

03-May-2017

Estee Lauder Cos., Inc. (EL)

Q3 2017 Earnings Call

CORPORATE PARTICIPANTS

Dennis D'Andrea

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

Fabrizio Freda

President, CEO & Class III Director, Estee Lauder Cos., Inc.

Tracey Thomas Travis

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

OTHER PARTICIPANTS

Rupesh Parikh

Analyst, Oppenheimer & Co., Inc.

Andrea F. Teixeira

Analyst, JPMorgan Securities LLC

Joseph Nicholas Altobello

Analyst, Raymond James & Associates, Inc.

Erinn E. Murphy

Analyst, Piper Jaffray & Co.

Jason English

Analyst, Goldman Sachs & Co.

Bonnie L. Herzog

Analyst, Wells Fargo Securities LLC

Mark Astrachan

Analyst, Stifel, Nicolaus & Co., Inc.

Olivia Tong

Analyst, Bank of America Merrill Lynch

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC

MANAGEMENT DISCUSSION SECTION

Operator: Good day, everyone, and welcome to The Estée Lauder Companies' Fiscal 2017 Third Quarter Conference Call. Today's call is being recorded and webcast.

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

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 our remarks today contain forward-looking statements, let me refer you to our press release and our reports filed with the SEC where you'll find factors that could cause actual results to differ materially from 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. You can find reconciliations between GAAP and non-GAAP figures in our press release and on the Investor 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.

Fabrizio Freda

President, CEO & Class III Director, Estee Lauder Cos., Inc.

Thank you, Dennis, and good morning, everyone. Our company delivered an excellent performance in the third quarter. Our business accelerated, driven by many brands, channels and markets that experienced strong momentum. In constant currency, our sales rose 9% and adjusted diluted earnings per share increased 28%, both of which exceeded our expectations. The outperformance was generated from stronger organic sales growth, largely in China in travel retail channel; a better-than-expected performance of our newest brands, Too Faced and BECCA, as well as disciplined expense management.

When fiscal 2017 began, we said our sales were expected to accelerate every quarter, culminating in a robust second half. As we look to the fourth quarter, our sales growth should increase farther, enabling us to deliver our financial and sales target for the full year and position us for a strong start in fiscal year 2018.

Our success this quarter came despite continued external macro headwinds in certain areas. In the U.S., foot traffic continued to decline in brick-and-mortar department stores, our largest domestic channel. And Macy's closed 68 stores, as expected. In certain other countries, we faced difficult economic or political climates, particularly in the Middle East, Turkey and Latin America. And the continued strength of the dollar impacted our reported results.

Globally, we encountered stiff competition from both established and upstart brands. The fact that we have achieved a strong performance against this backdrop speaks to our successful strategy, which is anchored by our increasingly diversified business model and multiple engines of growth. We also are benefiting from our choice to stay focused on a dynamic prestige industry that has been growing steadily for many years and continues to grow faster than many other household and personal care centers.

As global prestige beauty undergoes rapid change, we are embracing new opportunities, accelerating penetration of the fastest-growing channels, reallocating resources to the leading business drivers and pivoting for the future in our industry. Consumers' appetite for beauty products is intensifying, particularly in the luxury arena and in makeup, which fuel outstanding growth in our high-end brands and continued double-digit growth in our makeup category. In addition, we enjoyed superb growth in the fastest-growing beauty channels, with travel retail, online and specialty multi, each rising strong double-digits.

By geography, we grew strong double digits in certain emerging markets, notably China. Altogether, we generated higher sales in every region and in our three largest product categories, fueled by an acceleration of our hero products, new product innovation and increased social media presence, new digital initiatives and greater penetration in the fastest high-growth channels. At the same time, we continued investing in priority areas and capabilities and our Leading Beauty Forward initiative.

Our diverse portfolio of brands continues to be a strategic advantage. We leveraged each brand in the most appropriate prestige distribution channels to target different consumer segments. This approach yielded outstanding results for our luxury brands including Tom Ford, La Mer and Jo Malone. Each generated double-digit sales growth in constant currency in every region. La Mer's new hydrating serum and brightening mask were well

received and benefit from an increase in travel in Chinese consumers around the world. The brand gained share in Asia-Pacific and maintained its leading position in luxury skin care there.

Among our largest brands, Estée Lauder achieved the solid growth globally for the second consecutive quarter, with higher sales in skin care, makeup and fragrances. The brand was well positioned to capitalize on increased travel and consumption from Chinese consumers, which favorably impacted its business in travel retail, the UK, and Asian markets and lifted its skin care sales. Estée Lauder's makeup category excelled in Asia-Pacific with increases in face, lip and eye products.

The Estée Lauder brand continued to support its two key hero franchises, Advanced Night Repair and Double Wear, with new products combined with more effective marketing and communication. The investment paid off. The two highly desirable product lines reached the new consumer, posted positive growth in every region and increased double digit for the fiscal year-to-date. Around the world, Double Wear is the best-selling prestige foundation in many markets such as the U.K. and attracts consumers across generation to the brand, including millennials.

We have successfully created a new growth engine with our luxury and artisanal fragrance brands and they continued to advance strongly, while at the same time improve the profitability of the entire fragrance category. Jo Malone and Tom Ford accelerated rapidly, particularly in travel retail and we also see great potential for our newer fragrance brands, Le Labo, Frédéric Malle and By Kilian. This is the first full quarter that reflected a contribution of our newest brands, Too Faced and BECCA and their sales exceeded our expectations.

We also started to extend their presence internationally. Adding these brands to our portfolio accelerated our penetration in both makeup and in the fast-growing specialty multichannel and increases our reach with millennial consumers. Indeed, many of our brands are expanding in fast growing channels to reach new consumer. Since today, they have wider choices of where to shop for prestige beauty products.

