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The Estée Lauder Companies, Inc. (EL)

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Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC

MANAGEMENT DISCUSSION SECTION

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC

Right. Hi, everybody. Thank you all for joining the Virtual Bernstein Strategic Decisions Conference this year. Thank you especially to Fabrizio Freda for joining us from Estée Lauder. I am Ali Dibadj, Bernstein's former I guess now, US household and personal products and cosmetics analyst.

I very much appreciate all of you being with us today in this new format. We're going to try to keep this as fireside chatty as we can. By way of logistics, I have a set of questions as true to my form that we'll be going through live, but the audience can also input some questions along the way. You'll have pigeonhole, you can certainly email me questions as well, and I'll do my best to toggle between them.

Also please note that at the end of this conference, you'll have a survey question, couple survey questions about what you heard, this is good feedback both for us but certainly hopefully for Fabrizio and his team at Estée Lauder in terms of [indiscernible] (00:00:59).

So, before we get to question and answers, I think Fabrizio has a few words and then we'll just start the conversation as usual. So, Fabrizio, with your permission, let me hand it over to you.

Fabrizio Freda

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

Sure, thank you, Ali, thank you everybody. It's a pleasure to be with you virtually today. So, it is great to be with you today, and I want to wish Ali much success in his new role. I hope you are all in good health and as the world begins to emerge from the effects of the pandemic. Our hearts continue to be with those affected.

Now, since some of my remarks today contain forward-looking statements, let me refer you to our most recent company reports filed with the SEC, where you'll find factors that could cause actual results to differ materially from these forward-looking statements.

Now, to begin our successful strategy built on multiple engines of growth is as vital as ever. Our diversified prestige beauty portfolio, categories, channels, geographies, brands, consumer segments and price points give us many levers to fuel the business.

In different moments over the last decade, we were driven by different engines, resulting in prestige beauty share gains each year. Our vast global skin care portfolio, vibrant online business, a broad exposure to Asia Pacific are the engines of this moment.

These were powerful forces in the first out of our fiscal year, delivering terrific double-digit sales growth, and their significance has been further magnified throughout the crisis. For skin care, the desirability of the category has increased to even higher levels as self-care and [indiscernible] (00:02:55) have risen in the importance.

In this period of uncertainty, consumer are newly discovering and continue to return to brands and products they trust. Our latest innovation in hero franchises like Estée Lauder Perfectionist, Clinique Even Better Clinical have performed exceptionally well. Our commitment to innovation in our hero franchises is not wavered and we have an exciting pipeline ahead of us.

For online, the tremendous global sales growth and accelerating conversion rates are seeing across all demographics a further strengthening, the highly profitable channel for us. Our brand.com sites, brand boutiques and platforms such as Tmall and retail.com doors are excelling around the world.

Online is an area where we have been investing for years, which has been a distinct benefit in this moment, and we have many strategic initiatives underway to further unlock the channel's potential.

Asia Pacific continue to be a dynamic engine of growth, with Mainland China and Korea moving from containment to recovery. Our business in Mainland China was a bright spot already in the third quarter, growing mid-single digit and we expect it to deliver strong double-digit sales growth in the fourth quarter and beyond.

We continue to advance our work towards a new state-of-art innovation center, which will open in Shanghai as we aim to best meet the needs of Chinese and Asian consumers with local relevancy and local trends.

Throughout the pandemic, we have been steadfast in our commitment to the long term. We aggressively work to mitigate impacts in the short term. I believe that the decisions we make for our people, our consumers, our communities, our retailers and our environment are so important as how we recover will inform the next 10 years.

To this end, I have reorganized my leadership team in four groups. The first is dedicated to managing throughout the crisis, with flexibility and agility, while the second is focused on health and safety protocols for employees and consumer as we reopen offices and stores. The third is concentrated on adjusting our cost structure throughout this temporary phase, while the fourth is fully focused on the future as we anticipate new drivers for the business.

Each work stream is moving our business forward in earnest. The progress in the four group as we update our 10-year compass reinforces our optimism for the future of our business as a pure play in prestige beauty. The growth opportunity we foresee are incredibly compelling.

Since the outset of COVID-19, I've been inspired by our employees' enduring compassion, spirit of collaboration and [ph] elevated (00:06:10) sense of creativity. Next year, we will celebrate our 75th anniversary, as we had begun reflecting on all of the milestones our company has achieved together. We are more intent than ever on becoming an even better company throughout these challenging moments.

Thank you and now to our [indiscernible] (00:06:35).

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC

Thank you, Fabrizio. Thank you for that background. And certainly in the 75 years, almost 75 years of history of the company, this must be one of the most challenging times in the company's history and for many companies.

Fabrizio Freda

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

Yeah.

