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# Estee Lauder Cos., Inc. (EL)

Q1 2018 Earnings Call

## CORPORATE PARTICIPANTS

**Dennis D'Andrea**

*Vice President-Investor Relations, Estee Lauder Cos., Inc.*

**Fabrizio Freda**

*President, Chief Executive Officer & Director, Estee Lauder Cos., Inc.*

**Tracey Thomas Travis**

*Chief Financial Officer & Executive Vice President, Estee Lauder Cos., Inc.*

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## OTHER PARTICIPANTS

**Jason English**

*Analyst, Goldman Sachs & Co. LLC*

**Wendy C. Nicholson**

*Analyst, Citigroup Global Markets, Inc.*

**Ali Dibadj**

*Analyst, Sanford C. Bernstein & Co. LLC*

**Lauren Rae Lieberman**

*Analyst, Barclays Capital, Inc.*

**Caroline Levy**

*Analyst, Macquarie Capital (USA), Inc.*

**Jonathan Feeney**

*Analyst, Consumer Edge Research LLC*

**Dara W. Mohsenian**

*Analyst, Morgan Stanley & Co. LLC*

**Stephanie Wissink**

*Analyst, Jefferies LLC*

**Mark Stiefel Astrachan**

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

**Rupesh Parikh**

*Analyst, Oppenheimer & Co., Inc.*

**Bonnie L. Herzog**

*Analyst, Wells Fargo Securities LLC*

## MANAGEMENT DISCUSSION SECTION

**Operator:** Good day, everyone, and welcome to The Estée Lauder Companies Fiscal 2018 First Quarter Conference Call. Today's call is being recorded and webcast.

For opening remarks and introductions, I would like to turn the call over to the Vice President of Investor Relations, Mr. Dennis D'Andrea. Please go ahead, sir.

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### Dennis D'Andrea

*Vice President-Investor Relations, Estee Lauder Cos., Inc.*

Good morning, everyone. On today's call are Fabrizio Freda, President and Chief Executive Officer; and Tracey Travis, Executive Vice President and Chief Financial Officer.

Since many of the remarks today contain forward-looking statements, let me refer to our press release and our reports filed with the SEC, where you'll find factors that could cause actual results to differ materially from these forward-looking statements. To facilitate the discussion of our underlying business, the commentary on our financial results and expectations is before restructuring and other charges and other adjustments disclosed in our press release. You can find reconciliations between GAAP and non-GAAP figures in our press release and on the Investors section of our website.

During the Q&A session, we ask that you please limit yourself to one question so we can respond to all of you within the time scheduled for the call. And I'll turn it over to Fabrizio now.

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### Fabrizio Freda

*President, Chief Executive Officer & Director, Estee Lauder Cos., Inc.*

Thank you, Dennis, and good morning, everyone. Our new fiscal year is off to a terrific start. We delivered an outstanding financial performance in the first quarter, powered by multiple engines of growth across our business. Both sales and earnings per share rose double-digits, and all of our regions and major categories advanced. Our 13% constant currency sales increase exceeded our forecast, and we leveraged the incremental top line results into excellent earnings growth, aided by cost savings and efficiencies.

We accelerated the momentum that we experienced at the end of fiscal year 2017 by continuing to focus on fast growing brands, channels, and countries, and fueled these areas with additional resources and investments. We targeted new consumers as we expanded our reach, especially with millennials, and they were drawn to our innovative, high-quality products. More influencers' attention, sophisticated social media programs and a digital-first mindset across our brands helped drive our success.

With an encouraging start to the year and continued confidence in our outlook, we are increasing our full-year sales and EPS guidance. In constant currency, we now expect our sales to rise 8% to 9% and earnings per share growth of 12% to 14% in fiscal year 2018. At the same time, we are mindful of external geopolitical and economic issues that could pose challenges to our business.

Looking out our categories, makeup has been strong for several years and continued to be robust across many of our brands. Too Faced and BECCA contributed significantly along with Tom Ford and Estée Lauder. What stood out in this quarter, however, was our skin care performance which rebounded strongly, a trend we are seeing in

the industry. Our improvement stemmed from strength in existing products and successful recent launches from Estée Lauder, La Mer, and GLAMGLOW, as they captured many new consumers.

Our fragrance categories growth came largely from our luxury and our artisanal brands, which are gaining traction worldwide and have developed into a strong growth engine. Nearly all brands in our portfolio advanced globally. Our flagship Estée Lauder brand generated double-digit global growth with positive results in every region, led by particular strengths from Chinese consumers and global travelers.

Aligned with the company's strategy, Estée Lauder has developed multiple engines of growth across its categories, channels, and geographies. Much of the brand's momentum stemmed from an acceleration in skin care on top of continuous strength in makeup. This was reflected in the success of these powerful hero franchises, including the Advanced Night Repair and Re-Nutriv skin care collections and Double Wear and Pure Color makeup lines. This marks Estée Lauder's fourth consecutive quarter of solid sales growth, in the last two quarters, up double-digits.

Our M·A·C brand grew modestly on a global basis, thanks to excellent gains in Asia/Pacific, particularly in China, where its business more than doubled. Growth also came from travel retail, where its sales climbed double-digits. M·A·C has successfully captured new consumers, helping to deliver sequential improvements also in North America.

Our luxury brands continued to enjoy strong worldwide demand. La Mer, Jo Malone, Tom Ford each grew double-digits in every region. And our newness brand are performing well, and we build their equities and broaden their reach to a targeted consumer base.

