freda

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

A

...accepting that in the short-term, we are focusing more on other category and innovating better [indiscernible] (39:34) to reactivate the consumer interest.

Michael Binetti

Analyst, Credit Suisse Securities (USA) LLC

Q

Thank you very much. Congrats on getting North America back to positive.

Fabrizio Freda

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

A

Thank you.

Operator: The next question will come from Erinn Murphy with Piper Sandler. Please go ahead.

Erinn E. Murphy

Analyst, Piper Sandler & Co.

Q

Great. Thanks. Good morning and let me add my congratulations. I guess my question is around Amazon. There's been some press out recently talking about them potentially evolving their model to launch some luxury brands, maybe using a concession model. If something like this was to play out, would you ever consider – or reconsider, excuse me, Amazon as a channel for luxury beauty?

And then just a follow-up on China. Can you share, Tracey, maybe what percent of physical doors have been shuttered and are you seeing any major change in trend in the online business in China since the outbreak has escalated? Thank you.

Fabrizio Freda

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

A

Okay. On the first question is – the answer is no. At this point, we are not considering Amazon a channel for our luxury beauty products, and we are focusing our current channels and our current partners to build, continue the stabilization in North America [indiscernible] (40:46). As far as the China question, is the number of physical doors, I'll let Tracey go with that.

Tracey Thomas Travis

Executive Vice President-Finance & Chief Financial Officer, The Estée Lauder Companies, Inc.

A

Yeah. So, as you can imagine, it's quite fluid, and one of the things that we've seen is the Chinese New Year extended for many of our employees. Our stores have closed as malls have closed, so very recently two-thirds of our department store doors were closed, and the remaining doors were on reduced hours. Now, that could change next week. So this is a very fluid situation.

Fabrizio Freda

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

A

And on the second part of the China question, which is the online, absolutely the online channel is very strong in China [indiscernible] (41:34) said in the second quarter. But in this moment, also online is suffering because in this moment, in the middle of the outbreak, the delivery system in homes and in the big distribution centers also people are not working, like in this moment till February 10, many people with non-essential activity in factories and other situation, this is stopped. The same is for distribution centers, the same for other activities. So online at least in the short-term is having the same issues of brick-and-mortar. In term of the role of online in the recovery in the future, we are optimistic that online will play a very strong role in the recovery when the recovery will happen.

Erinn E. Murphy

Analyst, Piper Sandler & Co.

Q

Thank you for that context. All the best.

Fabrizio Freda

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

A

Thank you.

Operator: The next question will come from Steve Stryculia (sic) [Steve Strycula] (42:30) with UBS. Please go ahead.

Steven Strycula

Analyst, UBS Securities LLC

Q

Hi. Good morning.

Fabrizio Freda

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

A

Good morning.

Steven Strycula

Analyst, UBS Securities LLC

Q

So first part of my question just wanted to follow up on Erinn's question and can you give us a little bit more texture as to how to disaggregate how Mainland China sales are performing versus the Travel Retail component of the business, primarily as how we think about modeling the back half of the year? One of those businesses is housed within the EMEA segment, the other business is clearly housed in APAC. So, just wanted to get a little bit of more texture as to which one is being impacted real-time?

And then, Fabrizio, if you use history as a guidepost here, how do we think about once the issue is call it "contained," what is like the recovery path from that moment forward? Is it typically from what you've seen before, three, four months for Travel Retail to come back online from flights being booked? Any help would be appreciated. Thanks.

Fabrizio Freda

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

A

Yeah. So the short answer to the first question, in this moment, Travel Retail is the most impacted channel. Because if you think what – just to give you the context of what's happening, you probably know that, more than 60 airlines just closed their flights. So in this moment, the travel in and out of China is suspended in the large majority of cases. So there is lack of traffic for just in and out of China.

Second, in general, tourism in this moment is not prudent because it's a global issue the outbreak – is a global concern. And so many people which are concerned to travel in this moment are reducing their choice or postponing some of their travel, and I'm speaking touristic travel.

Then there is a third factor, is many companies have banned travel to any – to China but also to any other place where there is the virus. And so business travel is being reduced, not to count the many companies reducing business travel for cost containment reasons. So in this moment, the amount of travel in airports is reduced and traffic is significantly reduced. So that's the biggest impact.