QUESTION AND ANSWER SECTION

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC

I want to dig a little bit into that and the challenges you're facing right now and how you reacted. So, can you just talk a little bit about what you've seen both in terms of the impact negatively from COVID, perhaps, starting in your Asia markets, and then what you're seeing in particular from a rebound there and perhaps even starting in the US, just in broad terms?

Q

Fabrizio Freda

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

Yeah. What we have seen is obviously the – in Asia, where everything started, we have seen initially a very strong impact in the – particularly in the brick-and-mortar because of closures, because people going at home. But at the same time, we have seen an increase in online. And so, in Asia, after these double event, meaning [ph] important heat (00:07:39) in brick-and-mortar but really an increase in online, then Asia started recovering faster than anyone else.

A

And during the recovery, we are seeing the same trend. We are seeing a trend where the online increases stick and the brick-and-mortar recovery is actually gradual even in Asia, but the online acceleration sticks. And so, the proportion of the business between online and brick-and-mortar, including within the retailers is evolving and is evolving in a situation, where at least we assume that there will be a higher percentage of online business in the future also after the pandemic would be finished.

In the West, we have seen the same phenomenon, but a bit deeper, meaning we have seen a deeper impact of closures and – of brick-and-mortar and a moment of pause and then start of recovery online, but the same phenomenon is happening.

Now, the online recovery is going to stay in our opinion, meaning the percentage of business that will go online is going to stay after the pandemic for the reason that there have been a lot of new consumers going online. And interestingly, these new consumers are mainly 55-plus, so is basically me – our target group seems to have discovered the convenience of online commerce more than in previous normal life during this pandemic.

Now, many of them give us the intention to continue in a bigger proportion in the future. And so, there are new consumers that now are online also in the West, and we see an acceleration of online also there, but as I said a deeper brick-and-mortar hit in the short term during the pandemic.

The other thing that we are seeing in that obviously has been a very difficult period for many retailers around the world, and so we see difficulties in some of our partners that we are supporting the best we can, but obviously this will result, in the West, in closures of stores, and particularly in North America and in some European countries. And this will further evolve the balance between brick-and-mortar and online over time. And so, that's what we're seeing.

Now, from a consumer standpoint, the level of passion of the consumer for beauty is remained completely unchanged. The level of interest in beauty is unchanged. The concept of luxury is evolving and the concept of luxury is evolving from [ph] badging, show off (00:10:46), pleasure of having the best for yourself to quality, to creativity and innovation, new spirit, new ideas and to a concept of sustainability even reinforced but I would say purpose. So, the new luxury is [ph] string (00:11:10) quality of performance combined with the sense of purpose and sustainability and most importantly supported by amazing creativity, which frankly is coming farther in the space of most of our brands in that sense.

So, the consumer is evolving also in term of which categories during the pandemic they seems to prefer. Obviously, already before the pandemic, skin care was on [ph] a role (00:11:41) globally. After the pandemic and during the pandemic, this has further accelerated. I'm saying during the pandemic in the West and even during the initial recovery in Asia, we see skin care further accelerating. As you can imagine, with people being locked in their homes, we have seen makeup at least in certain areas of makeup, mainly color makeup, further decreasing the growth, further decreasing the business, and the same for fragrances, while hair care was more stable and more resilient, but skin care was the big winner.

Face makeup was the other big winner, mainly foundation, concealers. And with our team, we are [ph] calling (00:12:27) these, we have gone from the moment of the selfie generation to that Zoom generation. And the makeup is obviously and skin care moving from selfie at [indiscernible] (00:12:41). Obviously, on a Zoom, there are some categories within makeup for example, which are doing better. [indiscernible] (00:12:51) are doing better than lipsticks or other category like this. And again all this is temporary.

My point of view, actually our strong facts on makeup is the makeup is cyclical, and in this moment, there is a cycle, obviously accelerated by the pandemic, where color makeup in certain category is softer, but this will come back and will accelerate as life normalize.

So, the last thing on the consumer I want to say – sorry, the last thing on the company I want to say is that also what we have gone through is a big containment efforts. During our Leading Beauty Forward, we've been able to move our company more into variable cost, less fixed cost. And during this period, we are benefiting of these higher agility in cost to try to mitigate the short-term cost and to try also to move our resources toward the new drivers of the future. I think we are able to do this faster than we could have done it without Leading Beauty forward.

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC



Okay. This is great. This is great. It sets up a lot of things we can dig into. The first one, I wanted to dig into a little bit is online. And clearly what Estée Lauder has done over many, many years has really ramped up online

particularly in Asia-Pacific, but really globally. Are there any changes to your strategy for online that you think you need to do given the, perhaps, permanent consumer shift more towards online?

Fabrizio Freda

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

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Yeah. There are – first of all, our online is very strong, meaning we have strong technology at the base of our e-commerce, we have strong relationship with our retailers around the world to do better retail.com, and we have strong relationship with all our platform partners like Tmall and others around the world. So, and now pure plays are also accelerating a bit stronger. So, we had strong market share, first of all, online everywhere in the world in every single platform.

