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The Estée Lauder Companies, Inc. (EL)

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CORPORATE PARTICIPANTS

Fabrizio Freda

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

Peter Johannes Jueptner

President-International, The Estée Lauder Companies, Inc.

OTHER PARTICIPANTS

Callum Elliot

Analyst, Bernstein Research

MANAGEMENT DISCUSSION SECTION

Callum Elliot

Analyst, Bernstein Research

Good morning, everybody. We're just past the top of the hour, so I'm going to get started. And I am delighted to welcome Fabrizio Freda who is the CEO of Estée Lauder as you know. And alongside Fabrizio, I'm particularly delighted that we're also joined by Peter Jueptner. Peter as some of you might know was recently promoted to Head of International at Estée which includes the important Chinese business. So hopefully, very helpful to have Peter join us today and chime in on some of the Chinese questions, and also for us to get a picture on some of the bench of talent at Estée Lauder today.

So, Fabrizio, Peter, thank you very much for joining us.

Fabrizio Freda

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

Welcome.

Peter Johannes Jueptner

President-International, The Estée Lauder Companies, Inc.

Pleasure.

Callum Elliot

Analyst, Bernstein Research

Just a quick housekeeping, comments, there are QR codes around the room. You can scan and submit questions to submit to me; I'll get them on this iPad. And if there's any very interesting ones, we'll integrate amongst the conversation as we go through, so feel free to do that. And otherwise, without any further ado, let's get started.

Fabrizio Freda

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

Let's get.

QUESTION AND ANSWER SECTION

Callum Elliot

Analyst, Bernstein Research

Q

Let's start with China. I think it's probably the elephant in the room. The business has obviously faced huge challenges recently with COVID lockdowns in Shanghai in particular. But I know we've got a lot of generalists in the audience, a lot of portfolio managers who may not be completely familiar with what's been going on and in particular how it's impacted your business. So, maybe for the benefit of the audience, could you start with just a little bit of background on what's been happening in China and to your business in particular and why Q4 is expected to be so challenging?

Fabrizio Freda

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

A

Yeah. As you probably know, as a strategy to stop COVID's spread, China government has decided to manage it with a zero tolerance policy against COVID. This created a lot of closures of entire cities, and on this city particularly Shanghai. So, what we saw is starting about mid-March, we saw the closures of a lot of retail, of brick-and-mortar retail. Some retailers were not asked to close were reducing timing of opening. Overall, the traffic in retail in most of the country really dropped, dropped significantly to minus 40%, minus 50%, minus 60% depending on the part of China. The travel, the rules anti-COVID also impacted travel which impacted Hainan, so the Chinese travel retail part that till mid-May was in the minus 70%; in April it was minus 80% traffic. And then, on top of this big traffic reduction, we, Estée Lauder, have the distribution center, the main distribution center in Shanghai that distribute both online and brick-and-mortar. Because of this, we got the distribution center almost completely shut down for as of March 15 exactly and for the entire month of April.

So, when we reported, this was the situation at the time in China. So, less travel retail, less brick-and-mortar, impossibility to ship to other brick-and-mortar travel retail for some time. And so, there was a very big impact on quarter four. Frankly, that's the reason why there was an impact on quarter four that we had estimated. To be clear, those are temporary or these were temporary issues. And we communicated, we remain very, very positive on the inherent demand of the Chinese consumers. But this was a temporary issue that, by the way, we are familiar with because the same happened in the US, in Europe during the 2020 when there were the COVID lockdowns also in this part of the world. So, it's a similar thing but just amplified in terms of severity of the lockdown methodology.

Callum Elliot

Analyst, Bernstein Research

Q

Okay. Perfect, and that's helpful sort of background. So, we heard from your Q3 results at the start of May, and at the time you were saying you were expecting Shanghai to start reopening in the middle of May. We're at the start of June now and it seems like that has started to happen from what we can see here. But maybe you can share with us what are you seeing on the ground now today in Shanghai. Were your distribution centers operational by mid-May as you had expected?

Fabrizio Freda

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

A

The short answer is yes. Our distribution center started getting better, meaning going from not operating to operating gradually more as on mid-May, as we expected. And now is, meaning early June, the very good news is that June 1, Shanghai has reopened. May 30, Beijing travel, internal travel lockdown stopped, meaning people can move around Beijing. And as for our distribution centers, early June we are approaching the 100% capacity. So, I would say that China, from a point of view of distribution, is back. However, I use the word gradual to explain that this is not just from one day to another; it's been a gradual process of improvement.