To stay in the lead in prestige beauty, we continued to successfully pivot to the high-growth channels, where more consumers are shopping. Our sales in travel retail, specialty-multi and online each grew strong double-digits. Sales gains in travel retail reflected higher passenger traffic, a greater number of Chinese travelers to Hong Kong and Macau, compelling offering and a wider exposure [ph] to some – (6:02) of mid-sized brands.

All of our brands benefited from the positive trend. Tom Ford, Jo Malone, and La Mer were standouts while most of the portfolio had healthy gains, including Clinique, which rose sharply on strong demand for its moisturizers. All regions grew in travel retail. Asia/Pacific led the growth with Chinese consumer traveling in greater numbers within Asia as well as to key tourist destinations in Europe. We continued rolling out some of our newer brands in major airports, including By Kilian or Le Labo.

For the fiscal year, we expect our travel retail business to remain robust based on expected strong passenger traffic growth, increased conversion of travelers into buyers and sustained demand for our products, particularly from emerging market consumers. We plan to invest more in China and other emerging markets this fiscal year to further build awareness and demand for our brands. We should benefit consumption in both the local market and several travel corridors.

Our strong online business was led by third-party and retailer sites. Globally, our metrics improved across the board, including higher traffic, conversions, and orders. We continued to garner new consumers throughout our business on Tmall in China, where our sales more than doubled, fueled in part by M·A·C's successful launch in May. In the recent quarter, M·A·C also successfully launched on a large online platform in Southeast Asia owned by Alibaba called Lazada with a brand building distribution model similar to Tmall, where we control the look and the content of the virtual store. We expect to expand on the platform in more markets and with more brands starting this quarter.

We continue to broaden our global online footprint with new site launches and retailer distribution expansion. In the quarter, we added more than 100 sites. The majority were retailers and most of them in the European region, demonstrating the scalability of our digital model.

Spurred by the growth of social media and technology advancement, mobile is the focus of our digital strategies. In the recent quarter, mobile accounted for 70% of our global online traffic. We are seeing the results of our investment in mobile, as it is an important factor driving first time digital consumers in emerging markets and increasing the frequency of purchases in more developed countries.

We also continue to strengthen our position in specialty-multi retailers globally. Many of our brands expanded their target reach as they pushed younger consumers drawn by the channel. M·A·C roll out in ULTA Beauty in North America has resonated strongly, as approximately half the consumer who purchased M·A·C products were new or lapsed users of the brand.

M·A·C has become a best-selling makeup brand in the large majority of ULTA Beauty stores where it opened. And based on the strong initial performance, we plan to accelerate its expansion there. By opening in more specialty-multi stores globally, M·A·C will continue to balance a meaningful presence in all major channels, department stores, freestanding stores, specialty-multi, online, and travel retail.

Internationally, we are strategically expanding our newest brands, Too Faced and BECCA, in the specialty-multi channel which is their primary distribution focus. We have entered certain European markets through Sephora and other retailers and are highly ranked. Several brands are actively expanding in specialty-multi in Korea where sales has been excellent. For example, Clinique and Origins each added more than 50 doors of Olive Young.

Turning to our geographies, our sales in China soared. Virtually all our brands there grew double-digits, while some, notably M·A·C, Tom Ford, and Lab Series, more than doubled. Our makeup business in total doubled for the second consecutive quarter while skin care accelerated. Our luxury fragrance brands also performed beautiful.

Our brands have strengthened our position with Chinese consumers, and our analytics show that much of this growth is coming from consumers new to our brands. Our retail sales accelerated sequentially from last quarter, and importantly, we gained share.

The surge in consumption for luxury beauty in China is due in part to stronger demand from millennials in lower prices as a result of import tax reductions which have given consumers more purchasing power. We foresee continued strong interest in luxury products by Chinese consumers and plan to continue investing in the country.

Hong Kong delivered strong gains as the tourist traffic increased and local demand improved, contributing to increases across categories. More investment in digital and social media helped drive awareness.

We have been strengthening the portfolio of our newness brand by providing R&D and supply chain capabilities. We are also identifying new distribution opportunities where we see strong consumer interest. As a result, we launched several of our new luxury fragrance brands in European flagship department stores that have significant tourist traffic.

In the U.S., we are committed to collaborating with department stores to drive growth both in store and online by exciting consumers with product innovation and better services. This quarter, our sales from many of the stores'

online sites were robust, and although our business in brick-and-mortar continued to be challenged, we saw early signs of progress.

We are encouraged that our organic sales in North America department stores showed sequential improvement for the quarter, despite the impact of hurricanes that affected our business for several weeks in Texas, Florida, and Puerto Rico. This speaks to the breadth and strength of our portfolio, as well to our channel mix. On a more personal level, we are proud of the work that the company has done to help our affected employees and their families in the areas disrupted by the storms.

Fueling our success across channels and geographies was an array of exciting products that captivated consumers. We continue to focus our innovation on our biggest franchises, striving to make our hero products in every brand even more valuable, introducing new products is an important franchise brings it more attention and increases sales across the key areas of our business. Through effective social media, our brands are inspiring more trial of core product lines, which more often lead to repeat purchases and brand loyalty.

For example, Estée Lauder introduced a new eye serum under Advanced Night Repair line, the ANR Eye Concentrate Matrix. It was highly successful worldwide and helped drive sales of the entire franchise. Likewise, Clinique newest Moisture Surge product, a supercharged concentrate, boosted the collection and created the halo effect on the moisturizer's sub-category, which is a strategic focus area for Clinique. Moisture Surge sales have increased significantly for the last two years globally and, in the recent quarter, rose more than 30% as retail in the U.S. Clinique plans to bolster the Moisture Surge franchise with additional products.