So, what is changing is first of all, we – the consumer experience online is changing helped by technology. For example, virtual try-on is going very well, virtual chats has been a big idea for us. Imagine that in China, we have been doing what we call social selling, meaning that when the stores were closed, and our consultants were locked in their homes, they went to do clienteling online using the onlines of the retailers or our own depending on the situation to continue selling and continue having relationship with their consumers. This worked extremely well. That's one of the reason of China fast recovery. And we never lost our clients in the shadow. We were with them all the time.

And so, all this – this is possible by a technology that we call consumer chat online, where you can follow your client, have a chat like you and I are having now with the products on our brand.com and in other forms of dot-coms.

So, this new technology are changing and evolving. We have the strengths in this area, particularly much stronger than many of the more [indiscernible] (00:16:29) competitors that do not have, at least today, this – most of these capabilities, so this is an area of evolution.

The second area of evolution is in logistics, in fulfillment. I mean the acceleration of online around the world has been extraordinary. And so we had strong fulfillment capabilities in every country and we are further reinforcing them. And so we are investing in reinforcing mostly the capacity and the ability to react and the flexibility of our fulfillment capabilities, which again are revealing to be a strong competitive advantage. We basically didn't have big issues or big delays despite the – in this moment our online, as we communicated during our quarterly call, we're speaking triple digit in every single country in the world. So, obviously in order to get this sudden acceleration, you need to have strong fulfillment capabilities, and that's the other area of investment.

And then, the third area of investment is the area of taking this moment to accelerate online penetrations in the countries where online penetration was not very strong. As you know, our strongest online penetration are in US, UK, China, which are the biggest market for us, where online is in the 25%, 30% already before the triple-digit acceleration.

Now, the countries like Italy or countries like Canada or others, the online penetration was much smaller. So, what is changing that we are taking this opportunity to further accelerate that in a big way. And as I said, the reason why this is working, because there are so many new consumers that entry online.

Importantly, the new consumers are new to online but also new to our brands, because that in the online environment, having – [ph] being (00:18:28) our market share stronger than in some brick-and-mortar situation, particularly in some countries in Europe for example. We've got new consumers to our brands, so a very interesting trend.

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC



So, Fabrizio, when the consumers come online, did they shop at the same places, or are they shopping places where perhaps you're not. I know we've always had this dialogue about Amazon's beauty portal for example or other places where you could show some presence. Does that change at all in this new normal as they call it?

Fabrizio Freda

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



I think they shop more in known places, where they're looking for their brands and they're looking for new experiences. So, the consumer in this moment are not very exclusive in the world of online. They are really searching for a new experience. So, we have seen new consumers, so increased traffics in our online. I'm sure others have seen the same.

But the beautiful insight is that we have seen a big acceleration of conversion, meaning out of 10 consumers that visit our sites or retail.com with our partners or our stores in Tmall et cetera, in all these visits, we see more of them buying and more of them coming back. So, this combination of increased traffic and increased conversion is the point of strengths. And yes, there is a lot of competition out there, but frankly the consumer are much more willing than before to navigate and discover online. And so, I see the competition actually more manageable than in the future. And particularly, what we see online is that the consumer has two needs in this moment. One is replenish the product they love and they are more difficult to access today. On these ones, like buying their Estée Lauder Advanced Night Repair that they're missing, because they've been one month-and-a-half or two months locked in their homes, their conversion is extraordinary. They come and buy online to replenish instead of waiting for when their brick-and-mortar will feel comfortable or safe to them.

But then, the interesting thing they also have maybe probably more time in this moment, but they have more time to discover new things, so they navigate, explore, and in these new customers, new exploration, new navigations, the ability to retain them and to convert them is about again creativity, quality, branding, is the power of the brands, and we see the power of the brands and the power of our hero product in that online environment [indiscernible] (00:21:14).

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC



And Fabrizio, are you seeing in this navigation and this ability to take more time to search online, any more price sensitivity?

Fabrizio Freda

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



There've been a lot of promotionality in different parts of the world depending on the moments in this period. So, obviously, the consumer have taken advantage of promotions in certain parts of the world in certain moments of this lockdowns, but I don't see personally more pricing sensitivity at this point of time.

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC



Okay.

Fabrizio Freda

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

Now, obviously, we can speak about the risk of recession and what would be the attitude of the consumer on that.

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Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC

Sure.

Q

Fabrizio Freda

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

But during the lockdown, frankly I didn't. Actually, I saw the opposite and – but there is an explanation, so I don't pretend this attitude to stay in the long-term, but the consumer during the lockdown didn't spend a lot of money for other things. They didn't travel, they didn't go on vacation, they didn't go to restaurants, they didn't go anywhere, so they had some available income – at least the ones that have not lost their jobs, some available income for extra things, and that's why I believe there was all these bigger interest and it's more time and there will be more available income, again, depending by consumer group...