In this regard, we are excited our M.A.C. brand will launch this month in Ulta Beauty, one of the fastest growing specialty multi-retailers in the United States. Ulta's consumer are devoted beauty enthusiasts and have been requesting the brand. M.A.C. will first be available on ulta.com starting next year, followed by about 25 stores beginning in June, with more than 100 doors planned by the end of December. The locations will feature dedicated M.A.C. makeup artists in a boutique-like setting, allowing M.A.C. to provide it exceptional artistry services.

Expanding into specialty multi globally is integral to M.A.C.'s strategies to grow its consumer base, continue to raise awareness, become more accessible and drive incremental sales. Although M.A.C. is the number-one prestige makeup brand worldwide, it is in less than 3,000 doors, a fraction of the location of most of its direct competitors, in some cases, in even less than 15%. M.A.C. continues to make great inroads in specialty multi internationally. In Brazil, for example, M.A.C. is the leading brand on sephora.com and will open in some of the retailers' top brick-and-mortar stores this August.

In Europe, M.A.C. is increasing consumer reach by opening more doors with Douglas, as well as other specialty multi retailers including KICKS in Sweden. Our Estée Lauder brand launched in Ulta last fall in 30 doors and successfully tapped into a new audience. During the first three months, more than 40% of consumers who bought its products were new to the brand. And over 65% of the new makeup consumers were millennials. With strong sales results, Estée Lauder plans to roll out to more Ulta stores.

Clinique's experience in Ulta has been terrific and it is building on its business there with more in-store boutiques. By the end of fiscal 2017, our three largest brands will have strategically expanded their consumer reach in the U.S. specialty-multi channel.

Several of our other brands have achieved strong sales in the U.S., specialty multi, including GLAMGLOW, Smashbox, Tom Ford in Sephora and Darphin in Bluemercury. During the quarter, we launched Jo Malone and La Mer into a few key Sephora doors, including its largest one that recently opened in Manhattan, and also on sephora.com. Initial response has been terrific. Both brands are recruiting new consumers from these efforts.

Internationally, our business has also performed well in many specialty multi retailers, including Mecca, Boots, Douglas and [indiscernible] (11:18). More specialty multi retailers are entering Korea, and Clinique and Origins have expanded their consumer reach to some of these new locations. Clinique and M.A.C. has launched in specialty multi in Thailand with fantastic results.

We had outstanding results in travel retail, led by our business in Asia-Pacific. Our vibrant retail sales showed the strongest quarterly growth in over three years and far outpaced passenger traffic growth in the quarter. Sales increase in every product category. Makeup sales surged, led by M.A.C., Tom Ford and several other brands. Higher skin care sales were driven by Estée Lauder and La Mer in the greater number of Chinese and other Asian travelers.

And in fragrance, which still leads total beauty sales in the channel, we achieved the superior results and share growth led by Jo Malone and Tom Ford. We believe there will be strong demand among consumers for our newer luxury and artisanal fragrance brands in travel retail as we roll them out, enabling us to further penetrate the channel's most important category.

We also continued to expand the availability of our other brands that aren't widely distributed in travel retail and brought more brands into more high potential airports.

Our sales from our e-commerce channels continue to grow at an exceptional pace, up 30% globally, more than twice the growth of e-commerce in general. Sales rose double-digits across brand, retailers and third-party sites and also grew double digit in every region, driven largely by increased traffic, order size and conversion. Mobile-driven sales rose significantly and are now a larger portion of our total mix.

We entered Hong Kong, a new market for our online business, with a brand size from GLAMGLOW. And in China, our online sales soared, led by our brands on Tmall. M.A.C. plans to launch on Tmall this quarter, which should provide more fuel for our China business and allow M.A.C. to reach new shoppers in smaller Chinese cities who don't have access to its products in brick-and-mortar stores. Globally, we continued to successfully launch additional brands online in more markets.

Department stores are striving to provide consumers with strong experiences they can't get anywhere else. International department stores remain strong, particularly in Europe and China. We continue to work our – with our U.S. department stores to create in-store and omni-channel excitement and innovate with product, services, merchandising and education. We are devoting additional resources to the top door and promoting in-store events on retailers' websites where, as I just mentioned, our business had been brisk. Research shows the consumers who shop both in-store and online spend more than those who buy in just one channel. We are being proactive with department stores to design strategies to reinvigorate traffic, while addressing productivity challenges in brick-and-mortar.

Now let me turn to our recent and upcoming innovations. Across our brands, we are focused on the biggest global opportunities which in Clinique's case means its core products like moisturizers. Its initial launch of Fresh Pressed serum and cleanser with concentrate Vitamin C was a global hit that garnered terrific attention and demand, and validated the brand's strength to leverage the initial success with a more extensive rollout in the coming months. The serum is used with the brand's moisturizers, which increases their sales as well. Fresh Pressed helped drive improving retail trends for Clinique in China and travel retail.

In another move to strengthen its position in moisturizers, Clinique just introduced a supercharged hydrating formula of Moisture Surge developed from [ph] proprietary (15:45) technology that is expected to elevate the best-selling franchise. Clinique marketing was focused on the instant benefits of Moisture Surge, which has been growing in most markets.

Estée Lauder will begin introducing Advanced Night Repair Eye Concentrate Matrix in July. This product, which contains innovative technology based on scientific breakthrough research repairs the visible signs of aging on eyes to make eyes look refreshed and features a custom designed massage applicator. It is one of the brand's highest scoring products in testing with consumers. For example, after four weeks of usage, almost 90% of women said their eyes looked more youthful. It will be supported by a 360-degree campaign based on strong insights from consumers around the world.

In makeup, we are very excited about Estée Lauder Double Wear Cushion Compact for Asian market which will be supported by strong investment in China and Pure Color Love lipstick, a global launch that is aimed at younger consumers.

M•A•C new Next to Nothing sheer Face Color is a lightweight foundation that makes skin glow. It is being supported with a major social media campaign that is already helping fuel M•A•C sales this quarter.