As we promote our wide array of beauty products, we are focusing our marketing spending on digital to allow how consumers are seeking communications and information. Each of our brands has adopted a digital-first mind-set with an emphasis on mobile. With a tailored approach, each brand continuously decide which platforms and messages are most effective in reaching their target consumers.

Another important piece of our digital strategy is social media, especially the use of influencers, who have proven to help our brands standout. The Estée Lauder brand recently named a new global beauty director, who is attracting younger consumer and collaborating on product development. Clinique uses hundreds of local influencers all over the world, who promote its products in culturally-relevant ways. Clinique China business was solid this quarter, due in part to improved consumer engagement.

Looking to the holiday season, we believe our compelling programs will drive traffic to stores and support our overall business. Clinique has developed desirable sets that will be competitively positioned, while M·A·C's Snow Ball collection reflects current fashion trends. We continue to invest in capabilities and talent. Our performance is the reflection of our terrific teams across the globe who were able to quickly pivot and execute change smoothly. We continuously developed our bench strength to ensure that our business leaders are in the best positions to perform with excellence and advance our strategies.

Our Leading Beauty Forward initiatives is enabling us to cut expenses, become more efficient, and create great leverage of our sales growth. This will allow us to invest more in best growth opportunities by also expanding our operating margin.

We are maintaining some flexibility to allocate further resources to our biggest opportunities with the potential to [ph] spur (17:34) momentum. We plan to devote greater resources to our strongest growth engines; China, global digital commerce, product innovation, and travel retail, to advance our industry leadership and sustain our growth above global prestige beauty. We are gratified to be starting this fiscal year on such a high note, which is a

testament to our winning strategy to the agility of our talent and to our execution capability. We are optimistic about our future and excited about the global opportunities that lies ahead while remaining mindful of potential macro risks.

Now I will turn the call over to Tracey.

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## Tracey Thomas Travis

*Chief Financial Officer & Executive Vice President, Estee Lauder Cos., Inc.*

Thank you, Fabrizio, and good morning, everyone. First, I will review our fiscal 2008 first quarter financial results and then cover our expectations for the second quarter and for the full year. As a reminder, my commentary excludes the impact of restructuring and other charges and adjustments primarily related to our Leading Beauty Forward initiative.

Net sales for the first quarter were \$3.27 billion, up 13% in constant currency compared to the prior-year period. Incremental sales from Too Faced and BECCA contributed approximately 4 percentage points of this growth, as expected, which means our organic growth accelerated this quarter to 9%, exceeding our expectations.

Net sales in our Europe, the Middle East and Africa region rose 18% in constant currency, driven by a strong double-digit increase in our global travel retail business. Travel [ph] corridors (19:22) in Asia led much of the growth and they were fueled by strong demand in local markets that drove solid passenger traffic, exceptional like-door growth, and some additional points of sale outside of travel retail.

Business was more mixed in the region's other markets. Our sales in the Balkans, Turkey, and India grew strong double-digits and we had solid increases in Italy, the U.K., and Switzerland. These gains were partially offset by declines in Germany, the Middle East, and South Africa. In the Asia/Pacific region, sales rose 17% in constant currency, driven primarily by the accelerated momentum in China. Sales in China rose almost 50%, with broad-based growth across brands and channels. Hong Kong also accelerated, rising 14% off of a very soft performance prior year.

We also achieved solid sales growth in Taiwan and Malaysia. Net sales in the Americas grew 7% in constant currency. Excluding the incremental sales from the acquisitions of Too Faced and BECCA, the region's sales declined 3%. The U.S. had continued strong growth in specialty-multi, retail and online, including department store online sites but remained challenged in much of the mall-based brick-and-mortar stores. Canada also declined slightly due to softness at Sears Canada, which is liquidating. And Latin America sales fell moderately in the first quarter.

Our gross margin declined 90 basis points compared to the first quarter last year due primarily to the impact of the fiscal 2017 acquisitions and the associated inventory step-up. The mix of sets of new products largely offset favorable category mix and efficiency gains.

Operating expenses as a percent of sales improved 360 basis points, primarily due to lower selling expenses due to our sales channel mix as well as continued expense controls. We also benefited from a change in the timing of stock compensation expenses due to a new provision in our equity award agreements, which will adversely impact OpEx in the second and third quarters, offsetting the first quarter benefit.

Operating income rose 34% and operating margin increased by 270 basis points. Our effective tax rate this quarter was 22.3%, reflecting the impact of the adoption of the new accounting pronouncement related to excess tax benefits on share-based compensation. In our first quarter, we recognized \$23 million of excess tax benefits

as a reduction to our income tax provision. This benefit, which flowed through stockholders' equity prior to the change, reduced our effective tax rate for the quarter by 420 basis points and added \$0.06 to our EPS.

Diluted EPS of \$1.21 increased 42% compared to the prior year and grew 41% in constant currency. Earnings per share for the quarter included \$0.02 of favorable currency translation. EPS was higher than expected due primarily to the outstanding results delivered by our China and travel retail businesses, stronger overall growth in skin care and continued disciplined expense management. Given our strong results, we plan to maintain the flexibility to redeploy some of these funds to further support areas of momentum over the next few quarters.