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Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC

Sure.

Q

Fabrizio Freda

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

...that we saw it coming online in a big way.

A

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC

Okay. So, I wanted to spend a little bit more time later in terms of top line growth and industry growth, but one of the questions that always comes up about online is, gosh, the margins are so much better, right? So, as there's a bigger shift to online, can you talk a little bit short-term and long-term in terms of the margin impact of that shift and COVID-19 on your numbers?

Q

Fabrizio Freda

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

Yeah. In the long-term, there is no doubt that the swing online will be margin accretive to our company. That's not true for everyone in our industry. It's not true depending also on the scale or your brand and your operation, because the profitability online is also very much linked to your scale online and to...

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Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC

Sure.

Q

Fabrizio Freda

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

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...the investment you've done for years. We've done now for the last 10, 12 years significant investment online. We are today in a very good position. So, today, our profitability online is accretive to the company, and the proportional and gradual wing to the online sales is going to be good news in terms of profitability improvements over the long-term.

In the short-term, our impact of the closure of brick-and-mortar, particularly in the West, meaning Europe, UK, US, Canada is being brutal. As you know, the brick-and-mortar was a minus 90% in April in the US as an example, the market, not only Estée Lauder. And so, in that situation, since a lot of costs are still in the brick-and-mortar, the impact on margin obviously on the total would be very negative. And I want to clarify as we explained in the call that our quarter four will be worse than quarter three in terms of margin compression in the short-term, temporary margin compression. Also because in quarter four on top of the lack of leverage of our expenses in brick-and-mortar around the West, particularly in some Asian countries where there is not yet recovery, we have the manufacturing negative impact, of course.

Because as you can imagine, when the factory are closed for a month and then the people are still paid and then there are all the costs of the factory there, there is a temporary negative impact on gross margin which is very, very, very significant. It will be a very significant in quarter four, also because quarter four, there will be a combination of this negative impact on gross margin and the fact that the reopening of our factories that now is in place, by the way, good news all our factories around the world, all our distribution as of today are open and functioning. However, they are functioning with new rules of social distancing, timing, because our priority is and will remain the protection of our employees in the best possible way, our factories looks amazing by the way in that sense today and our employees for all our feedback feel very comfortable and we are proud of that.

However in the short-term, we have lost productivity doing that. And so, the combination of closures and diminished productivity has a temporary cost to margin. So, the online margin is actually the mitigating factor of the other points in this moment. So, yes, there is as we speak already strong positive impact on the online and I want to clarify that while in the long-term this will be very visible. In the short-term, this is not going to be very visible because of the negative impacts of margin in the short-term which I was explaining.

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC

Q

Okay. If I still had [ph] Estée Lauder model (00:26:40), I think you've given me enough clarity for the next quarter [indiscernible] (00:26:45). So, you mentioned the industry and competitors. Let's take a step back a little bit. What do you think the industry grows this year and when do you think it gets back to kind of this 4% to 8%, 5% to 6% sales growth in prestige

Fabrizio Freda

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

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I think that the – again, those are estimates looking at the market.

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC

Q

Yeah.

Fabrizio Freda

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

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I believe that this – the recovery will be gradual is now evident and there are still many unknown factors to judge the timing of the recovery. So, today, I'm very optimistic and very positive on the fact that there will be a recovery. When the recovery will be full then the consumer will come out actually stronger in terms of interest for beauty in general and luxury beauty with the new definition of luxury I just gave in the long-term and that we will be ready to enjoy that recovery.

Also, I remain very positive on the fact that our market share of this market is increasing. As we speak, we are gaining market share. We've been gaining market share in quarter three. We are gaining market share as we speak and we will continue to gain market share in the long-term. What I don't know is that the speed of this recovery and how fast we'll go back to normal. Our current estimate is that the first six months of our next fiscal year or if you want the July, December period is going to be gradual recovery of brick-and-mortar and the further acceleration of online. And the gradual recovery of brick-and-mortar will be, in some markets like the US, combined with closures of brick-and-mortar, and while in other places of the world, like Asia, there will be much less closures, but still there will be a gradual recovery.

To support that belief, I look at China today, China today is already growing in double-digits, is already going in the direction of where we came from, meaning, from the strong growths we had in the past, but the composition even in China is different. The composition is brick-and-mortar has not yet back to 100%. Even in China brick-and-mortar is still well-below the previous year, but online is so much stronger than the total is double-digit stronger. So, even in China, we see that the recovery of brick-and-mortar is gradual and I assume this will be even more prominent in Europe, UK, US, North America, meaning, the graduality will be even more evident, and as I said combined with some closures. But then, as of the calendar year 2021, I assume that if there is no second wave, we are going to see some stronger and faster recovery, very excited.

