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Estee Lauder Cos., Inc. (EL)

Q2 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

Lauren Rae Lieberman

Analyst, Barclays Capital, Inc.

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC

Bonnie L. Herzog

Analyst, Wells Fargo Securities LLC

Rupesh Parikh

Analyst, Oppenheimer & Co., Inc. (Broker)

Stephanie Schiller Wissink

Analyst, Piper Jaffray & Co.

Stephen R. Powers

Analyst, UBS Securities LLC

Caroline Levy

Analyst, CLSA Americas LLC

Jason English

Analyst, Goldman Sachs & Co.

Wendy C. Nicholson

Analyst, Citigroup Global Markets, Inc.

MANAGEMENT DISCUSSION SECTION

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

For opening remarks and introductions, I would like to turn the call over to 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 contained 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.

Fabrizio Freda

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

Thank you, Dennis, and good morning, everyone. I'm pleased that in the second quarter we delivered our financial targets. Our sales grew solidly, up 5% in constant currency. It was a meaningful acceleration from the first three months. In constant currency, our adjusted diluted earnings per share rose 5%, reflecting strong growth in high profit channels and disciplined expense management coupled with phased growth leverage.

During the quarter, we enhanced many important strategic growth levers which created positive momentum across our diversified business in our brands, channels, geographies and categories. These gains were fueled by strong strides in our innovation, social media and digital engagement. We continue to make priority investments through our Leading Beauty Forward initiative, which is proceeding according to plan. I will elaborate on each of these in a moment.

Our two biggest challenges currently are the brick-and-mortar business in U.S. mid-tier department stores, which continues to be impacted by soft traffic and a slowdown in consumer purchasing in the Middle East. Additionally, Hong Kong continued to be soft, and we remain cautious about the impact of political issues and terrorism affecting our business in certain markets. We also continued to be penalized by the strength of the U.S. dollar.

Despite these headwinds, we continue to successfully activate many of the elements of our strategy, which give us confidence in the strength and sustainability of our business growth. The first successful element of our strategy is the positive momentum of our diverse brand portfolio, and we continuously build from this strategic advantage.

In the quarter, our best performers were our mid-sized and luxury brands, which continue to gain devoted consumers and strengthen their desirable product offering and services. They are headed on a path to become big brands. Tom Ford, La Mer, Jo Malone, Darphin and the brands we acquired in the past few years generated impressive constant currency double digit growth globally. Tom Ford products were particularly well received, and the brand grew in every category in every region.

Two of our big brands generated improved sales and grew globally in constant currency. The Estée Lauder brand sales increased mid-single digits with positive growth both in skin care and makeup. Estée Lauder Revitalizing Supreme+ was the largest U.S. skin care launch in calendar 2015 according to NPD. The brands' makeup sales increased in every region and globally were up double digits led by foundations and lip products.

Estée Lauder brand grew in every region, which included an acceleration in China and in travel retail. Makeup fueled growth in the UK where the brand has a high makeup penetration.

M•A•C. global business also grew in constant currency, as we had anticipated. The brand international business further accelerated with double digit gains in most market as well as in travel retail. In the U.S., M•A•C. sales showed improvement versus the first quarter, but still declined, due primarily to weak traffic in brick-and-mortar mid-tier department store and its tourist-focused freestanding stores.

We expect M•A•C. international sales to increase further in the second half of the fiscal year with continued rapid online growth, creative innovation, expanded consumer coverage in overseas markets including launching in new cities, improved merchandise in store and accelerating its successful efforts in social media. Our aim is to strengthen the brand competitiveness in the U.S. while investing behind its international momentum.

We also strengthened our portfolio with the acquisitions of BECCA and Too Faced, two of the fastest growing prestige makeup brands. With a strong millennial following, they extended our presence in specialty-multi retail, which is one of the fastest growing channels for prestige beauty.

Too Faced joined our company in mid-December, just as it was introducing its Sweet Peach collection, which became its most successful launch ever. The collection attracted nearly 100,000 consumers online who waited up to four hours to make a purchase. We were excited about the prospect of maximizing the potential of BECCA and Too Faced forward, as we are doing with our other new brands.