Our Leading Beauty Forward efforts are going very well. We have great momentum with approximately 60 initiatives identified and approved, and we continue to uncover further opportunities. For example, we are optimizing our go-to-market selling and education areas and providing employees with digital tools to better and more efficiently serve our retailers and our consumers.

We established a new global shared services organization called [ph] 1Source (23:30), which is designed to efficiently deliver fundamental services to the company. Initially, [ph] 1Source (23:35) will provide select finance, legal, and HR services and, over time, will expand its offering to generate even more services. And our brands are building locally-relevant consumer engagement capabilities with increased investment in digital assets and experiences.

We are very pleased with the progress we've made and the hard work of all of the employees involved who have embraced Leading Beauty Forward with [ph] The Estée Lauder Companies' (24:03) competitive spirit. During the quarter, we generated \$93 million in net cash flows from operating activities and we invested \$116 million in capital expenditures. We used \$111 million to repurchase 1.1 million shares of our stock and paid \$126 million in dividends. We also announced this morning that our board approved a 12% increase in our quarterly dividend to \$0.38 per share.

Now, let me turn to our outlook for next quarter and for the full year. We've had a terrific start to our fiscal year and yet we do recognize that a variety of macro risks, including the UK's anticipated exit from the European Union, political instability in many areas around the world, and soft economies in certain markets create an ongoing level of uncertainty in many parts of our business. Additionally, I want to remind you that comparisons will normalize more in the second half of the year when Too Faced and BECCA will be in the base year, and we are more closely lapping more of the sequential improvements we saw throughout fiscal 2017 in China, Hong Kong, and travel retail.

That said, we are raising our sales guidance expectation to 8% to 9% in constant currency for the full fiscal 2018 year. This estimate includes approximately 2 points of growth from the incremental sales of Too Faced and BECCA. Currency translation is expected to benefit reported sales growth by 2 percentage points, reflecting weighted average rates of [ph] \$1.18 (25:45) for the euro, [ph] \$1.34 (25:46) for the pound, and [ph] \$112 (25:48) for the yen for the fiscal year.

The strength of our first quarter performance allows us to both raise guidance and to maintain some flexibility to invest in areas of strength to propel momentum and help protect against downside macro risk. Supporting the strong performance we have in the Asia/Pacific region remains a priority, as does accelerating the rollout of our newest brands.

We are raising our EPS expectations to a range of \$4.04 to \$4.12 before restructuring and other charges, including approximately \$0.16 of benefit from currency translation. In constant currency, we expect EPS to rise by 12% to 14%.

At this time, our effective tax rate is expected to be approximately 26%. While this guidance includes the first quarter impact of the new accounting pronouncement for share-based compensation, we are not forecasting the impact for the remainder of the year given the level of uncertainty in estimating how the stock market will perform, as well as uncertainty with both the timing and level of employee stock option exercises.

For the second quarter of fiscal 2018, our sales are expected to rise by approximately 10% to 11% in constant currency, reflecting early confidence in our holiday assortments, new products, and expanded targeted consumer reach. Currency translation is estimated to add approximately 3 to 4 percentage points. Too Faced and BECCA are also forecast to add approximately 3 points to sales growth for the quarter. As I mentioned before, by the end of the second quarter, these two brands will have lapped their acquisition dates and will be part of our organic growth in the back half of the fiscal year.

EPS is forecast between \$1.38 and \$1.41 before restructuring charges, and this includes about \$0.07 benefit from currency. We are, obviously, pleased with the momentum we saw in the first quarter and with our progress, executing our Leading Beauty Forward initiative. We remain focused on delivering another successful year of solid top-line growth, margin expansion, and double-digit EPS increases.

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

## QUESTION AND ANSWER SECTION

**Operator:** [Operator Instructions] Our first question today comes from the line of Jason English with Goldman Sachs.

Jason English

*Analyst, Goldman Sachs & Co. LLC*

Q

Hey. Good morning folks. Congratulations on a strong start to the year.

Fabrizio Freda

*President, Chief Executive Officer & Director, Estee Lauder Cos., Inc.*

A

Thank you.

Jason English

*Analyst, Goldman Sachs & Co. LLC*

Q

You're welcome, and thank you for letting me ask a question. I guess I wanted to delve a little bit deeper in terms of the swirling tide of what's happening underneath the hood of beauty growth overall, prestige beauty growth. You mentioned skin care getting better, makeup slowing. We've also seen in some of the measured data out there a bit of a slowdown in some of the small brands that have encroached upon the territory in the last couple of years. It's raised some consternation of what it means for the sustainable growth of some of your recent acquisitions.

I'd love to hear you weigh in on what you're seeing, and what you expect from Too Faced and BECCA as they roll into the base? But, maybe as importantly, if not more importantly, weigh in with what this shift may mean in terms of your stronghold in skin care, the implications for your market share overall, and the implications for margins on the Forward?

Fabrizio Freda

*President, Chief Executive Officer & Director, Estee Lauder Cos., Inc.*

A

Wow, this is one question. But yes, basically, prestige market we believe will continue to grow 4% to 5%. In this moment, it's pretty solid. The drivers of the global prestige market, frankly, are not changing, and they are the higher consumption of prestige from the millennial consumers. The higher access to luxury and prestige businesses in emerging markets, particularly in China. And the continuous – the higher level of usage, particularly on makeup, of the millennial consumers versus previous generations.

The recent improvements of the trend is in skin care where the millennials are also entering more than skin care business. Now what is the consequence of us of this is frankly a better balance of the growth between makeup and skin care is favorable to us because our skin care margins are better than the overall makeup margins, but I want still to remind that, within makeup, there are certain categories like face or foundation, which are also very profitably like many other skin care categories. So it's a very good positive.