Now, from a distribution standpoint, it's 100%. But also, the situation remains in China as expected, that the traffic in the store is still below the – 40% below in term of the time of recovery. Brick-and-mortar is higher, but the opportunities online now are very strong. So, online is back but brick-and-mortar, it will more gradually recover. And the other important thing to know that the travel retail part, so the travel to Hainan will also gradually recover as we said but will recover more based on when the rules will change. So, for example, as of June 1, when Shanghai is reopen, then we expect the travel also to Hainan will improve. But before the reopening of the big cities, obviously the travel has been improving very gradually, very slowly. So, it's a gradual process [ph] overall (00:02:53), but the good news is that the distribution capability is as of early June is back to normal.

Callum Elliot

Analyst, Bernstein Research

Q

Okay.

Fabrizio Freda

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

A

By the way, another thing I want to add because it was part of what we discussed before. The one important element of the recovery was the participation to the 618 event, so to the big online event. And the good news is that we are participating. We are in a position to ship and to reach our consumers in 618. By the way, it started on May 23 and now is the first phase that is finished between June 1 and June 4, so we are exactly in the middle of the finishing of the first wave of sales and we are participating. We have been able to, as I said, do that part of the distribution normally correctly.

Callum Elliot

Analyst, Bernstein Research

Q

Just a final short-term question. So, you're participating in 618. Do you have enough capacity to fulfill 618 demand and the backlog of demand that has built up as you've taken online orders through April and May?

Fabrizio Freda

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

A

Yeah. I think we have the distribution centers close to 100%, so we have the capacity to operate as demand will evolve. So, the key question remain how demand will evolve, but we have the capacity to serve the demand.

Callum Elliot

Analyst, Bernstein Research

Q

Perfect. Okay. I think that's clear on the short-term. And as you said, they seem to be transitive impacts in the short-term, so let's pivot and talk about some of the longer-term Chinese questions. Maybe just starting broadly, how do you view the opportunity in China and maybe with Chinese consumers globally as well?

Fabrizio Freda

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

A

So, we remain very, very keen and strong on the Chinese consumer opportunity in the future. That's the question, correct? How do we view the long-term? So, as the recovery from the COVID lockdowns will happen, we strongly believe that the acceleration of Chinese consumers will continue and will be there for the long-term. So, the key drivers that I've discussed in several locations, but the key driver is the growth of the middle class that in China remains. If you look on a three, five years, it's the biggest part of the world. They're not only just entering middle class but the creation of high-end part of the middle class is the biggest of the world. The other important driver is the sales per consumer that as I – I think I presented the numbers at the time of the Investor Day a few years ago. Imagine, this was almost three years ago. Since then, this is already double the spending for consumers, and these can still double again and again, still reaching the levels they should reach at a certain moment of Korea or even US if you make comparison to when this will happen in the group of high and middle class. So, that's the other opportunity which is just at the beginning of the journey.

Then, we have the opportunity of distribution. We are in 142 cities with our most distributed brand, Estée Lauder, but other brands are in 40, 50 cities, 30 cities, so enormous amount of distribution opportunities in front of us. We have opportunity to further distribution online. We are very strong in Tmall and we are going to stay; they are excellent partners. But also now, we are expanding in JD and we are expanding in many other opportunities that will emerge as we go. We are also increasing our social media coverage, so the online penetration both in sense of marketing, access both or consumer access via marketing and in sense of distribution as opportunity to grow, we – now that the animal testing rules have evolved, we have the opportunity in the future to bring more of our brands, more of our strong brands to China. So, we have still plenty of brand expansion opportunity in front of us.

Then, I believe one of the most important opportunities globally in beauty is the development of the Hainan Duty-Free space which we believe is just the beginning of the journey. I want to remind everyone that Hainan is domestic travel, so it's open to the entire middle class in China while international travel is only exposed to people having a passport. And so, Hainan is not an alternative to international travel; it is much, much bigger opportunity than international travel just because the entire middle class has access to it. And that explains, by the way, the incredible results in travel retail during the COVID Western lockdowns because Hainan was more than substituting the amount of travelers in airports around the world just because it was domestic travel duty-free in China. So, a huge opportunity; this will continue. Now, the great strengths of the Hainan opportunity is that this is mainly creating new consumption in small cities, in Tier 3, Tier 4, Tier 5 cities, so it's increasing the penetration and exposure of luxury beauty to the entire population. So great, great opportunity.