The other acquisitions we made over the last two years are growing rapidly. We continue to integrate them into the company while we expand their consumer coverage and offerings. As an example, we launched Le Labo in Nordstrom and created a new fragrance set, which were popular gifts and best sellers online.

Our important strategy of diversifying our distribution to expand our consumer coverage is progressing well. We are evolving the company distribution footprint to meet consumers' changing shopping patterns. We are accelerating the execution of the strategy as some U.S. department stores closed unproductive doors while our most profitable channels delivered outstanding performances, including specialty-multi retail, travel retail and online, all of which rose double digits in the quarter. We have deep experience successfully managing our business across a wide variety of distribution channels, for example in the UK and in many European countries.

In a fast growing specialty-multi retail channel, we are increasing our presence by launching more brands globally to reach new consumers. In the quarter, we launched Estée Lauder initially in 30 ULTA stores in the U.S. and on ULTA.com and had very strong results. Clinique's expansion in the channel included more than 50 new doors with Sephora in JCPenney where it was the number one skin care brand in those doors. Outside the U.S., Clinique launched in the largest specialty-multi retailer in Korea.

In travel retail, our strategy to make our limited distribution brands more widely available and offer a broader portfolio of brands in the channel has yielded outstanding results. We have broadened our makeup offerings in travel retail to capture growing demand while Jo Malone growth has helped drive a reinvigorated fragrance business, and we are introducing some of our newer artisanal fragrance brands to airport locations.

Our retail sales growth was more than double the 8% passenger traffic growth in the channel, as more than half of our top 30 travel retail markets posted double digit gains. However, it bears mentioning that travel retail remains volatile as political issues as well currency fluctuation can cause significant changes in travel patterns.

We continue to execute on our e-commerce strategy, which delivered accelerating double digit growth in the quarter as we supported our whole sites and retailer sites with new programs and innovation. Our sales were strong across brand sites, led by M•A•C. as well as retailers and third-party sites.

Traffic in orders rose strong double digits compared to last year. We opened our – or launched an approximately 100 new sites globally for our brands and products and began selling online for the first time in Hong Kong, the Middle East and the Balkans. In North America, several brands had record breaking online sales during holidays, including Estée Lauder, Clinique, Origins and Aveda.

We continue to focus on mobile engagement and saw significant growth in traffic, which drove m-commerce sales increase of 75% over the Thanksgiving Cyber Monday weekend. Our brands on retailers' site also posted double digit growth in the quarter.

Our online business was exceptionally strong in China where sales nearly doubled, thanks to a highly successful single day on Tmall. During that event on November 11, sales of our six brand stores on Tmall were twice that of previous years. At Estée Lauder, most of the consumers who purchased products that day were new to the brand on Tmall, illustrating the success of our strategy to reach new consumer through different channels.

From a geographic standpoint, two of the largest markets we had expected to improve this quarter did so. Our business in France showed solid growth, and our U.S. sales improved, led by our high-end fragrance brands, which were big winners at holidays. Estée Lauder's Blockbuster Set helped drive traffic and sold out weeks before Christmas.

Our sales in China were strong with many of our brands rising double digits. La Mer was a standout, driven by the successful launch of its Renewal Oil and Skin Color Collection, a key entry in the fast growing area that bridges skin care and makeup. The Skin Color line is at the incremental sales and having a positive halo effect on the brands' skin care business.

Makeup continue to be fast growing category in China, and we are responding to the demand. M•A•C's growth in China was outstanding, as lipstick sales rose strongly. The brand's upcoming launch on Tmall is expected to further drive sales, particularly in cities without brick-and-mortar.

We expect Estée Lauder brands' momentum in China to continue. In our third quarter, we plan to launch its best selling Double Wear Foundation in a [ph] cash room compact (12:51) a package innovation that is coveted by Chinese consumers.

Looking at our categories now. Our three major ones are growing solidly on a constant currency basis. Skin care returned to growth, and we have created a new profile growth engine with a fragrance category with our now extensive portfolio of high-end fragrances, which includes, Jo Malone, Tom Ford, AERIN [ph] at Zegna Sensa (13:20) as well as newer brands such as Kilian, Frédéric Mall, and Le Labo. They had growth of nearly 30% during the quarter. These luxury fragrance brands were primarily powered by strong new fragrance launches and social media.