In term of the impact of this trend on Too Faced and BECCA, makeup is growing. Now the new news is the acceleration of skin care. Frankly, I don't see any big issue with deceleration of makeup, also because makeup continues to grow internationally in a very strong way, and we are, in fact, deploying Too Faced and BECCA more internationally.

So what is our expectation for Too Faced and BECCA? Obviously, after we have finished – when we will add them in the base, we plan to continue growing this brand double-digit and, as part of this, the internationalization of these two brands will be an important step.

**Operator:** Our next question comes from the line of Wendy Nicholson with Citi.

Wendy C. Nicholson

*Analyst, Citigroup Global Markets, Inc.*

Q

Hi. Thank you. My question had to do with the U.S. business. Tracey, I think you threw out a number of the U.S. business being down 3% ex the acquisitions. And I know that's just sort of a reflection of tough times in department stores, et cetera, et cetera. But what's your outlook there? I mean when does the specialty-multi distribution become big enough so that it really offsets your exposure to the department stores so that we can see positive growth in that core organic U.S. growth? Thanks.

Tracey Thomas Travis

*Chief Financial Officer & Executive Vice President, Estee Lauder Cos., Inc.*

A

Well, I'll start and then perhaps Fabrizio will pipe in. So we do expect, Wendy, to your point and spoke about the fact that we do expect to roll out more brands in specialty-multi this year. We've rolled out Bumble and bumble into specialty-multi. We continue to rollout M·A·C into specialty-multi. So we now have a good representation of brands in specialty-multi, and are doing quite well as we said in our prepared remarks.

At the same time, Fabrizio reinforced the fact that we are also partnered with our department store customers to try to stabilize some of the declines that we've seen in their brick-and-mortar business – again, the retailer dot-

com business is growing quite nicely, but in the brick-and-mortar business. And a lot of good dialogue and discussion there, and we hope to see some improvement in that area.

Those two things combined, we expect to come out of this year in a much better position as it relates to the U.S. market, both in terms of us having diversified our distribution more with our brand portfolio and hoping for some stabilization based on the activities of ourselves in combination with our retail partners in department stores and brick-and-mortar.

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**Fabrizio Freda**

*President, Chief Executive Officer & Director, Estee Lauder Cos., Inc.*

A

Yes. And I just want to underline the point that we are working very closely to our department store partners to look for accelerating and finding a better way to attract higher traffics also in the brick-and-mortar malls – stores, and we see some promising signs that some of the activity we are testing and learning about has a stronger effect on consumers than what we have done in the last couple of years.

So we will keep focusing on that. But to Tracey's point is the balance [indiscernible] (34:30) being where the consumer is. And I want to underline where the consumer is, is more and more online. And so our strength online including our strength online with our department store partners is a big part of this mitigating impact of the change of traffic in the country.

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**Operator:** Our next question comes from the line of Ali Dibadj with Bernstein.

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**Ali Dibadj**

*Analyst, Sanford C. Bernstein & Co. LLC*

Q

Hey, guys. So I have an admittedly two-part question about your guidance. So first on top line, the back half of the year implies organic sales growth decelerating from, call it, 9% roughly now to below the 6% to 7% organic sales growth number. So can you talk through that organic top line deceleration a bit? And what's your expectation on comp store versus distribution growth? And then similarly in guidance, so your SG&A this quarter was down 380 basis points it looks like. Can you talk about the drivers of that specifically? How much was mix? So channel, product, geographic, but how much was mix? And how much is actual apples-to-apples cost reduction? And all that's really tied together, but trying to understand the run rate going forward for you guys, especially in the back half of the year. Thank you.

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**Tracey Thomas Travis**

*Chief Financial Officer & Executive Vice President, Estee Lauder Cos., Inc.*

A

Sure, sure. So let me start with the cadence of the year in terms of organic growth. As you'll recall, Ali, we are anniversarying a fairly soft quarter last year. Our organic growth last year was 2% – a little over 2%, and so the 9% is on top of the 2% from last year from an organic standpoint and obviously not having Too Faced and BECCA in our numbers.

We saw sequential improvement throughout the year, particularly in the second half in terms of our organic growth. So we started to see the pickup largely in our Asian markets, so certainly in China, in Hong Kong, as well as in our travel retail markets and that would be global.

And so we are anniversarying that. And when you look at the second half of the year, both the combination of having Too Faced and BECCA embedded within the second half of the year still growing double-digits for both of those brands but also anniversarying that sequential improvement that we saw in our Asia and travel retail

markets last year, that's where you see the organic growth starting to mitigate a bit in the second half of the year, still meaning that we have a terrific year that we expect to well outgrow the industry and gain share.

As it relates to the SG&A in the quarter, I did talk about one timing issue that was imbedded in that number, and that was a change in our stock comp plans that actually just caused a timing shift in the recognition of some of our stock comp expense. This is not the tax accounting change, but this is actually embedded in our expenses. So we had a little over 100 basis points of impact of that in terms of favorability in the first quarter that we'll see reverse out in the second and third quarter.

The balance of the favorability was, to your point, a combination of mix as well as expense controls, and I would say it's about 50-50 in terms of the balance of between mix and expense controls. After that shift, that timing shift.