In fragrance, Jo Malone launched Star Magnolia cologne, which is expected to have wide appeal and Tom Ford created SOLE DI POSITANO, which evokes [indiscernible] (17:28) Italian coast.

With the help of our Leading Beauty Forward initiative, we continue to reallocate resources faster and cut cost deeper to invest in talent and capabilities that will drive our business in today's evolving beauty landscape. This includes social media, digital technologies, retail operations, and analytical expertise. To help leverage both new and existing brands, our brands continue to increase their social media activity and capabilities to engage consumers across numerous digital platforms using influencers, brand ambassadors, and other compelling voices and technologies.

For example, Smashbox collaborated with a popular influencer to help promote its Cover Shot Eye Palette and the collection became one of the brand's largest launch ever. And in China, the Estée Lauder brand significantly lifted its makeup sales by leveraging a combination of in-store and social media campaigns. This kind of digital content created by influencers and third-parties is measured in terms of earned media value. In the third quarter, M•A•C remained the second largest beauty brand among prestige and mass makeup players in earned media value in the U.S. as measured by Tribe Dynamics. M•A•C has improved its earned media value share in makeup in each of the last three quarters.

Our brands are also creating inventive digital experience for consumers. For example, a cutting edge technology used by Estée Lauder and Smashbox lets consumers virtually apply different lipstick shades, either in real-time or in [indiscernible] (19:16).

Our performance this quarter further demonstrated our company strategy, built on multiple engines of growth and leading to agile resource reallocation, when need, is sustainable and working.

Our company has the most desirable portfolio of prestige brands in the industry. And we are [indiscernible] (19:38) to strategically deploy them brand across fastest-growing channels and consumer segments around the world.

Importantly, we have the highest quality workforce with extremely capable people committed to our company's success. At the same time, we are reducing costs, redesigned for better sales growth leverage, and reallocating our resources to make priority investment in the most attractive areas that are expected to drive our growth in both the fourth quarter and next year.

As a successful high growth company in a growing industry, we have continued to increase our global share in prestige beauty. And as we enter our fourth quarter, we are further building momentum to deliver another year of strong profitable growth.

Now, I will turn the call over to Tracey.

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 2017 third quarter results, and then cover our expectations for the remainder of the fiscal year. As a reminder, my commentary excludes the impact of restructuring and other charges, which are disclosed in our press release this morning.

Net sales for the third quarter were \$2.86 billion, up 9% in constant currency compared to the prior-year period. Incremental sales from our most recent acquisitions of Too Faced and BECCA contributed approximately 4 points of this growth. And the balance was driven by strong performance in several areas of our business, most notably travel retail, online, China, and our mid-sized and luxury brands.

From a geographic perspective, every region grew sales, led by Europe, the Middle East, and Africa. Net sales rose 13% in constant currency in EMEA, led by a 30% increase in global travel retail. The substantial growth in travel retail was supported by an 8% increase in international passenger traffic, as well as further expansion of our makeup and fragrance brands in the best airports.

Notably, our travel retail business in Hong Kong and Macau returned to strong growth in the quarter. We are closely monitoring the political tensions that have curtailed Chinese consumers traveling to South Korea but we do expect the slowdown in this travel quarter to be offset by Chinese consumers traveling to other Asian destinations.

The EMEA region also benefited from strong sales in Italy and the U.K., which rose high-single-digits while most other Western European markets grew mid-single-digits. The region's major soft spot this quarter was the Middle East, where net sales fell again as distributors continue to align their inventory to much weaker retail traffic. This negative sales trend, however, did begin to ease this quarter and is expected to further improve in our fourth quarter as we anniversary the turndown.

Excluding the Middle East, the total EMEA region grew 15%. Sales in the Asia-Pacific region grew 8% in constant currency. Growth was led by China where net sales rose more than 20%. Most of our brands grew double-digit in China this quarter and our online business in China grew more than 70%. We also achieved solid sales growth in

Taiwan and Malaysia, and both Japan and Australia rose low-single-digits while sales in Hong Kong continue to stabilize. Net sales in the Americas rose 5% in constant currency.

Latin America sales grew 5%, led by strong growth in Mexico and Chile while Brazil remained challenged. Sales in North America benefited from the addition of our newest brands, Too Faced and BECCA, as well as double-digit growth in both the online and specialty multi-channels. These increases were offset by continued declines in the brick-and-mortar business of department stores, as well as in freestanding stores.

Our gross margin declined 160 basis points from the prior-year period due primarily to adverse product mix, including the impact of the fiscal 2017 acquisitions and the associated inventory step-up related to purchase accounting. Obsolescence was also a slight contributor to the margin decline.

Operating expenses as a percent of sales improved 370 basis points, primarily due to lower selling and promotion expenses that reflected our changing channel mix, along with prudent expense management in line with softer sales in U.S. department stores and freestanding stores. General and administrative expenses also declined, reflecting the benefits of our cost savings programs, equity income from our investment in Have & Be Company, and the deferral of some IT and R&D projects to the fourth quarter.

As a result, operating income rose a strong 23%, and operating margin increased by 210 basis points. Net earnings rose 24% to \$340 million, reflecting the operating income improvement and a lower effective tax rate, partially offset by higher net interest expense. Diluted EPS of \$0.91 was 25% above the prior year, and grew 28% in constant currency. Earnings per share for the quarter included \$0.02 of unfavorable currency translation and \$0.02 of dilution from acquisitions.

EPS was higher than anticipated due primarily to the margin accretive sales beat, coupled with disciplined expense management by our teams, and the deferral of some projects to the fourth quarter.

With respect to cash flow and capital allocation, for the nine months, we generated \$1.25 billion in net cash flows from operating activities, and we invested \$316 million in capital projects. And approximately \$1.7 billion in acquisitions. In early February, we issued \$1.5 billion of senior notes, which we used to repay outstanding commercial paper and to refinance \$300 million in senior notes coming due on May 15. We also continue to return cash to shareholders utilizing \$363 million to repurchase 4.2 million shares of our stock, and \$361 million to pay dividends.