In addition, innovation is driving our success across multiple engines of growth, expanding our brands, regions, channels and target consumer groups. We are leveraging opportunities across the largest and fastest growing subcategories in areas of consumer benefits while creating a leading new breakthroughs. We are increasing our speed to market and creating more superior products.

Additionally, our research and development team continues to develop new proprietary technology platform, and our innovative concept extends beyond product towards include packaging, delivery systems, merchandising, services and even new approaches to digital engagement.

One of our numerous products in packaging innovations is Clinique's Fresh Pressed Daily Booster. Launching this month, the Booster represents a new subcategory for our company. The product concentrated vitamin C is intended to be freshly pressed into our moisturizer to immediately brighten and even skin tone. Fresh Pressed should also increase sales of Clinique core moisturizer business since they are used together.

Our brands are also focusing innovation around hero products and hero franchises, creating new offerings around a core collection is very efficient and rose a renewed attention to the brand priorities. For example, Estée Lauder recently introduced new products to reinforce its two biggest franchises, Advanced Night Repair and Double Wear, and it paid off as both grew double digits. In the U.S. sales of the core Advanced Night Repair Serum rose 17%, boosted by its innovative Intensive Recovery Ampoules. And a new eye mask that just launched last month as part of the franchise should further lift the serum and the entire collection.

I'm proud that several of these products are being recognized for their innovation. Last month Estée Lauder received Marie Claire's prestigious Prix d'Excellence Award in research and development for three products: Advanced Night Repair Powerfoil Mask, Advanced Night Repair Ampoules and Revitalizing Supreme+. This award honors the most Innovative Products of the Year.

Our innovation is helped by our brands and retailers' websites, which play a key role as a marketing vehicle to raise awareness of our new products. Millions of people can research the latest launches and read ratings and reviews before purchasing. We will continue to invest in capabilities to further expand our presence online and our brands are making important strides to stay on the cutting edge of social media, which continues to strongly influence beauty choices. As an example, in the last years, M•A•C has significantly increased its digital engagement. The number of global Instagram followers of M•A•C has increased by 75% to 40 million and its number of global Facebook fans has climbed sharply.

M•A•C has launched local Instagram's account in several markets including Brazil, Germany and Russia and the content is shoppable. M•A•C's global makeup artists are engaging consumers with locally relevant content, as the brand is using more influencers a user generated cost to augment its messaging. We just announced a collaboration with 10 global beauty influencers and bloggers who will create their own M•A•C lipsticks.

Our brands' actions to drive earned media value through influencers is working well [ph] a win made (17:58) gains in all product categories. As a company, we have tied to the number one position in earned media value share in Total Beauty is measured by Tribe Dynamics, which quantifies the value of digital content created by third parties about a brand. We have the largest corporate share in skin care and fragrances and we have tied for first in makeup. We have Tom Ford, Smashbox and now Too Faced a strongly growing share of engagement with influencers, which is reflected in the higher shares in prestige beauty.

In the second quarter M•A•C strongly increased its social influencer engagement, which led to a 30% rise in earned media value. And in another impressive achievement in China, the Estée Lauder brand was ranked number one and the only genius brand in the recent L2 China Beauty Index, which cited the brand leadership in digital marketing, mobile and social media.

Now let me turn to outlook. We expect to achieve constant currency sales growth of 6% to 7% in fiscal year 2017. This includes approximately 1% of incremental sales from our recent acquisitions of Too Faced. We continue to expect our sales and profits to accelerate in the second half. The stronger gains are expected to come from four main factors, including organic growth, regular price increases that took effect in January, increased consumer coverage tailored by brand and contribution from the recently acquired brands.

There are certain brands, channels in countries that we believe will be superior growth engines. They include our luxury brands and the online, travel retail and specialty-multi channels. By market, we expect China to remain strong and Hong Kong should start stabilizing.

As we capitalize on the best growth prospects, we are also managing costs and reallocating resources from lower growth area to priority ones, aided by Leading Beauty Forward. We continue to hire talent where we need skill sets and investing capabilities that will position us to win in the fast moving competitive world of global prestige beauty for the long-term.

With a diversified business that's directed by proven strategy and powered by multiple engines of growth, which we have strengthened even further with our artisanal fragrances and our recent acquisition of fast growing makeup brands, we are confident in our long-term outlook. Our results will continue to be fueled by the best brand portfolio and the best people in the industry which will drive our winning strategy and continue our leadership in global prestige beauty.