And the second biggest impact is obviously China Mainland itself and Hong Kong, which are reduced significant. So I would say the Greater China area. Because all the reason that we already discussed in the prepared remarks that I'm not going to repeat but the most important thing is that – keep in mind that till February 10, most of the cities and not even – people are not back to work [ph] and till at February (45:14) children are not back to school and people are requested, rightly so, not to get out of home for reason which are not essential and not to go in public transportations where there is a risk of contamination, so the behaviors of the entire population is fundamentally changed. And because of this, this is the second area, where in the short term, we expect an impact.

The second part of your question is the recovery. Now the recovery – we know what – you know we have studied all the previous cases and all the previous situation and what we see is that the recovery tends to be a hockey stick. Meaning when the things is back, is back particularly in the traveling. When traffic is back, traffic is back and the people buy.

The thing that can – that we can do more in term of the business learning that we're [ph] planning out (46:07) during the period before the recovery in Travel Retail will be very important to push conversion, meaning when there is – Travel Retail is built by traffic and by conversion. Conversion is an area where we're making many improvements. So in this period of transition where traffic will be low, we are reworking our plans to use conversion as a key mitigating element of the dip, and then obviously we are preparing for future recovery plans when the time will arrive.

The last point I want to make is that we will try to tune the recovery to the recovery of the Chinese economy, the Chinese population. We don't want just to look this as a business, we want to see – look at this as a contribution to the recovery of the country and really supporting our employees [ph] at the country in this (47:02). And the same will happen in Travel Retail where, for example, some of our customers and retail partners are Chinese, and we are going to stay close to them to contribute to the recover of the Travel Retail business to make sure that our long-term retail partners will benefit from the recovery as much as possible and to start this all again to restart the right process and to regain momentum not only for us but for the entire industry.

Operator: The next question is from Andrea Teixeira with JPMorgan. Please go ahead.

Andrea Teixeira

Analyst, JPMorgan Chase & Co.



Thank you. Good morning. And I just want to echo the congrats on your results.

Fabrizio Freda

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

A

Thank you.

Andrea Teixeira

Analyst, JPMorgan Chase & Co.

Q

[indiscernible] (47:48) as a follow-up on the North America and the comments that you made for mix, Fabrizio, and obviously there was international getting the holidays as more giftables, skin care and fragrances and you also putting more – I think prudently putting more marketing behind those lines. So do you think that innovation and momentum continue to build into the next few quarters or we maybe potentially had some seasonal positive impact for that into the second quarter? Thank you.

Tracey Thomas Travis

Executive Vice President-Finance & Chief Financial Officer, The Estée Lauder Companies, Inc.

A

So, I'll start. And then Fabrizio can also add his comments. We are progressing towards stabilization in North America, and clearly it was a strong holiday and strong second quarter for us in North America and in other parts of the globe. So our teams have worked awfully hard to make this holiday season a very good one, and consumers responded and we're very happy about that.

As we look at the back half of the year, Fabrizio touched on the fact that we do have tourists that we expect that that business to be a bit softer, given the situation that we're managing through globally. And I would also say that North America is making progressive progress; however, I would not expect that the second quarter would necessarily be reflective of a continued acceleration from there. But the North America team is executing against all the strategies that were laid out last year, and we're seeing some good outcomes from that. So what we told you last quarter was North America, we expect certainly to have better performance this year than we did last year in North America. So that is progression towards stabilization.

Lauren asked earlier about the Macy's announcement. And clearly as we've been saying for some time, we believe that brick-and-mortar needs to be taken out of North America. North America has been over-retailed for some time. So we are very much aligned with what Macy's has announced in their Investor Day yesterday. The doors that actually would be closing in our fiscal year were already included in our guidance.

Andrea Teixeira

Analyst, JPMorgan Chase & Co.

Q

[ph] That's helpful (50:26).

Operator: The next question will come from Mark Astrachan with Stifel. Please go ahead.

Mark Stiefel Astrachan

Analyst, Stifel, Nicolaus & Co., Inc.