And then, the last thing I want to say is that the productivity per door in China is extraordinary because the traffic is extraordinary. But also, as I explained, we have a limited number of doors in brick-and-mortar, still a limited number of cities, high concentration of traffic places like Hainan. And then, a lot of the coverage of the country is done via online, not brick-and-mortar, so the issue that many other market have, brick-and-mortar is becoming less productive as online develop, that issue doesn't exist in China. Brick-and-mortar is very productive, maybe not during a COVID lockdown, but in general. And online is super-productive, and Hainan is amazing for that since in luxury beauty, which is a service business as well, the productivity per door is the key driver of profitability. That's why China is a very profitable market as well and, in our in our assumptions, this will continue for many years to come.

So, very positive on the long-term of China. This is intact. The COVID situation today is temporary in our view. And in fact, we are preparing for investing in growth acceleration in the post-COVID lockdown period.

Callum Elliot

Analyst, Bernstein Research



You touched upon the distribution runway for some of the longer tail of brands beyond Estée Lauder, beyond La Mer. Could you build upon that a bit? Which of that longer tail of brands are you most excited about? It seems like today, the majority of the growth is still coming from those two big brands.

Fabrizio Freda

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



Actually, no. I think most of – I would say all of our brands in China are growing, but you are true that Estée Lauder and La Mer are bigger. So, let me first say that they are bigger but they are not finished to grow at all also because they are mainly serving – Lauder is serving also makeup and in a little part in China fragrances. But they are mainly skincare brands. And in China, differently from the West, 65%, 70% of the market opportunity is skincare. So, Estée Lauder and La Mer are the biggest not only because they've been earlier and, by the way, they're doing a fantastic job, but also because they are completely in the biggest part of the Chinese market in luxury beauty which is skincare.

And so, those two brands are at the beginning of a journey particularly because the biggest segment and one of, sorry, one of the fastest growing and one of the very big segments in China is luxury skincare beauty. So, La Mer is growing. Many of our competitor, very luxury brands are growing. In our portfolio, Estée Lauder is part of the brand which is called Re-Nutriv which is in the luxury space like La Mer. Brands like Tom Ford which are extraordinary in China is in the high-end luxury segment; that segment is explosive in China. Now, sometimes I get the question do you see China consumer moving down? Frankly, if you look at the market and even in our sales, it's the opposite. You see consumer trading up to the luxury part of the business. So, Lauder and La Mer, solid brands. They are – both of them are in the top five brands in China in prestige luxury, so extraordinary strong brands with great critical mass. So, that story will continue.

Now, we have new brands come. As I said, makeup is growing in China and long-term will grow because today it's still much smaller percent than the business that is in the West. And MAC is an important brand. Tom Ford is in the makeup luxury segment; MAC is in the entry price of prestige segment, so those brands are also growing and accelerating over time. We have Bobbi Brown which is also in the makeup which is doing very, very well. And then, Tom Ford has also a fragrance luxury business, and we have Jo Malone in the fragrance segment which also are very, very, very strong. And they will – are growing but, as you say, will reach the critical mass where their growth will be even more relevant to the results of the total market. Just to mention a few brands, but those are extraordinary.

The other thing that is important to understand, that the fragrance luxury segment in China is at the beginning of the long journey because in China, just few years ago, about 5% of the total luxury market was fragrances versus 30%, 40%, 50% in countries in the West, depending by market. So, huge opportunity to grow. This growth has started but has started in a different way. In the West, it's the entry price for fragrances, so many designer fragrances that are very big. In China, it's the other way around; the very luxury, sophisticated, artisanal fragrance brands which are growing the fastest and getting the biggest part of the market. We anticipated that. That's why as a company, we decided several years ago to look for market leadership of this high-end segment with brands like Tom Ford, Jo Malone, Frédéric Malle, KILIAN, Le Labo. So, all these brands now are an extraordinary opportunity to continue tap in the growth of the Fragrance segment in China. And as I said, we are also tapping with Bobbi Brown, MAC, Tom Ford in the makeup segment. So – and again, I cannot discuss the details, but there will be more brands deployed in China as I said before which also we'll participate.

So, in China, to conclude on the brand side, you need to look at China the same way we look at our global portfolio. As we explained in the Investor Day, we have the big brands which are \$1 billion-plus, the mid-sized brands which are brands which are growing globally, getting toward the \$1 billion or more. And then, we have the small brands that we see then develop that one day will be our mid-size brands. And then, we acquire new brands; they become smallest, are growing, etcetera. So, we have a process of developing the portfolio. Now, the same model we're using in China, so no surprise. We have two brands, as you said, that are very, very big. We have some mid-size brands which are growing, have clear potential. And we are going to launch more small brands that will then be and continue to feed the overall growth of the portfolio for the long-term.