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 second quarter results and then cover our expectations for the third quarter and for the full year. As a reminder, my commentary excludes the impact of restructuring and other charges.

As you have seen from our press release this morning, net sales for the second quarter were \$3.21 billion, up more than 5% in constant currency compared to the prior year period. Incremental sales from our recent acquisitions of By Kilian, BECCA and Too Faced contributed approximately 90 basis points of this growth, slightly less than half of that from Too Faced.

From a geographic perspective, Europe, the Middle East and Africa saw the fastest growth again this quarter. Net sales rose 9% in constant currency with double digit growth from the travel retail channel, developed markets like Italy, France and Germany and emerging markets like Russia, Central Europe, the Balkans and India. Sales in the UK were also a major contributor to the regions' growth in constant currency, up high single digits.

Last quarter, we called out France and the Middle East as two markets that pressured our first quarter sales in EMEA. As we anticipated, sales in France returned to growth in the second quarter as prior year comparisons eased, although the country continues to experience lower levels of tourism than before. Net sales in the Middle East again fell sharply as distributors in the area continue to align inventory to weaker retail traffic. This trend is expected to ease slightly in our third quarter and more significantly in the fourth quarter as we anniversary the downturn. Excluding the Middle East, the EMEA region grew 12%.

Sales in the Asia-Pacific region grew 5% in constant currency. Growth was led by a double digit increase in China and the Philippines followed by strong growth in Korea and Malaysia. Both Japan and Australia rose low single digits. Hong Kong sales continue to decline, although at half the rate of last quarter. Excluding Hong Kong, the region grew 7%.

Net sales in the Americas grew 1% in constant currency. Latin America grew 7%, led by strong growth in Chile, Peru and Mexico, while Brazil and Venezuela remain challenged. Canada was flat, and the U.S. declined 1%, representing an improvement from last quarter.

Our sales in both the online and specialty-multi channels rose double digits. However, we saw continued declines in the brick-and-mortar business of mid-tier department stores as well as tourist driven freestanding stores.

Net sales by product category were led by the 11% constant currency growth in fragrances for the quarter, reflecting the success of our strategy to focus on the higher margin luxury and artisanal segment of the category. Jo Malone fragrances again led the category growth this quarter as sales rose strong double digits, reflecting a very successful holiday program and expanded consumer reach.

Fragrance sales from Le Labo, Tom Ford and Frédéric Malle rose strong double-digits. Makeup sales rose 7% in constant currency. The biggest contributor was Tom Ford, which doubled its makeup business this quarter. Estée Lauder and Smashbox rose high single digits, and La Mer nearly tripled its small makeup business due to successful launch of a new foundation.

M•A•C's makeup sales grew globally with strong results in travel retail and in Asia-Pacific. The brands in North America business improved from last quarter, but still declined low single digits due to slow foot traffic in its core channels of distribution.

Clinique's sales were also soft as they were adversely affected by a promotional shift and the timing of new product launches. Skin care sales grew 3% in constant currency, a nice improvement from last quarter. Nearly all brands saw growth in skin care this quarter, led by double digit increases from La Mer, GLAMGLOW and Bobbi Brown, and solid contribution from Estée Lauder.

Hair care sales fell 7% in constant currency primarily due to the cadence of innovation on hair care products at Aveda. Our gross margin declined 90 basis points from the prior year due to – primarily to obsolescence, new product mix and currency.

Operating expenses as a percent of sales decreased 60 basis points primarily reflecting prudent expense management and general and administrative expenses in addition to our cost savings programs and partially offset by higher store operating costs associated with our retail store growth.

Operating income rose 1% and operating margin decreased 30 basis points. Net earnings decreased 1% to \$454 million reflecting higher net interest expense and a higher effective tax rate. Diluted EPS of \$1.22 was flat to the prior year, as reported, and grew 5% in constant currency.

Earnings per share for the quarter included \$0.06 of unfavorable currency translation and \$0.02 of dilution from our acquisitions, half of that from Too Faced. EPS was higher than anticipated due primarily to favorable channel mix and more prudent expense management.