Now turning to our outlook for the full year, we expect to end fiscal 2017 with sales growth of between 6% to 7% in constant currency, and that reflects approximately two points of incremental sales from the acquisitions of Too Faced and BECCA. Currency translation is expected to depress reported sales for the full fiscal year by nearly 2 percentage points, reflecting weighted average rates of \$1.08 for the euro, \$1.26 for the pound, and \$1.09 for the yen.

Diluted EPS is expected to range between \$3.32 and \$3.37 before restructuring charges, including approximately \$0.13 of dilution from currency translation and \$0.07 of dilution from the recent acquisitions. In constant currency, we expect EPS to rise by 8% to 9%.

Our sales in the fourth quarter are expected to rise 9% to 10% in constant currency, demonstrating the sequential acceleration in sales growth that we have anticipated throughout the year. The strong fourth quarter increase is expected to come from approximately four points of incremental sales from Too Faced and BECCA, expanded

consumer reach for our several brands, particularly in Specialty Multi, online and in our international free standing stores.

Further improvement in Hong Kong as sales are expected to return to positive growth as travel to the area picks up. An easier comparison in the Middle East, as we lap the period of soft retail sales and destocking, and continued momentum in China and other Asia-Pacific markets.

We are also committed to continue to invest behind our strategic priorities. We do plan to invest increased spending in our fourth quarter behind new products and marketing activities, support for the roll-out of the new distribution, such as M·A·C and ULTA and some projects in IT and R&D, information technology and research and development that were delayed from the third quarter. We expect fourth quarter EPS of between \$0.35 and \$0.40. This includes dilution of about \$0.03 from currency and about \$0.03 from acquisitions.

We are successfully executing against our Leading Beauty Forward initiatives according to plan as Fabrizio mentioned and will continue to reallocate resources to strategic areas of importance.

In closing, we are pleased with our third quarter and year-to-date results and are very proud that our organization continues to make great progress on achieving our long-term strategic objectives, while pivoting and successfully reallocating resources when necessary towards the fastest growth areas of our business. In this dynamic, ever-changing global macro environment, our success is a true testament to the collective efforts of our dedicated employees around the world.

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

QUESTION AND ANSWER SECTION

Operator: The floor is now open for questions. [Operator Instructions] Our first question today comes from Rupesh Parikh with Oppenheimer.

Rupesh Parikh

Analyst, Oppenheimer & Co., Inc.

Q

Thanks for taking by question, and congrats on a great quarter. So my two questions are on BECCA and Too Faced. First, I wanted to get a sense of what type of growth rates you're currently seeing in those businesses? And then, it sounds like they're both trending above expectations, so just curious what's driving the above expectation performance so far? Thank you.

Fabrizio Freda

President, CEO & Class III Director, EsteeLauder Cos., Inc.

A

So the growth is very, very strong in these two brands. So, it's very strong double-digit growth in each one of the two brands and in every segment they're operating. And what is driving the success is actually same-door sales is a success, which is driven mainly by same-door sales and for the moment, a very small initial distribution deployment. These two brands are really strong and consumer demand is exceptional. And their recent launches are among the most successful launches in the entire marketplace.

And on top of that, for us, the great news are that they attract really new consumers that in the past we were attracting less, particularly Too Faced attract more younger consumers in our portfolio which is great extra

business for the company overall. And importantly, they have dramatically increased our penetration in Specialty Multi in the U.S. And this will continue internationally, which is a very important objective because as you all know, the Specialty Multi-Channel globally is one of the fastest growing channels in our sector.

Operator: Your next question comes from the line of Andrea Teixeira with JPMorgan.

Andrea F. Teixeira

Analyst, JPMorgan Securities LLC

Q

Hi. Good morning, everyone. Thank you for taking my question. I just wanted to see if you can kind of elaborate more on basically the Clinique products into ULTA stores and how – I understand you've been there for five years, and how that learning can be applied to the M•A•C relationship? And along those lines, how you think about any cannibalization of the products within Specialty Multi against department stores.

And second, if you could elaborate more on the fourth quarter guidance for margins, because it seems conservative against your beat of \$0.21, and just \$0.03 increase over the low-end of the guidance. So if you can give us what is your embedding in terms of investments? I understand from Tracey's comment that you had some R&D that might be pushed over to the fourth quarter. So if you can elaborate more on the investments? And again, congrats on the results.

Fabrizio Freda

President, CEO & Class III Director, EsteeLauder Cos., Inc.

A

Thank you. I'll start with answering the ULTA question. So Clinique is very successful in the ULTA channel. And what we have learned is that when Clinique is exposed with all the strengths of the [ph] core (32:42) portfolio and the strengths of services to a good growing traffic, the brand responds very, very well. And Clinique is growing both makeup and skin care aggressively in every ULTA door in which the brand is deployed. In terms of what we can learn for M•A•C – by the way, as I said in my prepared remarks, we plan to increase gradually the number of Clinique doors in ULTA in agreement with our retail partner.

And as far as the learning for M•A•C, absolutely we have learned a lot for perfecting our upcoming M•A•C execution; also from the Clinique experience. And particular, we have learned the importance of the service aspect of making sure that the brand is deployed with all the necessarily SKU, assortment SKU and decorations of the SKUs to the consumer is the concept of decorated assortment that really fit the consumer, which has been a big learning that will be absolutely applied to every one of our brands.

The good news, that is true for Clinique based on your question, but is true for every other – our three big brands. So Lauder is the same. We really attract new consumers and a lot of millennial consumers. So the cannibalization is very, very limited. This consumer, our consumer that were not shopping in the brands before in a large majority, or they were lapsed brand users, because they were not anymore going in channels that – where the brands today are distributed. So the large majority of the business is net extra business. Tracey?