Q

Thanks and morning, everybody. Wondering if you could quantify the online percentage of sales from China and related to that, also if you could just quantify the impact benefit from e-commerce accelerating consumption via enhanced availability in China? In other words, previously consumers would have to visit cities selling the product, and now you're up to 123, but e-commerce obviously makes the product available everywhere. So maybe if you can just talk a bit about how you think about that dynamic as having helped, past tense, sales and how you think about that on a go-forward basis? And maybe if you think about some of those Tier 3 to 5 cities, which didn't

readily available – have product readily available but now people can order online, how do you think about that in terms of accelerating demand, maintaining that demand and kind of how it will impact future growth?

Fabrizio Freda

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

A

Yeah. No. And that is a very good question. As I commented other times on the subject, it is a very important phenomenon. Because today we have physical distribution in China in 123 city with our most distributed brands, which are Lauder and Clinique and much lower city coverage in the other brands, which are still on a growth trajectory. So there is a lot of physical distribution potential in the long-term still untapped. But at the same time, we know there is demand in China now in over 600 cities.

So there are over 450 cities where there is strong demand, and there is not yet physical distribution of prestige luxury and for sure prestige luxury of Estée Lauder brands. So this demand gets filled by online and gets filled by when this consumer travel also travel within China like in amazing 3-Tier markets like Hainan Island then where they can access the products or when they travel for internal business for vacation like going to Beijing or to Shanghai. So that's the situation. But online cover a lot these cities, and that's why also is growing and it's very strategic because give us access to these consumers in a very productive way.

The other important positive consequence of this dynamic is that the brick-and-mortar can remain very productive. It can remain very focused where there is the right productivity and online can cover productively the rest. So this is a good phenomenon. Continue to grow. It is definitely one of the reason behind my comment that we are having better and better results also in the Tier 3 and Tier 4 cities, also where physical distribution has not yet arrived.

In term of percentage of sales, China is the highest percentage of sales online versus other markets. It is on the high side, and it's continued to grow.

Operator: We have time for one more question and that question will come from Nik Modi with RBC Capital Markets.

Nik Modi

Analyst, RBC Capital Markets LLC

Q

Yeah. Thanks – thanks for the question. Good morning, everyone. I just wanted to follow up on Mark's question, Fabrizio, how much flexibility do you have to turn up the dial on really focusing on some of those lower tier cities that you just referenced? I'm just thinking about as kind of the year progresses and if you really wanted to turn up the dial to generate sales growth in some of these other tier cities, do you have that kind of control in the near term or is it a much longer term burn?

Fabrizio Freda

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

A

I mean we have control of the online I mean with our partners like Tmall and obviously our own online activity. But the – remember, we – our way to build distribution and also to build coverage is we are in luxury. And for us, selective distribution, which means demand ahead of supply is very important. So we gradually build the demand. And the reason why today demand is growing so fast also in the city is social media. Because while in the past advertising was local, meaning advertising was focused in the cities where there was physical distribution, social media by definition is national.

So you are in a dynamic where demand is normally ahead of supply, and that's the typical demand of the good luxury market. And we are [ph] fielding (55:29) this demand gradually and making sure that we keep the concept of desirability and high quality and high quality also the experience that we give to our consumer in mind. So we are not selling products, we are selling quality and full experiences. And we only do that when we can provide the best possible service to the consumer. So the short answer is gradually but yes we have the capability to dial up as the market opportunity reveals itself.

Nik Modi

Analyst, RBC Capital Markets LLC

Q

And just a quick follow-up. Of the 450 cities you cited in China as opportunity, how many do you believe Estée Lauder as a company has very good handle on demand and just some general consumer insights in those cities?

Fabrizio Freda

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

A

I will not give you a specific numbers, but I can tell you that we have the consumer data, so we know the number of consumers that are buying from different cities. Even we use this data analytics to decide where to open physical distribution. So we use the demand and the elements of the strengths of the demand from the cities also to judge our physical distribution strategy to make sure that we continue to provide better high touch services to the consumer when the demand is sufficient to be productive and to offer the quality and the service that we need to offer. So is a gradual development of quality service.

Nik Modi

Analyst, RBC Capital Markets LLC

Q

Very helpful. Thank you.

Fabrizio Freda

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

A

Welcome.

Operator: That concludes today's question-and-answer session. If you were unable to join for the entire call, a playback will be available at 1:00 PM Eastern Time today through February 20. To hear a recording of the call, please dial 855-859-2056, passcode 4437719.

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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