If there will be a second wave, we don't know, this may be again delayed by some partial temporary further closures in some markets. Interestingly, starting at the history of second waves in this kind of situation, second waves tend to be more local, they happen in certain areas, it tend to be less global, also because as evident in these days, certain communities, certain countries have a different way to react to the virus, a different way to protect from the virus. And so, the risk of second wave is different by country by perhaps to the world and that's why even less predictable for us. But I'm pretty optimistic that as of calendar year 2021, we are going to see a global recovery of the market. And then finally, your question was the number 5%, 6%. I definitely believe the market will go back to an ongoing long-term 5% to 6% growth per year after this crisis will be finished.

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC



Okay. Okay. So, we talked earlier about a few consumer behaviors that are going to change and probably sustainably change, so online is one example of that. One of the things that we're seeing in many different industries is this desire of the consumer to look more for health and wellness, to look more for better for you in some sense. Can you talk about Estée Lauder's positioning in that, clearly, Origins and Aveda, maybe in others, but how do you think about the evolution you have to make it that indeed becomes an accelerated trend, does there need to do more M&A, do you've to refocus your R&D, how do you think about that?

Fabrizio Freda

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



So, I've to say we were already in this direction. So, the consumer is more interested in self-care, in regimen, in skincare, in safety, in the right hygienic standards and is more interested in the area of skincare in performance, meaning, they have new very clear expectation of high performance. Now, the brands in our portfolio which are performing that are many. Well, you mentioned Origins, Aveda, which are very well positioned for the second kind

of trend which is sustainability, naturality, safety, which is also important. But they are two trends and there's some overlap there, not every consumer is looking for both trends.

The trend number one is performance, safety and really quality in the sense of confidence in the product. In this first trend, our brands like Estée Lauder or La Mer are flying. I mean our best performing brands are these brands and they are having amazing traction because of their performance, because they also have trusted hero products which are becoming part of the everyday life of many, many global consumers and the level of loyalty and repurchase rates of these brands are outstanding. Now, loyalty and repurchase rates, high repurchase rates in the 50%, 60% of consumer that ever tried are already extraordinary during normal times, but in this time in recovery, they will play an even bigger role. Because in a recovery mode, what we see the consumer first go back to their habits, to their area of comfort and then experiment again.

So, all our hero products in this space are really well positioned. And then, you're right, we have some natural brands like Origins and Aveda which are accelerating and getting new consumer because of the trend of sustainability and natural. But all our company, all our brands have a sustainability model by now and maybe they're different, it's not only about naturality of product or other sustainability, more in the S of ESG, more in the social area, but it was interesting, before the pandemic ESG, environment, social and governance, there was a very high on E, environmental sustainability. This is obviously staying, but the S is further increasing and accelerating. The importance that the consumer attributed to the social impacts of brands and things is further accelerating and our brands are very well positioned in this.

Then in term of R&D input as you said, yes, we are going further investment in R&D. The most important goal in terms of relevance, but also in terms of amount of investment is our new R&D center in Shanghai where we are doubling down on our ability to design products for the Chinese consumers with local relevancy for the Asian consumer, because this is going to be an R&D center in Shanghai for Asia. And we are taking these investments to get better [indiscernible] (00:35:16) better understanding, but also better local clinical testing capabilities, local ability to test on local skin and the local ability to have joint ventures with university, with other research centers, and to get technology and R&D investment going in the region. This obviously is not new. We have done it in the last years at a smaller scale, but the results has been so promising that we are ready to scale it back and go to the next level. This will be particularly focused on skincare and on face makeup, and those are the two areas where the consumers today have more expectations.

I will stop there, but if you want to go more in that I can, but those are the main points.

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC

Q

Yeah. No. I appreciate that very much. And if you think about R&D, there is obviously homegrown R&D, right, which is your own development, and then there's also the M&A, so the acquired R&D so to speak.

Fabrizio Freda

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

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Yeah.

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC

Q

And I'm glad you mentioned Origins. I think that's one of the few brands you did not buy, right, I think most of the other ones you did. How do you think about M&A for meeting the new consumer needs? So, DECIEM, obviously,

has been something you guys have been involved with [indiscernible] (00:36:37) is something out there that everyone thinks everyone has looked at. How do you think about those brands and what M&A means in this context today?

Fabrizio Freda

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

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Yeah. I think that, obviously, we continuously look at the M&A for opportunities, but R&D is not really the area where we need a lot of support from acquisitions. Normally, many of the brands are there, particularly makeup, but many of the brands out there are using third-party manufacturers. So, they outsource the R&D. You don't buy these brands because they add ingredients, formulations that you don't. We, actually it's the opposite, we buy brands that then can benefit from our R&D unique technology [indiscernible] (00:37:25). So, R&D is more an element of leverage to us than something we acquire for. And so, we look at the so-called indie brands or new brands over the last years we had tremendous success around the world. In his moment frankly one of them that are mainly focused on brick-and-mortar are suffering, and one of them which are more of online pure players are continue doing well.