Callum Elliot*Analyst, Bernstein Research*

Q

Perfect. I want to come back to the M&A model a little bit later, but just tying it off on China. We've got a question from the audience that also is pretty similar to one that I was going to ask anyway. So, the question is around the emergence of local Chinese brands and the local Chinese competition. Can you talk to what you see? And looking forward, what do you think that competitive landscape and the pressure from those local brands is going to look like over the next 5, 10 years?

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

A

Yeah. No, what I see – first of all, it's a very good question, a very fair question. We have seen this since a long time, also because the development of local brands is not only a China thing; it's happening in every single emerging markets in the story of the last 20 years. This is just a process. So, as you know, we do this compass which is the view of the next 10 years that Peter started many years ago and we just now updated in the last few weeks. Again, in that process, it was always clear that local brands will have developed; the question is how and how do we participate. And so, the first good news is that the underlying growth of the Chinese market is so strong that even if you assume that the local brands 5, 10 years from now in luxury will be 30%, 40% of the total, the remaining 70% will be much bigger than today here. So, there is growth. It's not a zero-sum game, it's not either local brands or international brands will grow; we all will grow, and there is no doubt on this.

Then, local brands in mass in China are already a reality. Local brand in prestige luxury in China for the moment, a very small percentage of the business; frankly, non-significant. Our assumption that they will develop and our assumption that we will compete, meaning that despite this development we will still compete in a growing market because the international – some brands and market will continue to develop strongly, and we have the opportunity to compete in the developing local brands via local acquisitions over time. And so, if you have a long-term view, you need to assume the competition as international brands and the competition as part of the local brands develop. Both will be great opportunities.

Callum Elliot*Analyst, Bernstein Research*

Q

Can you develop those local brands yourselves organically as well? I think you tried in 2013 with [indiscernible] (00:18:00).

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

A

Wow.

Callum Elliot

Analyst, Bernstein Research

Q

Maybe it wasn't the right time for...

Fabrizio Freda

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

A

I'm honored that you remembered that but yes, we tried. But we tried – tried sounds like a filler. No, we learn. We wanted to learn. We wanted to learn exactly to your question. And so yes, we can but we have three methodologies. We have organic incubation, and (00:18:26) was an example; but obviously, organic incubation doesn't work 100% of cases. And so, we used that learning and avoid to waste money when we see the learning doesn't give the results we expected, but that's an avenue. The second avenue is incubation of the many founders that are developing in China today where you can have minority investment, support the people, so where you can seed several bets for the long-term. We're already doing that and we have done it in the past. You have seen us buying DECIEM, you have seen us buying Dr.Jart+, you have seen – you know probably we are invested in an India brand called Forest Essentials.

So, we have done this since a long time. We have minority investment, then some of these brands become really attractive and then we have the opportunity to go majority or to buy the entire brand, so that's the second opportunity. And then, there is the opportunity of acquisition, regular acquisitions of brands which are already successful, have a reason for being in our portfolio. Also, we do obviously when appropriate. And so, those three avenues will allow us to continue to develop our brands and participate in the local competition at the appropriate time in the right way.

Callum Elliot

Analyst, Bernstein Research

Q

Okay. Peter, I want to bring you into the conversation. And obviously, this Chinese business is very relevant for you in your new role. It's a big cultural shift I imagine, moving from running a fairly stable EMEA business in your previous role to having responsibility for this huge, dynamic, volatile growth engine. Can you talk about the learning curve? I think you started the new job just earlier this year. It's early days. What surprised you?

Peter Johannes Jueptner

President-International, The Estée Lauder Companies, Inc.

A

No, happy to, Callum. So, first of all, let me say that EMEA is the most complex business we have in the corporation particularly as I always struggle to say to everybody I'm the President of 50% of the world population. It truly is 50% of the world's population because it covers markets like France where we obviously have our strongest established competition, over to the Middle East, to India, down to South Africa. And the last couple of years were quite volatile as you might imagine, managing the COVID situation in all these different situations and markets. But more importantly, and Fabrizio was referring to it, I created the original China strategy with Fabrizio in 2010 and we created what we call China 2020. So, this is, again, in the very spirit of having a long-term perspective on developing China. I think China at the time was \$200 million; it was really, really tiny.