Tracey Thomas Travis

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

A

And in terms of the fourth quarter. As we mentioned in the prepared remarks because we have some very strong launches coming up in the fourth quarter, we also have a fair amount of consumer reach expansion into Specialty Multi as well as some of the opening of our free standing stores and other points of distribution in the fourth quarter. And that's where the investment is coming in, in the fourth quarter.

When you look at the – our expense mix in the fourth quarter relative to last year, it's relatively comparable. And again, our model certainly here has been to start strong and stay strong. So a combination of very strong launch and distribution activity in the fourth quarter and certainly supporting products to accelerate into fiscal 2018 is what the fourth quarter represents.

Operator: Your next question comes from the line of Joe Altobello with Raymond James.

Joseph Nicholas Altobello

Analyst, Raymond James & Associates, Inc.

Q

Hey, guys. Good morning. First, curious if you guys have detected any change in overall market growth for global prestige beauty from the 4% to 5% it's growing at, earlier. And then secondly, a little bit more detail on the U.S. growth with and without Too Faced and BECCA and maybe what M•A•C did in North America this quarter? Thanks.

Fabrizio Freda

President, CEO & Class III Director, EsteeLauder Cos., Inc.

A

So on the total M•A•C growth, no. We're not seeing a big change. Overall, it's still between 4% and 5%; probably closer to 4% in this moment than to 5%, but still in the range. And – but what we have seen a change – we see a change continuously is where the growth is coming from. And the growth is coming from – by category, is coming more from makeup than in the past, as you know. And by recently in this quarter, the growth is again coming from Asia more than in the previous quarters. And then certain emerging markets have been more challenged than in the past, like, I don't know, Brazil or Turkey, obviously, and a few others. And so we see a variation where the growth come from. But what is interesting is actually the total growth is still between 4% and 5%.

Tracey Thomas Travis

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

A

And as far as the North America performance this quarter. As we indicated, the brick-and-mortar channels were pretty challenged, particularly in the U.S. in the third quarter. Excluding Too Faced and BECCA, the North America segment was down in sales and M•A•C was certainly a contributor to that performance.

The M•A•C team is working very strongly in the U.S. to accelerate performance, both in the department store channel and certainly in their freestanding stores and has some great programs coming up over the next couple of quarters.

Operator: Your next question comes from the line of Erinn Murphy with Piper Jaffray.

Erinn E. Murphy

Analyst, Piper Jaffray & Co.

Q

Great. Thanks for taking my question. I guess I wanted to focus on the comment, Fabrizio, you made on the earned media value for M•A•C picking up in the third quarter. When you look back, what was driving that? Was it new product launches? Was it product placement with influencers? And then I guess just a housekeeping question in terms of the cadence of openings at ULTA. You talked about 25 in June and over 100 by year-end. Should we just kind of model the balance of that in the next quarter? Or how do we think about kind of the next couple of quarters in the calendar year? Thanks.

Fabrizio Freda*President, CEO & Class III Director, EsteeLauder Cos., Inc.*

A

So, let me start from this last question, is – no, is what I said. [ph] Usually, our model (38:25) is differently, is 25 by June and then 100 and you can assume that the 100 will be equally split because it's a matter of capability opening. And the opening will be more aggressive as of September obviously because of the organization and capability things. But this is the total number that we're planning for at the moment. What was the?

Dennis D'Andrea*Vice President-Investor Relations, Estee Lauder Cos., Inc.*

A

Earned media for...

Fabrizio Freda*President, CEO & Class III Director, EsteeLauder Cos., Inc.*

A

Ah, the earned media value of M•A•C. So what was driving the improvement of the earned media value of M•A•C is, first of all, the M•A•C activation of many more influencers. And the activation also of M•A•C makeup artist has influenced themselves, which is a unique model created by the M•A•C brand. Meaning M•A•C is, obviously, activity is external influential, but also many of the very valuable makeup artists of M•A•C influence themselves. And being enabled by a lot of great quality asset to support do this job around the world and particularly in the U.S.

The other thing is, activity in this is M•A•C is back launching hero products. And as you know, a lot of these media value is driven by exciting new products. For example, Next to Nothing launch, which I mentioned in my prepared remark is an activity which is creating a lot of conversation in the social media arena, which is helping to support the brand. We believe this strength will continue. The M•A•C brand is very active among the various changes they're leading in the U.S. market and internationally in increasing the numbers of hero products that will be passed of their deployed portfolio of innovation.

Operator: Your next question comes from the line of Jason English with Goldman Sachs.

Jason English*Analyst, Goldman Sachs & Co.*

Q

Hey. Good morning, guys. Thank you for slotting me in. I just want to turn to margins. Your guidance implies that EBIT margins are going to be down for the full-year modestly. Another three year where you kind of fall short of your longer term targets of 40 basis points to 50 basis points. Can we go through some of the drivers? Like, obviously some deleverage in free standing stores, department stores, et cetera. Talk about the size of those, the path forward?

And maybe put a little more teeth on this Leading Beauty Forward program to give us some context of the savings when they can flow? And what it means for margins on the forward? Is this sort of just the new reality that we should get [ph] acclimated to service stagnant (41:09) margins? Or is there a path to improve on the forward? Thank you.

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

A

Yeah. Thanks, Jason. With respect to our margins this year, and I think we had indicated this was the case last year as well. One of the things as you all know that we've been experiencing for the last three years is negative

currency impact on our margins. So, in fact, if you look at the guidance that you're referring to, Jason, for this year, we have 80 basis points of improvement in margins. That is being offset by a combination of currency as well as our acquisitions. And so we've had a bit of that experience over the last couple of years as we have done a fair number of acquisitions. But most importantly the currency drag on our margin.

So, yes, we've had deleverage in free standing stores and that's had an impact. We are offsetting much of that with some of the shifts that we are doing in terms of expansion into specialty-multi, and you'll certainly see more of that impact in fiscal 2018.