And so, the world has being a bit divided into these two directions. And then, our priority in M&A will continue to be also to look into the Asia brands development. So, we are very proud of our recent acquisition of Dr. Jart+ that by the way is our biggest skincare acquisition ever and is a Korean brand and is obviously with the recovery, after the recovery we have great expectations from this brand, which is a good example of how our acquisitions continue to be focused on the strategic opportunity in that movement. In this moment having our latest acquisition being a major skincare brand is exactly an acquisition in the core opportunity of today, as you have – as you know from my description of the overall market opportunities at this moment. So, we will continue looking acquisition in this way with filling clear strategic opportunity areas rather than buying for R&D technology which frankly is not our priority.

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC

Q

And Fabrizio, are you seeing better opportunities today given what's happened from an economic perspective that you can opportunistically go after or has the valuations really not changed in these smaller indie brands?

Fabrizio Freda

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

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I mean my point view, the valuations are changing. People may not accept this idea, but in general, we don't look at acquisition in a tactical way based on short-term valuations.

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC

Q

Sure.

Fabrizio Freda

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

A

We look at it as feeling strategic opportunity in the long-term. So, yes, we will continue and – so, if your question is what are the new M&A opportunities. Frankly, the new M&A opportunity are coming from the new trends that we are describing. Meaning the most interesting M&A opportunity will be in the area of skin care, will be in the area of brands with strong online capabilities, will be in the area of brands that have traction also in the East, and will be opportunity in area of brands which have a reasonable pricing position, and also importantly, brands that

have the ability to have long-term profitability. So, the idea of these brands that built in the last four years without visibility or profitability, I don't think these times any more the times for that kind of platforms, but there are new opportunities that are linked to the new drivers that will appear to be very important in recovery.

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC

Q

Okay. Okay. Yeah. And infinite times profitability as a multiple is always difficult for people like me to swallow. So, one thing you haven't talked directly in the past, little while today is travel retail. And clearly, that industry has been just overturned given what's been going on right now. How do you see travel retail evolving? I mean what's the impact on you not just on margins on your growth cycle [indiscernible] (00:41:25)?

Fabrizio Freda

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

A

So, that's a great question. First of all, long-term and then I will answer short-term. Long-term, I believe that travel retail will remain one of the most exciting channels for luxury, in general, and luxury beauty in particular, and this is going to come back. And obviously, travel will come back, but travel will come back also in different forms. Second, also in travel retail, the phenomenon of online that we call pretail is accelerating extraordinary. Today, it's very interesting what we've said. I always spoke about TR as two drivers. TR is driven by traffic, and that's not a good moment for that, and is driven by conversion, and that's actually an extraordinary moment for that. We are seeing conversion numbers go through the roof in this situation, obviously, [indiscernible] (00:42:27) there is more traffic for the time being. But directionally that's interesting, and this is driven by pretail meaning by the possibility of buying online when you have the ticket before you travel.

Now this pretail phenomenon is a – I think is going to be even more relevant when in the beginning before we are all more comfortable with travelling again and the virus would be completely defeated that – that will happen by the way. But before that moment, we will be more prudent in travelling and be more prudent maybe we want to go less to the store with a lot of people buying and we prefer to buying online before traveling. And so, once we will experiment with this in the moments of less comfort like today then again some of these will stick. So, we are assuming that there will be an acceleration of pretail driven by the more prudent approach to travel over the next several months.

So, in the long-term, I envision the travel retail channel, they will go back to more normal traffic. And this may take time and may take a year or more, but will happen. And also envision a higher conversion rates than usual that will make the travel retail, although the traffic may not increase for some time, the way it used to, the conversion will. So, I expect travel retail to go back to more normal level of relevance of growth [indiscernible] (00:44:06) moment, but with a different mix of traffic and conversion driven by the online channel. So, that's my long-term positive vision on the channel.

In the short-term, we see already some of these happening. In this moment, first [ph] to go (00:44:22) the travel retail in Europe and in the Americas is basically minus 90%...

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC

Q

Yeah. Yeah.

Fabrizio Freda

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

A

...of traffic as you know from the number. So, it's basically all closed. And by the way, this will have a big impact on our quarter four, because in our quarter three, we had some travel retail challenges in the east. But we didn't have a lot of travel retail challenges in the west. While quarter four will represent the worst quarter in that sense, and then we expect gradual recovery as of next fiscal year. But the – so, the west is closed and will reopen later. But in the east, we already see some phenomena, for example in China, international travel is not yet started in any significant way, but domestic travel has, and we see already areas for internal domestic travel, which had duty-free like Hainan and the Hainan island where tourism is already increasing, because it's the way they've decided they can had a moment or relax in this moment after the virus internally, and we see sales there are already being pretty strong. We see sales there today what is open is Korea, internal travel is open, and numbers are very strong. Hainan is open, numbers are very strong. Macau, Hong Kong are open and number are starting to recover. So, what is opening is showing impressive [ph] conversion (00:46:03) rates and the increase in traffic. So, net in the short-term, I believe this will continue to be a challenge and will be the recovery, will be the recovery of traffic, will be very gradual. But in the longer term, we will see a more moderate traffic, not much higher conversion, that will bring back travel retail to be a key driver of growth, and most importantly, an accretive driver of growth to the company, and thanks to that retail even more accretive.