And it's very interesting. To Fabrizio's point, the fundamental growth drivers are still intact, the ones we were talking about at the time. If you ask me, though, what was my biggest surprise coming back into the world of international and reconnecting with China, it was really Hainan and the growth of Hainan and the rise of Hainan that happened over the last couple of years. And that will be, again, as Fabrizio said, one of the major, major growth drivers in China going forward.

Callum Elliot

Analyst, Bernstein Research

Q

So, I'm...

Fabrizio Freda

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

A

And I would like just to add that EMEA under his leadership was not a stable business, what he said. It was actually growing market share very well, and what Peter has done in the entire EMEA, which is relevant to his now international thing, is also he's developed probably one of the most interesting online organization and business opportunity because in EMEA, as you know, online was coming from a low base and now is a significant part of the business. And the online opportunity remains one of the biggest opportunities also for international in general.

Peter Johannes Jueptner

President-International, The Estée Lauder Companies, Inc.

A

Yeah. We tripled online in EMEA in [ph] two (00:22:17) years.

Fabrizio Freda

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

A

Do I need to [ph] sell (00:22:19) your results?

Peter Johannes Jueptner

President-International, The Estée Lauder Companies, Inc.

A

Apparently.

Callum Elliot

Analyst, Bernstein Research

Q

So, I'm fascinated by this idea of the China 2020 vision that you set out 10 years ago, and you said you've just been working through the next 10-year vision.

Peter Johannes Jueptner

President-International, The Estée Lauder Companies, Inc.

A

Yeah.

Callum Elliot

Analyst, Bernstein Research

Q

Anything you can – sort of, any teasers that you can provide for us for how the next 10 years you think might look different to the past 10 years?

Fabrizio Freda

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

A

Non-confidential [ph] immunity (00:22:46).

Callum Elliot

Analyst, Bernstein Research

Q

Exactly.

Fabrizio Freda

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

A

First of all, I think our compass look at the consumer evolution. And the consumer evolution in China is very interesting because the Chinese consumer is absolutely passionate of beauty and passionate of the beauty category in every aspect of it. And so, what the compass shows in the future is that this passion for the category will continue, that many other today is being expressed in making the Chinese consumer probably the most discerning and sophisticated consumer in skincare globally. And so, what the compass shows that the Chinese consumer is not in skincare an amazing consumer, is also a – is an opportunity for learning what then will be interesting for the rest of the world. So, Chinese consumers in skincare I believe have evolved from extraordinary consumers to the most discerning and sophisticated consumer, that if they like something, the world will. And that's why we are putting an R&D center in Shanghai because China is becoming not only a market or a reference for export, but is becoming – the consumers, you want to have in your side for developing the future.

At the same time, what the compass confirm that the opportunity in makeup, fragrances, frankly haircare in luxury in China are enormous because these three categories are not very developed yet. But the consumer interest in them, and the education to use this category is on a roll, and so this is net extra. If – and by the way, that's the secret; if you connect the two things in the compass, work is super clear. That's why we are speaking so positively of the increased consumption per person because the consumer is using today skincare already at levels which are comparable with US and Korea, but not makeup, not fragrance, not haircare. And so, the moment this category improve the consumption for consumers, it will explode. But that explosion is only available to companies with a portfolio of brands that cover all the areas of development. For companies which are mono brands or take one segment only, obviously the growth of middle class is equally valuable but the growth of consumption per person is less, less reachable. And so, that's why are really well-positioned to leverage the best the future growth of China.

The last thing I want to say on the evolution of the Chinese consumer is the interest for innovation. It's a consumer that has the propensity to try new things, experiment which is among the highest of the world, and that's why we brought all our innovation programs globally to now we are at the capacity of 25% to 30% new product launched every year which are new. Just to give you a reference which I talked in the past, when we started with the strategy 10 years ago, we were at 7%; our R&D could be 7% on new products sold in a year, and the company was half of the size of today. Today, the company is more than double the size at the time and we are at 25%, 30%. So, an enormous R&D capability and productivity that is perfectly fitting the way the consumer, the Chinese consumer and, frankly, every consumer but particularly the Chinese consumer is really growing and developing in the world of beauty, of luxury beauty.

So, that's maybe the big insight. And maybe, the last insight I want to speak about the consumer is by age. If you think of China today – actually, think of the West, US as an example. The majority of the consumption and majority of the wealth to have this consumption is in women and men 50-plus, so what we call the ageless segment. They are very good users of our products and they have the wealth to buy them when they want in the large majority of cases. In China, the majority of the consumption is 20-30, 30-40 because the more ageless consumers, so the other group frankly have not lived during their youth in a period where they could either afford or that this was interesting enough as a category. So, the China profile by age of consumption is very different from the West today; it's much younger.