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

Lauren Rae Lieberman

*Analyst, Barclays Capital, Inc.*

Q

Great. Thank you. I was curious if you could talk a little bit about GLAMGLOW. It's been about two years since the acquisition and you just called it out as an outstanding double-digit growth in the release. So I was just kind of curious about, I guess, one would be how the product line has expanded, two, any international expansion that's going to happen that maybe [ph] it's going to (38:47) slipped beneath the radar screen for me? And just over kind of outlook for that business, particularly now that the skin care category's accelerating. Thanks.

Fabrizio Freda

*President, Chief Executive Officer & Director, Estee Lauder Cos., Inc.*

A

Yeah. No, GLAMGLOW is doing extremely well. It's continued to grow in the U.S. and is expanding internationally, is, in this moment, very successful in the U.K., for example, and is expanding in other markets. The target that we are hitting is the younger consumer. So millennials really like GLAMGLOW. The strength of the GLAMGLOW, in this moment, skin care proposition, are several, but two standouts in my opinion. One is that the glow overall promise of the entire brand, the benefit of glowing skin is one of the most desirable benefits in the market in this moment and, importantly, is the most desirable benefit for younger skins, which is behind a lot of the growth we are seeing in skin care around the world, which is driven by that target group.

The second strength is the fact that this brand is focused on masks, and masks is the fastest-growing product category in skin care in this moment in most of the global regions. And third is that this brand is, as you said in your question, expanding into other categories beyond masks. And every single very careful decision we have taken to expand the category is working and is giving great results. It is coherent from a consumer standpoint. And finally, as I already said, the internationalization of the opportunity. So again, a good acquisition, a good promising start of the acceleration of this brand, and a lot still do to in the next years to make this brand one of our mid-size and then one day very big brands in our portfolio.

**Operator:** Our next question comes from the line of Caroline Levy with Macquarie.

Caroline Levy

*Analyst, Macquarie Capital (USA), Inc.*

Q

Good morning, and congratulations from me. I'd like to know a little bit more about your online growth. You did talk about how strong it was in China. Can you talk about other markets; what you're seeing in terms of growth

rates online? Are they accelerating or declining in any of your big markets, specifically the U.S.? And is your market share, as far as you know, bigger or smaller online?

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**Fabrizio Freda**

*President, Chief Executive Officer & Director, Estee Lauder Cos., Inc.*

**A**

So our online business is still growing very strong. We were up 33% in quarter one. And our online by now represent about 11% of total sales now globally, but the penetration is much higher than 11% in some of the top markets where online is very strong. We are growing our online business this quarter in general in our estimate for the year. We have growth in our brand dot-com, in our retail dot-com, and in platforms. So all the three segments are growing very strongly.

This quarter, particularly brand dot-com remain very strong, but we saw a tremendous acceleration of platforms, namely Tmall. And as we said in the prepared remarks, the beginning of our investment in Lazada in Southeast Asia. And we saw amazing progress in retail dot-com across the world. So growth in department store retail dot-com in the U.S., growth in the specialty-multi retail dot-com and growth in many retail dot-coms around the world. Actually, the exception is China where in China is now retail dot-com driven but is Tmall driving the growth. So very strong and, as we said also in the prepared remark, clearly scalable. We have opened 100 sites just this quarter in a very efficient way, scalable and agile, meaning where we see it works, we can invest more. Where it doesn't work, we can smoothly change and revise and review what we're doing.

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**Operator:** Our next question comes from the line of Jonathan Feeney with Consumer Edge Research.

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**Jonathan Feeney**

*Analyst, Consumer Edge Research LLC*

**Q**

Good morning. Thanks very much. I guess bigger picture here, your operating margins were 17% in 2014 and your guidance has you about getting back there by 2020 and recognizing a lot of that in the Americas where you've had a big currency headwind. It's now a tailwind. E-commerce makes it seems to be a tailwind. Why shouldn't you be able to get back towards peak margin in that segment, which would mean peak margin across the company and beyond that? And what are the margin drivers that are still going on with the Americas right now that sort of limit that now that you have these mix factors and maybe a little better performance in department stores happening? Thanks very much.

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**Tracey Thomas Travis**

*Chief Financial Officer & Executive Vice President, Estee Lauder Cos., Inc.*

**A**

Yeah. I think that in terms of the currency headwinds that we've had in the past, it's beyond the Americas, right? So, certainly, in the last couple of years, we've had negative currency that has offset quite a few of the initiatives that we've had in terms of cost-savings initiatives. When we guided the year, we said that we expect over the next few years to have on, average, 50 basis points of margin improvement. When you strip out all the noise from last year, we actually had 100 basis points of margin improvement. So – and we certainly have, in addition to continuing with some basic cost-saving programs, have the Leading Beauty Forward initiative, which is expected to deliver a fair amount of savings and allow us to leverage our organization in the next few years.

So I believe that we will certainly get back to the historical margin and then some, given all the initiatives that we have over the last few years – over the next few years. But right now, our guidance is, on average, 50 basis points a year. And, as you know, we'll update that at the beginning of every fiscal year.

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

Dara W. Mohsenian

*Analyst, Morgan Stanley & Co. LLC*

Q

Hi, guys. First, just a quick detail question. Tracey, can you give us a sense of your A&P spending year-over-year as a percent of sales in Q1 and how that compares versus the balance of the year, just given the SG&A performance in Q1? And then, the real question, Fabrizio, is you had this tremendous sales momentum in China in travel retail the last two quarters. How sustainable do you think that momentum is as you look out longer term? Tracey mentioned those areas should slow a bit in the second half with more difficult comparisons. So just want to get some more detail on the key drivers behind the recent strength and how much they extend longer term from your perspective? Thanks.