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC

Q

And so, do you see the future [ph] sit state (00:46:44) of travel retail driving any type of mix of category that consumers purchase, the travelers purchase or brands and what does that mean to your market share?

Fabrizio Freda

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

A

Yeah. So, this is frankly all favorable. Well, what we see is that, in this moment, meaning in a moment where the travel retail, which is opened is mainly in the east, and the consumer that buy are mainly in the east, obviously, you'll see a much stronger performance in skin care – in travel retail and less in makeup and fragrances. But, these obviously will change as soon as the global distribution is changing. Because to be clear, the travel retail Asia has a higher percentage of skin care even in normal times.

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC

Q

Yeah.

Fabrizio Freda

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

A

The travel retail Europe has the highest percentage of fragrances, and the travel retail Americas is very strong in makeup, et cetera, et cetera. So, however, in Asia, we see a – we saw before the crisis, already an acceleration on makeup and fragrances that will continue during the normal times. But in this moment, there is a [ph] overproportion of (00:48:01) skin care. But when travel retail will normalize, we believe that all the categories will get a positive growth. So, more than a difference by category, what you will see is different by brands, meaning in travel retail, only the strongest brands are really able to generate the level of productivity. They make them choose by the travel retail, [indiscernible] (00:48:30) et cetera to be there. So, scale matters in travel retail. Is that – travel retail is a channel where scale is very important, and that's why we believe that most of our brands will have – as today will continue to have a relative advantage in travel retail.

The other thing that matters in travel retail are hero products. When you travel, you are less willing to experiment because you buy [ph] products added for (00:48:59) yourself. But then you try things you know or for gifting, and

then you don't want to be wrong in your gifting. So, there is much less experimentation in travel retail and much more search for heroes for well proven product.

Now, our market share of heroes is extraordinary. You heard me speaking about the strategy now pretty overtly in the last three, four years, we built it because we knew that our two most accretive channels, online and travel retail were driven more by heroes than by enormous amount of SKUs, and that's why we have over time strategized in that direction, nor now we are in pretty good shape. So, we see this to be further emphasized.

And last, travel retail is also driven by what we call the high traffic moments, there are moments of the year, where people travel more. But most importantly, travel is composed by tourist travel and business travel. Business travelers have more or less the same purchasing attitudes during their all business trips, but tourists don't. Tourists are much more driven by specific [ph] peak and valleys (00:50:20) or moment where they're willing to buy. And so, today, we had a very sophisticated ability, we have all the data point to know exactly which moment the consumer buy what, and how much traffic there is in that airport, what are the most interesting SKUs that they will buy in that airport, depending on the profile of the customer who's coming to the airport, the more Russians, Middle East, Chinese, Indians and depending who they are, where they go, we know exactly what to put in exposure, what to put in retail, which kind of stocks to have. All of this has become much more sophisticated, thanks to data. And this will be an advantage over the long-term.

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC

Q

Okay. So, I have just a couple more questions to get to. One of them is more broadly about permanent consumer behavior change. And I guess if you were to set back and close your eyes and say, these are the one or two permanent consumer behavior trends, Estée Lauder is most concerned about, right. That would really impact us negatively, and how I'm tracking those. What would those be. Are there a few that really come to mind as a concern whether we trade down, whether [ph] it would be (00:51:41) really broad recession, what are the types of things post COVID-19, consumer behavior changes that you would be most concerned about or at least investors should be most concerned about.

Fabrizio Freda

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

A

Yeah. The one we are concerned with – and again in Estée Lauder teams, the concern means actions normally rather than just being worried.

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC

Q

Yeah. Yeah.

Fabrizio Freda

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

A

So, the one which are concerning us and we are acting on are, first of all, the consumer be more concerned at least in the short-term with safety, and the potential impact on that be or that concern on their willingness to be in brick and mortar experiential situations in the future, short-term, and then what's the impact of that even when the virus will be gone, okay. So, for example, what are we acting here. We are trying to make our in-store experiences really safe. For example, there is a team which is working on what we call confident retail, meaning the future of retail that will be designed in a way that our consumer will be completely comfortable. So, that's one trend. And again instead of giving you too many details on that.

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC

Yeah, yeah.

Q

Fabrizio Freda

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

I'll speak about another one. But you need to imagine that's obviously important to us.

A

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC

I'm imagining drive-thru as there are lot of counters.