As it relates to Leading Beauty Forward, when we announced the program about a year ago now, we indicated that the structure of the program is efficiency, effectiveness and redesigning certain organizations to allow us to achieve greater leverage in the future, and leverage implies margin expansion. So, we've delivered 80 basis points of savings from just our cost savings programs this year. Leading Beauty Forward will take another chunk out of our cost base, and also allow us to grow in a more leveraged fashion. And we've got lots of great activity around Leading Beauty Forward.

When we announced the program, and certainly still maintain this, we said that we would not see benefit this year. We will start to see some benefit next year, but it will not impact our margin guidance for next year. And then you'll start to see Leading Beauty Forward lead into our margin results over the following few years until it achieves its full potential and that full potential is \$200 million to \$300 million.

We will invest a portion of that back but a portion of that will also be dropped to the bottom line. So it is the reason that we have so much activity around Leading Beauty Forward and, as both Fabrizio and I mentioned, it is actually slightly ahead of plan in terms of some of the initiatives under the program as the organization really rallies behind this to not only create some of these leveraged structures from an organizational standpoint, but also build some of the capability for the future support of our strategic objectives.

Operator: Your next question comes from the line of Bonnie Herzog from Wells Fargo.

Bonnie L. Herzog

Analyst, Wells Fargo Securities LLC

Q

Good morning. I have a couple of quick follow-on questions on M•A•C. First I just wanted to clarify that it did improve sequentially in the U.S? And then in ULTA, I imagine this will be incremental in the top line. But will it be a drag on your margins given some expected cannibalization of your more profitable M•A•C retail stores? I guess how do you balance that?

And then I was curious about a potential halo effect that you might be seeing, broadly speaking, with your new innovation on some of your hero franchises or maybe as you further penetrate new channels, such as specialty-multi with some of your big brands. I guess I'm curious if you're seeing any evidence that Estée Lauder customer baskets are increasing? Meaning that your customers are buying more of your portfolio brands and possibly spending more per transaction? Thanks.

Fabrizio Freda

President, CEO & Class III Director, EsteeLauder Cos., Inc.

A

So, let me start from this line. I think we said it in prepared remark and everywhere we comment on this new distribution. The new distribution is bringing new customers. And so we have absolute evidence. That's why we

have tested our way first with 30 doors, then in certain areas internationally, the same. We have done this very gradually with a lot of attention. And there is – the large majority of consumers are new to the brands.

This is true for new distribution, both online in specialty and this is true for a lot of our new innovation which is focused on segments where we have strategic opportunities or strategic gaps. And that's actually been the big strength. And the other information we – that I have already shared but I want to further clarify it is that the large majority of these new consumers are millennials. And that's true in all these things that we have. We have year-end data that comport all these learnings and then based on this data, we made decision on distribution evolutions around the world.

Tracey Thomas Travis

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

A

In terms of M•A•C in the U.S., no, we think some up and down performance as it relates to M•A•C in the U.S. So the expectation, obviously, is in the fourth quarter and beyond that the M•A•C performance given certainly the expansion into specialty-multi along with, as Fabrizio said, many of the programs that they're working on and the increase in some of the digital activity that they're doing will start to gradually improve sales in the U.S. And also, as we said, M•A•C is quite strong other than a couple of pockets in international, quite strong in international, particularly in Asia.

And again, in addition to some of the expansion into specialty-multi that's being done here in the U.S. and the work that is going on to grow sales in the freestanding store and distribution – and department store channel, they're also launching in Asia on Tmall. So we expect next year to be a strong year for M•A•C going forward.

Fabrizio Freda

President, CEO & Class III Director, EsteeLauder Cos., Inc.

A

And then in term of profit dilution of the new distribution, M•A•C is very dependent from traffic. And so if we – where we are able to create good sales per door, M•A•C is a profitable brand. And so our priority is to stay focused on really making M•A•C a good brand with great sales per door in every single distribution channel and that will make M•A•C – will keep M•A•C as a very profitable brand. And in term of the overall dynamic, I want again to clarify the – M•A•C exposure to, in this moment, the declining brick-and-mortar department store traffic is the key issue we are trying to solve.

M•A•C has enormous demand and attention from consumers. It's a very desirable brand. Wherever M•A•C is exposed to traffic, it's performing well. And that's the key issue we are trying to work on. As we said, we have many international pockets where M•A•C is booming. And we need to address the U.S. issue as we have discussed. And I hope you see many of the pivoting activity that we are doing to achieve this goal as fast as possible.

Tracey Thomas Travis

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

A

And the only thing I want to add to that is M•A•C is one of the strongest, if not the strongest, brand online in terms of growth.

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

Mark Astrachan

Analyst, Stifel, Nicolaus & Co., Inc.

Q

Yes. Thanks and good morning, everybody. Wanted to go back to the overall category growth question and answer. So obviously, good quarter sequential improvement but still pretty decently below your large peers in terms of absolute organic growth. So I guess I'm curious to what do you attribute this? How much is Americas? The M•A•C commentary that you've touched on, how much is Clinique as a brand that hasn't been touched on but seems like it declined in the quarter? And then how do you think about improving those trends relative to peers? Or do you think this sort of normalize over time as overall growth moves back towards what you're calling 4% to 5% prestige beauty category growth? Thanks.

Fabrizio Freda

President, CEO & Class III Director, EsteeLauder Cos., Inc.

A

Our growth algorithm is 6% to 8% and we are obviously on this trend. And the key point is this industry is not a zero-sum game. All the big companies are growing. And depending by quarter and by year, some are growing a bit less or a bit more, but we all are growing. So the key point is that there is a strong category growth and there is space to grow for a lot of big companies. And they believe that small brands are diluting the growth of big companies is clearly not demonstrated by the facts, because big companies are growing, are growing their brands and enriching their portfolios. If there are some smaller brands which are doing very well, some of them get acquired by the big companies when they have the right rate of return. And so I believe actually this is an environment where many big companies can grow and can grow at the same time in this amazing part of the industry which is prestige beauty.