Tracey Thomas Travis

*Chief Financial Officer & Executive Vice President, Estee Lauder Cos., Inc.*

A

So I'll start with your question on A&P. In the first quarter, we did see quite a healthy increase in A&P spend. It did not grow as fast as sales that we saw a slight amount of leverage in our A&P spend, but we actually expected to deleverage for the year. Again, we are making investments in several areas that generate momentum for the organization. And so we ultimately expect that it will – the A&P spend will grow faster than what we're projecting our sales growth to grow for the full year, which is a nice increase for us in terms of investment in markets that are growing quite fast.

Fabrizio Freda

*President, Chief Executive Officer & Director, Estee Lauder Cos., Inc.*

A

Yeah. On the other two questions, so the short answer, and then I'll give you more detail, is that we believe that a double-digit growth is sustainable. Now, the 50%, 40% are – may happen again by quarter depending on volatility, but I could not [ph] define (47:17) them as sustainable model, obviously. The double-digit growth in China and double-digit growth in retail over the long run should be sustainable trends.

Let me go one by one. In China, we are seeing, in this moment, an amazing results, but also in like-door we have 33%. And that's super strong, we are growing market share. And interesting, this quarter we saw these amazing results without increasing the number of cities, but just increasing the number of doors in the cities where we need to be more penetrated, where we need to put more brands. So it's about more establishing our strengths rather than further expanding the number of cities this quarter, which, again, shows the power of online in city – in China, where the cities where we're not expanding brick-and-mortar yet, because it's not yet efficient, we still can reach the city with online. So the model is pretty interesting, pretty sustainable, and has power.

The second thing I would like to say on China, the market continued to grow. So we are growing above the market and building market share, but the market was about 30% growth, so very strong. It's about new consumer. It's about new access, as I said in my prepared remarks.

The other important thing in China is we are growing in every single channel in China: department stores, Sephora, freestanding stores, online. They're all growing double-digits. So there is a really well spread. And then in every brand in our portfolio, we are growing. We are growing in makeup. We are growing in skin care. We are growing in fragrance. So it's broad growth, and so it's sustainable, in our opinion, on a more or less double-digit trend.

On travel retail, travel retail has been very strong. We have seen this quarter an acceleration of travel retail in the retail – at retail levels, so a retail acceleration. And this is driven by trends which are sustainable, some trends are the market, meaning the traffic of travelers is very solid.

But a lot of what's happened is driven by us. One is about conversion, meaning today we estimate that 15%, depending on [indiscernible] (49:27) region, of people entering [indiscernible] (49:30) shop anything. So it's just driving the conversion from travelers to shoppers is an enormous opportunity to continuous traffic growth, and this [ph] isn't the (49:38) of the brands because this has a lot to do with investments we do in the current – in the market of [ph] all regions (49:46).

So the fact that we are investing more in China, we are investing more in Brazil, we are investing more in Russia, et cetera, this is the reason why our countries in travel retail is working better and better, because our conversion in travel retail thanks to the marketing work that our teams do in every one of these countries is working better and better thanks to the assortment we choose in these places is getting better and better.

So it's not only about traffic, it's about what we do and what we invest in every single country. And that's why we believe that this is sustainable of more or less a double-digit trend in the long term.

The other reason why it's sustainable is very broad. As I explained, it's not only Asia. We grew in travel retail in EMEA, in Latin America, in the U.S., in Asia. Obviously Asia has been particularly strong, but it's broad-based the growth that we see in this moment. And we have developed a strategy where we really can follow the consumer across traveling corridors, and we can make sure also our innovation speaks to them in a coherent way between current country [indiscernible] (50:56) and where they travel. And so, in summary, strong and sustainable, but not at the levels we have seen this quarter.

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

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**Stephanie Wissink**  
*Analyst, Jefferies LLC*

Q

Thanks. Good morning, everyone. Our question relates to skin care margins. We saw a very, very strong increase year-over-year and just generally I think the strongest skin care margins we have in our models going back a couple of decades. I'm just curious if you can talk about sustainability within the margin profile of skin care. And then, Fabrizio, to your comments on the millennials, are you seeing anything trend-wise that would give you confidence in that margin structure in that category? Thank you.

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**Fabrizio Freda**  
*President, Chief Executive Officer & Director, Estee Lauder Cos., Inc.*

A

Okay. Skin care – and now, Tracey, please add any perspectives. Skin care has strong margins structurally in our business. However, when there is a beat of skin care sales where the extra skin care sales versus our original forecast comes without a lot of expenses, this margin gets boosted in the short term. So I will [ph] now (52:10) consider the quarter one margins as sustainable, but definitely we can count on stronger than average skin care margins in the future for the growth of skin care.

And in terms of millennials, the millennials are obviously getting more and more in skin care in what I define in summary, instant benefits. Before I was speaking about GLAMGLOW and the glow benefit, there are other benefits which are instant, [indiscernible] (52:41) is about preparing the skin for makeup. It's about benefits for the day.

So not only traditional anti-aging but instant benefit for the skin are very popular with millennials around the world, and this will continue also because we are driving it and, frankly, the industry is driving that. So I believe this can be an interesting medium-term trend. Tracey?

Tracey Thomas Travis

*Chief Financial Officer & Executive Vice President, Estee Lauder Cos., Inc.*

No. That's good.

A

Fabrizio Freda

*President, Chief Executive Officer & Director, Estee Lauder Cos., Inc.*

Okay.