Now what does this mean? So, when you do the compass, if you discover that the women that today are 30 will be 50 20 years from now [indiscernible] (00:28:11), these women will be very heavy users. So, you take the

consumption by age and you project it 10 years, and then you have a doubling or tripling of consumption in the more aging consumers that today doesn't exist. And that's the other way to cut the pie to understand why the overall growth is unstoppable because when you look at it with compass projection, from any angle you look at it there is growth opportunities.

Peter Johannes Jueptner

President-International, The Estée Lauder Companies, Inc.

A

And, Fabrizio, if I could just double down on what you said. We have a very clear view of the consumer segments in China and which channels they're shopping in and how we best serve them and how they evolve. So, a very granular perspective operationally to translate the strategy.

Callum Elliot

Analyst, Bernstein Research

Q

Genuinely fascinating. Thank you. You touched upon the innovation success and how you've gone from 7% to 25%, 30%. I wonder – we get a lot of questions about the investor perception of under-investment in R&D as a percentage of your revenues relative to some of your big international beauty peers and yet, as you say, you have been incredibly successful with the innovations that you have launched. So, is there a secret sauce to why your R&D seems to be so much more productive than everybody else is? And should we be even more excited about this now that you have this big, new Shanghai R&D center presumably about to launch later this year now that the city is reopening?

Fabrizio Freda

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

A

Yes, I'm very excited about the new R&D center in Shanghai, and I'll come to this in a second, and so I hope you would be as well. But the – so, what is the secret sauce? First of all, I think you should read the composition of the R&D investment to understand the choices. So, we have internal R&D and external R&D, external R&D meaning R&D that comes from partnering external. Skincare is very internal. Foundation of face in makeup is very internal, but color in makeup is a lot of external support. Fragrances, as you know there are fragrance houses that do a lot of the work there. And in haircare, some of our competitors are deep in – we are in a very high-luxury natural area of investment which is our strength but is a very specific area. By the way, it's a choice because we believe that area is the fastest growing and the most promising with the highest return. However, it's a choice of focus that we have in haircare.

So, if you take our investment and say very deep in skincare, very deep in face, and very deep but focused in haircare, and very externally integrated for color and fragrances, then you understand that the efficiency of our R&D spending comes also from clear choices and focus. Second key important point is the fact that the secret sauce is not only R&D. I know you're look – but the secret sauce is what we call product development. The way we organize is very unique. In every brand, there is a President of the brand; there is a Creative Director which is the soul of the equity of the brand; and there is a Product Developer, meaning a Creative Product Developer, somebody has the experience to invent new, amazing products and is connected to research and development to get this done. But the idea doesn't come from research and development; the idea comes from creative product development connected to research and development.

That unique model which we have fostered in the last 10 years, when you see this triangle where President of the brand normally is the leader that can lead from the financial direction of the brand to the equity to the consumer, and so is the leader of the overall. And then, you have a Creative Director that creates the equity, so give meaning, purpose to the brand. And then, you have a Product Developer which is at the core of the brand that

creates the product of the future, analyze the consumers, get the data, understand the trends, anticipate the trends, develop the product and an R&D which is at the service of all this brand-focused product developers that invent the future. You realize the secret of the power of innovation. It's basically our R&D is not only focused as I explained before but is also leveraged in an amazing way by a bunch of people which are, in reality, creative product developers.

And that's the secret sauce. And it's not too secret because it's known, but definitely is the sauce. By the way, all secrets is not secret anymore now, but is definitely the sauce that is creating productivity.

Callum Elliot

Analyst, Bernstein Research

Q

And Shanghai?

Fabrizio Freda

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

A

In Shanghai, you're right. Shanghai is – first of all, we were ready to open this summer. Let's see now with the COVID recovery, but we'll be hopefully a few months away from opening this amazing R&D center. Now, this R&D center is giving us, first of all, the ability to be much more locally relevant. Imagine a center where we can develop product working with the Chinese consumers, working with the university there, working with other external partners. Particularly in China, there's very strong ingredient culture, local ingredient culture which is extraordinary. And having all these product developers now which are in the brands having not only the R&D in New York, Melville, but having the R&D in China as well to create and ideate and use all their knowledge, your local content, all of this. Then, imagine the ability of increasing quality of claims because we don't claim things based on marketing, to be very clear; we claim things based on clinical studies. We are closer to a pharmaceutical company than to a marketing company in that sense.