Now, what do I attribute in the short-term in the last six months, nine months? Our growth be below some of our competitor is frankly 80% U.S. department store traffic. We are the company which has the highest exposure in percentage of our business and in our big brands to U.S. department store traffic. And that's the big thing. And then there are other – many, many other areas of the world where frankly we are growing faster than many other companies.

And the last point I want to make, we are building market share. So in a market we continue to grow 4% to 5%, we continue to grow market share. This was evident also in the recent [ph] Unimonitor (52:02) report for 2016 calendar and is obviously proven by these first quarter numbers where we are growing in constant currency 9% versus the market which is probably closer to 4%. So we keep growing market share. We keep growing well in all over the world and we do have an issue to solve – to address, which is that U.S. department store traffic and our high penetration of this channel. And we are pivoting to reinforce this channel and at the same time diversify our business in the needed way.

Operator: Your next question comes from the line of Olivia Tong with Bank of America.

Olivia Tong

Analyst, Bank of America Merrill Lynch

Q

Great. Thanks. First, we obviously talked a fair bit about M•A•C in the U.S. and the increase in ULTA and Sephora, but one of the things I want to know is how much of their issue for M•A•C in the U.S. do you think is a function of more competition in the makeup category versus just its retail positioning, particularly with younger consumers that M•A•C has captured for so long. And then perhaps can you give a little bit more detail in terms of what other opportunities are there for other brands in terms of the specialty-multi distribution, not just the smaller faster growing brands, but also the larger ones?

And then following up on that, as more activity moves online into smaller format channels, what's the difference in terms of the purchasing patterns versus your traditional retailers? Obviously, the consumer is younger. They are

clearly focused a little bit more on the smaller brands versus the larger brands, but what about like product category, price points and things like that? Thank you.

Fabrizio Freda

President, CEO & Class III Director, EsteeLauder Cos., Inc.

A

Okay. So let's start again. M•A•C is – there've been some recent research issued that M•A•C is the number one brand loved by teenagers in this market in the U.S., and just been published a research on this. All our consumer data showed that M•A•C is among the preferred brands among the millennials and, frankly, all generations. So M•A•C is a business built to be really very sensitive to traffic.

And that's the key thing we need to do. The brand is in excellent shape, very desirable. And as I said, to demonstrate this, there are markets around the world where the brand this quarter has been growing 40% or 45% despite the competition being the same. And so it's a very specific opportunity.

Said that, there is definitely a lot of new competition, and every big brand has to face this new competition. On this, I would like to make an – to do an observation. What we see in the data is that this increasing competition done by an ever-increasing number of brands is an increasing competition in the [ph] momental (55:06) trial. That is, we don't see increasing competition in the area of loyalty and in the area of retention and repeat, which where the profit is.

Let me explain this. We have, for example, in all our big brands, take Estée Lauder with Advanced Night Repair, take M•A•C with Studio Fix, the big hero products in this moment are getting more success and increased repeat despite the increased competition. What is tougher is to get the attention at the trial moment, because of [ph] many small brands, there's more activity out there (55:42).

But I would like you to think that the trial moment is not the profitable moment. Trial is an investment. Repeat is a profit. And so at the end, the profitable brands are still the big brands with great hero product, great repeat, and not many small brands that generate a lot of noise on trial, because unless they get the repeat, they will not be sustainable.

And so, we are very focused on a sustainable, long-term profitability strategy for our brands, and that's the way we are addressing the issue at M•A•C and the opportunity for all our brands.

So, the second question was specialty-multi, which is an opportunity for many of our brands, and I mentioned many of them in my prepared remarks exactly to give you maximum exposure to all the pivoting we're doing. Instead of repeating them, I would like just to clarify one point. Every brand has a unique distribution strategy in the Estée Lauder Company portfolio.

So, we don't do things by channel. We do things by brand. So, there are brands which are designed to win well in specialty, brands which are designed to be in multiple channels and brands that are designed to be more exclusive in a certain channel type. And our broad portfolio brands give us the possibility to play this growing multichannel portfolio globally in an excellent strategic way.

The last question was on online, and yes, we see a very different pattern in purchases online. Purchases online tend to be younger and tend to be, frankly, very profitable because consumers are very loyal when they get into it. There's a lot of good repeat.

But most importantly, the online sales allow us to reach consumers that sometimes we cannot reach with brick and mortar. This is particularly true in emerging markets. I just gave the good example of China where a good launch of M•A•C in Tmall that will happen in this quarter, we know by all our analysis, that will expose millions of Chinese consumers in cities of Tier 3 or Tier 4 that today cannot buy the brand to be able to buy the brand. And this is true for many other brands in our portfolio and many of our online activities around the world.

Operator: Your final question comes from the line of Ali Dibadj with Bernstein.

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC

Q

Hey, guys. So, I wanted to look at your two heritage brands, Estée Lauder and Clinique, and Estée Lauder looks like it's clearly stabilizing here. There's another quarter of sales growth in both skin care and makeup globally. What are you learning from that? Because on the flipside, it looks like Clinique is still struggling a little bit both in skin care and in color, not just in the U.S., but it looks like globally as well. So if you could help kind of figure out what could happen to Clinique and how you're learning from Estée? You mentioned some innovation. Is that really going to be the turning point in Clinique?

And then second thing, Tracey, maybe more for you on just more quantification on the drivers you'd mentioned regarding SG&A coming down in the quarter. How much of it was a shift in IT spend from this quarter to next quarter? Was there an ad spend shift perhaps versus how much of it was kind of more permanent in terms of actually the improved efficiencies from cost cutting or channel mix? Thanks, guys.

Fabrizio Freda

President, CEO & Class III Director, EsteeLauder Cos., Inc.