A

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

Mark Stiefel Astrachan

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

Yes. Thanks, and good afternoon, everyone. I wanted to ask about how to think about your thoughts on the 4% to 5% category growth. It seems like some conservatism there. Just wanted to explore that a bit more and maybe, put differently, why is company share accelerating if the 4% to 5% category growth is correct? And if you couple your performance with peers like LVMH and L'Oreal, that trio collectively is growing something like three-times what you believe the category is actually growing at. So is it share gains amongst the big three? Is it sustainable as a result of that or what is just driving it? Or, as I said, part of it could be that you're just being a bit conservative with the category growth. So maybe any help there would be appreciated.

Q

Fabrizio Freda

*President, Chief Executive Officer & Director, Estee Lauder Cos., Inc.*

Yeah. No, frankly, this is the number that we see, we estimate for the year. Now, could be more [ph] 5% than 4% (54:11), absolutely, this first quarter was very solid. But you need to look at the – this is a global estimate. Now the retail in the U.S. is not super-strong. The retail in Continental Europe is not super-strong. U.K. is softening in term of market. The Latin America market is not super-strong. So what you see today is actually an acceleration in Asia. Absolutely. But you don't see internal total market every single region accelerated.

A

So in total, with plus and minus, we still believe a 4% to 5%, probably more in the 5% area is what we see today. Which bring me to the second point that is, yes, we are – I cannot speak for our competitors but from the number I see, I would agree with you, the big three are strong and are delivering market share growth overall, and we definitely are. We are growing market share in a significant way. And I think this is explainable in many ways but one way maybe I want to add as far Estée Lauder Company are concerned.

The big amount of the small brands and new launches, innovation that's happening in the market has created a much more competitive trial environment, meaning consumer buying new products, try new products, have been able to access many more new products. But repurchase is continued to be driven by high-quality products at brand they trust. So while the trial game is more competitive, the repurchase game is still in the hands of the hero franchises, the big brands, and these brands continue to deliver very strong repurchase.

Remember, a lot of the profitability is in repurchase because trial, most of the time, is an investment. And so what you see is the power of product quality, the power of prestige experiences into play, and that in this very

competitive market out there, still strong brands, great quality products, and fundamental superior experiences remain the reason for success.

**Operator:** Our next question comes from the line of Rupesh Parikh with Oppenheimer.

Rupesh Parikh

*Analyst, Oppenheimer & Co., Inc.*

Q

Congrats on a great quarter, and thanks for taking my questions. I was curious to get additional thoughts on the U.S. beauty backdrop. Some of the specialty-multi players have called out softening trends in the cosmetics category within the U.S. market. So I was just curious, from your perspective, the dynamics currently playing out in the market, is it a shift more to skin care, less newness, or other factors at play? Thank you.

Tracey Thomas Travis

*Chief Financial Officer & Executive Vice President, Estee Lauder Cos., Inc.*

A

So I think that there has been a bit of softening in the U.S. market, again, mostly in, in brick-and-mortar. As we spoke about, certainly, we've seen a lot of strength in online. So we are certainly continuing to see that. The other thing that's happening in the U.S. – and Fabrizio was talking about online and how we play in various areas of online, but there are beauty brands that are direct-to-consumer that are online-only that bypass any retailer. And these are some of the indie brands as well. And we see more of this phenomena in the U.S. market than in some of our global markets as well. So I think that, too, is impacting some of the results of some of the retailers. They're not captured in the retailers' dot-com business because they're actually – it's a brand to direct sale, things that come to mind like Kylie Cosmetics for instance.

**Operator:** We have time for one more question. That question comes from the line of Bonnie Herzog with Wells Fargo.

Bonnie L. Herzog

*Analyst, Wells Fargo Securities LLC*

Q

Thank you. Good morning. I wanted to circle back on M·A·C, I just have a couple of questions. It's positive that M·A·C in total grew in the quarter, but I guess I was hoping you could drill down further on M·A·C's performance in North America specifically. Could you talk about your standalone M·A·C stores and how they're performing relative to your own online sales for M·A·C? And then when do you expect M·A·C's performance, particularly in your own M·A·C stores, to start to improve in North America? Thanks.

Fabrizio Freda

*President, Chief Executive Officer & Director, Estee Lauder Cos., Inc.*

A

So M·A·C North America, specifically, as we said, is continuing to decline in the brick-and-mortar part of the business, meaning the department stores and our freestanding stores, and had a tremendous acceleration online and is performing very well in ULTA – in the store of ULTA as we had explained. So that's the mix. So in total, there is a sequential improvement of the trend of the brand.

Also, the innovation of M·A·C is planned to improve gradually across the fiscal year to be more in tune for the key trends in the United States of what has been in the past.

So our expectation is that the brands, in total, will stabilize over time thanks to the distribution balance, the drive of online, the improved innovation program, and having then in the base the periods that the brand had in the last year. So this gradually will put the brand in a condition to stabilize and then in the longer term grow again.

As I said, in many other markets of the world, the brand is flying, and in China even doubling. So, in total, we continue to expect the brand to have the power to grow. But in North America, this will take a little bit of time to stabilize.

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**Operator:** That concludes today's question-and-answer session. If you were unable to join the entire call, a playback will be available at 1:00 P.M. Eastern Time today through November 15. To hear a recording of the call, please dial 855-859-2056, pass code number 10665255. That concludes today's Estée Lauder Conference Call. I would like to thank you all for your participation, and wish you all a good day.

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