Q

Fabrizio Freda

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

Oh, actually, that's one. And you can imagine omni-channel activities...

A

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC

Sure.

Q

Fabrizio Freda

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

...more connected online with the brick and motor.

A

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC

Yeah.

Q

Fabrizio Freda

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

You can imagine that the you know in our store we have testers, things that you need to [indiscernible] (00:53:25)...

A

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC

Yes.

Q

Fabrizio Freda

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

...to try product.

A

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC

Yeah.

Q

Fabrizio Freda

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

You can imagine at least in the next month that's not exactly...

A

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC

Yeah.

Q

Fabrizio Freda

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

...what every consumer [ph] would (00:53:30) want to do.

A

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC

Yeah.

Q

Fabrizio Freda

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

And so, for example what's the role of mini samples...

A

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC

Sure.

Q

Fabrizio Freda

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

...instead of testers.

A

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC

Yeah, yeah.

Q

Fabrizio Freda

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

...what's the role of safe retail in term of dealing with retail like we deal with our factories. So, hand sanitizer, mask availability, distancing in a certain way. How do we deal even in a store instead of patching the face of people with virtual makeup – makeovers...

A

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC

Yeah.

Q

Fabrizio Freda

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

A

...examples where you can interact on a video instead of the [indiscernible] (00:54:05) if you choose to et cetera, et cetera. So, this is all and some of it is temporary like the idea of [ph] touch (00:54:14). I think at a certain moment when the virus will be defeated, human being will go back to normal social relation. That's my also personal hope. But, the – but in the meantime, we are developing all these elements and we are keeping in mind that even when the virus will be defeated, some of these will stay. We are trying to learn the consumer what will stay and what will be [indiscernible] (00:54:38) for the long-term. So, this is a worrying thing.

The other worrying thing you spoke about recession and what happened in recession is evident that during – during recession, when there is a very strong impact, a certain part of the population is less hit by recession, and this part of the population is – tend to be more into our target growth. And so, as usual, the impact of the recession on our business is going to be reasonable versus when you look at history, there is an impact, but the impact is not so profound. What worries us is that in this moment, the potential short-term impact on recession is strong and is very deep. And so, we are studying what could be the short-term consequence in term of the trading down of consumers. And for example actions in this area is where trade down is at risk, we are reinforcing our brands which are the entry price point [ph] of prestige (00:55:48).

You remember probably, we already I think had a conversation in 2008-2009 period or what happened to us. Our brands like Clinique or M·A·C actually grew in that period, and in certain markets like in the United States. So, we had a portfolio where we can – we can mitigate the risk of the recession creating a trading down with reinforcing our entry price point brands. By the way some of these brands have the scale and have also the positioning to fit the new consumer needs pretty strongly. So, we believe that's actually something we could turn a problem into an opportunity.

Another thing that worrying us is regulations and around the world, and how the regulation will be impacted by the changes, and obviously, also we are – we remain concerned with the trade, with trade issues globally that may emerge out of these and although as we discussed in several times, our high gross margins model put us in a condition to manage possible trade – trade issue, [ph] trade problem (00:57:05), trade tariffs in a – in a manageable – in a manageable way. So, those are our main concerns in this moment. But the biggest, more than a concern, the bigger question is, is the shape or recovery because you know we can have – obviously, this impact on business has been very, very tough, and that is – the impact of this pandemic at the end is a temporary or is it one-time event hopefully, but has all the characteristic of one-time event, maybe not short, but is a one-time event.

The market share recovery is going to impact our business for the next 10 years, and that's why in my prepared remarks, I explained that I have created a team of people with me, which is really 100% focus on the future drivers, and how we're driving this because probably the most important thing we can do on top of the taking care of our employee, our consumers and mitigating our short-term cost. The best thing we can do is put us in a position to grow market share in the recovery because that's going to be a long-term net present value for all our shareholders.

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC

Yeah. Fabrizio, this has been as usual a very informative and dynamic discussion. I very much appreciate you spending the time with us. We could probably talk for a few hours, and if the social distancing goes away, perhaps we can do that, we're close to each other. But I really want to thank you so much, not just for this session, but for the other sessions we've done together here at [indiscernible] (00:58:45) and beyond, and you've always been a pleasure to work with and a pleasure to really give us a few notches of Estée Lauder, but really a visionary for the

whole industry. So, thank you so much for your work and perhaps, we will see you again here next year in a little bit of a different world.

Fabrizio Freda

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

Thank you very much. And again all the best for your new role, and thank you for all what you have done not only for all of us here, but for the industry in the last years when we have worked together really impressive. I always had a lot of respect for you, for your thinking, for your ideas, and thank you to all of your colleagues as well.

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC

Thank you. Very kind of you to say that. Thank you so much and we'll talk soon. Thank you everybody for joining.

Fabrizio Freda

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

Bye-bye.

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC

Bye.

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