A

Okay. I'll start from the Lauder and Clinique question and Tracey will take over. So first of all, Lauder is growing, so it's not stabilized. Lauder has been growing in a very exciting way in my opinion in this quarter. And this is the second quarter in a row where the Lauder brand is growing globally. What is driving that is successful innovation that is hitting new consumers combined with an amazing work on relaunching hero products, and that's the key point. I mean, Double Wear is a fantastic foundation product that millions of consumers around the world love. But still there are millions of consumers that have never tried this product. And so the ability of the brand to continue win with winning hero products is the key learning and this is working very well.

And for example, we have learned that Double Wear in specialty-multi attracts Millennials, despite being a foundation that's been there for many years and being a fantastic product for many years, attract new Millennials to the brand better than maybe specific Millennial launches targeted to Millennial. So we are now ready to leverage these new discoveries on Lauder and continue the acceleration. The third thing, which is helping the Lauder brand is that the Lauder brand is more exposed, positively exposed, to the Chinese consumers and to the Asian dynamics than the Clinique brand for example.

The Clinique brand in the country is more exposed to U.S. department store than any other brand in our portfolio together with M•A•C U.S. But globally, Clinique is more exposed in total. So the key point is that Lauder benefited from the comeback of growth in Asia and it being part of one of the brands, driving the comeback of skin care in Asia. And so the research of Asia, Asia skin care is obviously helping the Lauder brand and in our opinion will continue to grow – to support the growth of the Lauder brand.

The learning for Clinique are the same, is more hero products, more activity on innovation that on top of building specific new products, build existing hero products, the Pressed Fresh Vitamin C launch is an example of that.

Vitamin C is a new product per se, but at the same time create regimen with existing moisturizer of Clinique and so sell and build hero products and we have tested these successfully in the last year.

The art of learning for Clinique is that also Clinique need to accelerate the entrance in growing channels. So also Clinique is further accelerating the expansion in the successful specialty multi-channels where it's playing and online. And so we will continue to do that and, sorry, the last thing on Clinique is the makeup. Clinique is also working to further activate their makeup innovation and activities in fiscal year 2018 that should further boost the brand.

Tracey Thomas Travis

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

A

And in terms of the beat this quarter in the margin leverage that we had this quarter, I would say that about 65% of it is a combination of the sales beat as well as the mix of sales. So, favorable channel mix as well as category mix, as Fabrizio was just saying. We did see a pickup in our skin care category and as you all know, that is our most profitable growth category from a margin standpoint.

And then the balance of it was some shifts in terms of projects, and as well as A&P spend. So, again, we mentioned there were some of the programs that are launching in Q4 that we are spending behind that were initially thought to launch in Q3. The Cushion Compact would be one of those for Estée Lauder in China, and so we are spending behind that in Q4. So that's some of the shifts.

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 PM Eastern Time today through May 17. To hear a recording of the call, please dial 855-859-2056, passcode number 9981045.

That concludes today's Estée Lauder conference call. We would like to thank you for your participation, and wish you all a good day.

Disclaimer

The information herein is based on sources we believe to be reliable but is not guaranteed by us and does not purport to be a complete or error-free statement or summary of the available data. As such, we do not warrant, endorse or guarantee the completeness, accuracy, integrity, or timeliness of the information. You must evaluate, and bear all risks associated with, the use of any information provided hereunder, including any reliance on the accuracy, completeness, safety or usefulness of such information. This information is not intended to be used as the primary basis of investment decisions. It should not be construed as advice designed to meet the particular investment needs of any investor. This report is published solely for information purposes, and is not to be construed as financial or other advice or as an offer to sell or the solicitation of an offer to buy any security in any state where such an offer or solicitation would be illegal. Any information expressed herein on this date is subject to change without notice. Any opinions or assertions contained in this information do not represent the opinions or beliefs of FactSet CallStreet, LLC. FactSet CallStreet, LLC, or one or more of its employees, including the writer of this report, may have a position in any of the securities discussed herein.

THE INFORMATION PROVIDED TO YOU HEREUNDER IS PROVIDED "AS IS," AND TO THE MAXIMUM EXTENT PERMITTED BY APPLICABLE LAW, FactSet CallStreet, LLC AND ITS LICENSORS, BUSINESS ASSOCIATES AND SUPPLIERS DISCLAIM ALL WARRANTIES WITH RESPECT TO THE SAME, EXPRESS, IMPLIED AND STATUTORY, INCLUDING WITHOUT LIMITATION ANY IMPLIED WARRANTIES OF MERCHANTABILITY, FITNESS FOR A PARTICULAR PURPOSE, ACCURACY, COMPLETENESS, AND NON-INFRINGEMENT. TO THE MAXIMUM EXTENT PERMITTED BY APPLICABLE LAW, NEITHER FACTSET CALLSTREET, LLC NOR ITS OFFICERS, MEMBERS, DIRECTORS, PARTNERS, AFFILIATES, BUSINESS ASSOCIATES, LICENSORS OR SUPPLIERS WILL BE LIABLE FOR ANY INDIRECT, INCIDENTAL, SPECIAL, CONSEQUENTIAL OR PUNITIVE DAMAGES, INCLUDING WITHOUT LIMITATION DAMAGES FOR LOST PROFITS OR REVENUES, GOODWILL, WORK STOPPAGE, SECURITY BREACHES, VIRUSES, COMPUTER FAILURE OR MALFUNCTION, USE, DATA OR OTHER INTANGIBLE LOSSES OR COMMERCIAL DAMAGES, EVEN IF ANY OF SUCH PARTIES IS ADVISED OF THE POSSIBILITY OF SUCH LOSSES, ARISING UNDER OR IN CONNECTION WITH THE INFORMATION PROVIDED HEREIN OR ANY OTHER SUBJECT MATTER HEREOF.

The contents and appearance of this report are Copyrighted FactSet CallStreet, LLC 2017 CallStreet and FactSet CallStreet, LLC are trademarks and service marks of FactSet CallStreet, LLC. All other trademarks mentioned are trademarks of their respective companies. All rights reserved.