So, imagine they have the clinical studies done in China in the correct way on the Chinese scheme. And so, all the claims of what our amazing formulation can do become completely locally relevant but also a much more efficient costs because doing clinical studies in China from London is not as efficient than doing it in China which are consumers creating a model. So, huge savings in ability to better claim, more relevant claim. So, better innovation, better relevant claims. And finally, you can imagine that, as I said before, particularly in skincare, this center becomes a global center because there, we will learn, we will develop things that then will travel the world. The best example of this I already I think referred to it during the quarterly call, the last quarterly call is the La Mer Treatment Lotion. Basically, for the one of you which are familiar, a watery lotion is a product, is a moisturizing first-step product which is super popular in Asia in general, particularly in China and Japan, super popular in Asia and it's very little usage in the rest of the world.

Now, this is definitely developed with the Chinese consumer, and the La Mer Treatment Lotion now is one of our most popular launches also in Europe, in America, etcetera, and is all coming from having learned why there is space in the routine of every woman around the world of this extraordinary Asian routine. So, our R&D center will become the base for globalizing Asian routines in the rest of the world that, as I said, in skincare it's the right time to do it because Asian skincare is the most sophisticated skincare in the world.

Callum Elliot

Analyst, Bernstein Research

Q

Perfect. What's next after China?

Fabrizio Freda

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

Finally. Sorry. Say...?

A

Callum Elliot

Analyst, Bernstein Research

What is next after China?

Q

Fabrizio Freda

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

So, you want to get off of China? Is that it?

A

Peter Johannes Jueptner

President-International, The Estée Lauder Companies, Inc.

I can comment.

A

Fabrizio Freda

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

You can do that.

A

Peter Johannes Jueptner

President-International, The Estée Lauder Companies, Inc.

So, one of the things, and also during the Investor Day this was presented, it's the other emerging markets from a geographic perspective. And when you look at every emerging market by itself, other emerging markets like Middle East, like India, like Brazil, they're relatively small versus China. If you take them together, it's actually a mighty growth engine going forward. And so, we're working and working with the teams across the different regions on this emerging market strategy. And the interesting thing is that we have developed a model very much based on China actually, on the China evolution of penetrating these markets not anymore in the old way with brick-and-mortar. We took a long time, right? In the old world, we were brick-and-mortar distribution, but now we're really leap-frogging in reaching the consumers online.

A

So in India for example, over the last couple of years, [indiscernible] (00:37:40) India online penetration was if I remember correctly a single digit, can be 5%. It's now going on 50%, and so this consumer reach enables us also, to Fabrizio's earlier point, to keep the productivity in brick-and-mortar. So, it's really an amazing model that we have developed. Many other elements to it, but really very much based on the China learnings. So, [indiscernible] (00:38:03) on the emerging markets from a geographical perspective.

Callum Elliot

Analyst, Bernstein Research

How do you facilitate that kind of knowledge sharing, Peter, in your new job from the Chinese expertise to helping those...?

Q

Peter Johannes Jueptner

President-International, The Estée Lauder Companies, Inc.

Now, that's a super good question. One of the key challenges actually global corporations have, right, are knowledge sharing. I'll give you a good example maybe from the COVID times because it's very top of my head.

A

Actually, at the beginning of COVID, China was the first market obviously to close down with the virus but luckily only for a short period of time at the time, in 2020. But what the China team did, they were very, very entrepreneurial. So, what they did, they basically invented a new business model which we called social selling. So, they took their consultants in the department stores where basically there was no traffic, partially shut down and actually established this online WeChat model to sell directly to the consumers at home and then deliver it through our online capability. And this is something we actually developed then across the world, and this model basically traveled across the world. And we established a global working group on this across the different regions and developed a playbook, how do you do social selling. And a completely new business model that didn't exist basically 2.5 years ago, and now it's actually a significant part of what we do not just in COVID times but also ongoing going forward.

Fabrizio Freda

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

A

And how long did it take because I think it's an extraordinary how fast you guys did that?

Peter Johannes Jueptner

President-International, The Estée Lauder Companies, Inc.

A

About six weeks.

Fabrizio Freda

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

A

Yeah.

Callum Elliot

Analyst, Bernstein Research

Q

Amazing. So, we've got about six minutes left and I want to squeeze in about 20 more questions.

Fabrizio Freda

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

A

Any question without China?

Callum Elliot

Analyst, Bernstein Research

Q

Exactly. So, let's move to the US and...

Fabrizio Freda

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

A

Okay.

Callum Elliot

Analyst, Bernstein Research

Q

... I've got a question from the audience and another question from me. So, you talk about the US being an engine of growth. What gives you that confidence that it can be that where it maybe struggled to be that pre-pandemic?

Fabrizio Freda

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

A

Yeah. No, a lot of things have changed in our US business in the last years and, frankly, we took advantage of the COVID period to reshape the profile of the growth and the profile of the P&L opportunity. And I think now, we are in a much better position; that's why I say that today, US is ready to become another significant engine of growth for the future. Let me explain what are the drivers of change.

First of all, our distribution profile has changed. We were for years so strong in a segment that was declining on distribution; it was mainly department stores. In particular in a segment that was attracting less young people, that was difficult to grow the total when one segment which is so big is declining. So over time, gradually, we have rebalanced the distribution shape of the company. So first of all, today, we still are strong in department store, but our key department store partners today are more solid in brick-and-mortar and they particularly developed a big online business. So, our department store base today, in our opinion, is more solid, has potential to grow with us, and has particularly high potential to grow the online part much better than in the past. But then, we have also much more presence, a much bigger percent of the business today in the specialty-multi (sic) [multi-specialty] (00:41:43), Ulta, Sephora particularly.

And we have invested in having a very good start in the Ulta Target and Sephora Kohl's, directions where particularly in the Ulta Target, there is a lot of new consumers coming from mass which are entering prestige which is one of our key growth strategies because the growth of the market is composed by new consumers, and in luxury they come from mass in many cases. This started again. If you see the last years in the US, prestige have been growing more than mass. A moment of stop of this during COVID and then now again, this is continuing which shows how consumers keep coming. Obviously, the Ulta Target particular execution is very good in creating these new consumers for us, and so that's a good thing. Then, we have developed online now to about one-third of the company, including brand dotcom. Our freestanding store have become much more productive in this post-COVID. They did suffer during COVID but now becoming more productive also because now they are omni-channel, so linked to the brand dotcom side.

And so, the combination of the increase of our direct-to-consumer business, freestanding store plus brand dotcom is solid, profitable, and importantly give us huge access to data that in the past we didn't have. Interestingly, we always had much more data in Asia than in US. Now, US is improving our data availability, first of all, thanks to the partnership with some of our retailers but also because of our direct-to-consumer access which is improving and is fundamental to get information to operate more accordingly. Then, from a consumer standpoint, we had to penetrate more the growing groups of Latinas and Afro-American consumers, and we have done this. Now, we have much better penetration of this group. And then by geographical, we were East Coast, West Coast strong company, less strong in the middle. Now, we are much better balanced and we are much stronger in places like Texas or Florida which, as you know, they are also strong growth markets in this moment for beauty.

So, overall, better position with the consumers, better position from a distribution standpoint, better position in a direct-to-consumer access for data relevancy. Then, we have done better. We have better access in marketing. For example, like many others – we are not original in that – but our success in platforms like TikTok is extraordinary in this moment. So, we are now leveraging the evolving media platforms much better than in the past and making our return on advertising much better than in the past which is important for the long-term growth also in the US. Last is the portfolio brands. Different from China that was described before where I explain that the high-end luxury is actually the fastest growing segment of the market, in US it's different. It's always been – by the way, the entry price point of prestige is the most solid part of the luxury group. In other words, brands La Mer and Lauder you mentioned in China; in US, MAC and Clinique are much more important. And so, in the US, the development of MAC and Clinique in this moment is really promising, and for the US business those two brands

are very important. And so, the innovation program and the development of those two brands is again in the right direction which is part also the portfolio being in the right direction.

Last point, we did an important acquisition for the US, for the West – also, UK is very strong – which is DECIEM. If you think that the brand The Ordinary is the number four brand in skincare in the US, we just added this to our portfolio and is growing and is growing market share as we speak. And The Ordinary is the number four in value, but given the business model and then the unit price model is among the top two brands [indiscernible] (00:46:16). So, it's an extraordinary acquisition for improvement of skincare in the US. So, all these elements combined why I say the US today is in a much better position to be a very long-term sustainable growth engine to be added to the international growth engine that Peter had just illustrated and now Peter is leading.

Callum Elliot

Analyst, Bernstein Research

Perfect. Look, I think that multiple engines of growth is a great place for us to leave it. So, Fabrizio, Peter, thank you very much for joining us. And everybody in the audience, thank you as well.

Fabrizio Freda

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

Thank you very much.

Peter Johannes Jueptner

President-International, The Estée Lauder Companies, Inc.

Thank you.

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