With respect to cash flow and capital allocation for the six months, we generated \$824 million in net cash flows from operating activities and we invested \$208 million in capital projects and \$1.7 billion to complete the acquisitions of both BECCA and Too Faced. The acquisitions were financed with both cash on hand and commercial paper.

We continued to return cash to stockholders using \$363 million to repurchase 4.2 million shares of our stock and \$236 million to pay dividends. So we are pleased with our Q2 results. Now let's turn to our outlook for next quarter and for the full year.

With the inclusion of our acquisitions, we expect sales to grow between 6% and 7% in constant currency for the fiscal 2017 year, reflecting approximately 2 points from pricing, approximately 2 to 3 points from distribution as we expand the consumer reach of some of our brands, and 2 points from innovation and the acquisitions of By Kilian, BECCA and Too Faced. We expect Too Faced to contribute more than half of this impact.

Currency translation is expected to depress sales by 2% reflecting weighted average rates of \$1 or \$1.08 for the euro, \$1.25 for the pound and \$1.11 for the yen for the fiscal year.

Diluted EPS is expected to range between \$3.29 and \$3.33 before restructuring charges, including approximately \$0.16 of dilution from currency translation and \$0.07 dilution from the recent acquisitions, of which \$0.04 is from Too Faced. In constant currency, we expect our EPS to rise by 8% to 9%.

For the fiscal 2017 third quarter, our sales are expected to rise by approximately 7% to 8% in constant currency, including the incremental impact of acquisitions of approximately 350 basis points to 400 basis points.

Negative currency translation is expected and estimated at approximately 2 percentage points. The Middle East is expected to see sequential improvement over the next six months, as I indicated previously. Net sales began to slow sharply in the second quarter last year and declined about 15% in the fourth quarter. We expect to see more normal ordering patterns emerge as inventory becomes more aligned with current sales trends in the Middle East. Hong Kong is another market where we expect sequential improvement as the tourist business there has started to show a stabilizing trend. Our business in U.S. mid-tier department stores is expected to continue to remain challenged.

EPS is forecast to be between \$0.65 and \$0.70 before restructuring charges. This includes dilution of about \$0.03 from currency and \$0.03 from acquisitions. We delivered the first half within our sales range and importantly, above our EPS forecast in constant currency. We remain focused on delivering our full year guidance against an accelerating backdrop of political, economic and currency volatility. The political landscape around the world shifted considerably in 2016. We've recognized the potential challenges this changing landscape presents, and there may be implications for our business in the U.S. and around the world.

While we remain committed and constant in our strategy, we are somewhat cautious in the near-term as a result of the global macro uncertainty. We are very proud that despite the headwinds we have experienced, we continue to proactively manage our business around the globe to deliver excellent sales and profit growth with our amazing teams.

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

QUESTION AND ANSWER SECTION

Operator: The floor is now opened for questions. [Operator Instructions] Questions will be taken in the order in which they were received. To ensure everyone has the opportunity to ask their question, we will limit each person to one question. Time permitting, we will return to you for additional questions. [Operator Instructions] Our first question today comes from Lauren Lieberman with Barclays Capital.

Lauren Rae Lieberman

Analyst, Barclays Capital, Inc.

Thanks very much. Good morning.

Q

Fabrizio Freda

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

Good morning.

A

Tracey Thomas Travis

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

Good morning, Lauren.

A

Lauren Rae Lieberman

Analyst, Barclays Capital, Inc.

I was hoping you could talk a little bit about Leading Beauty Forward, actually, particularly given you guys – you referenced it a little bit. And my understanding or my interpretation of the program has been that in part, it's about investing for the future in new channels, new distribution and so on and new business systems more for more digital e-commerce freestanding stores et cetera. But the part of the reason we don't see sort of a margin benefit from the restructuring element of this is you need to keep your infrastructure around, for example, U.S. mature department stores fully intact until this new system is up and running.

Q

Can you just – is that a reasonable way of thinking about it? And given how sharply the U.S. piece of this is declining, is there an acceleration in sort of be able to take some cost out of this, if you'll call it legacy distribution model? Thanks.

Tracey Thomas Travis

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

Yeah, no, so thank you for the question, Lauren. Leading Beauty Forward actually is comprised of multiple programs, as you suggest. Some are – were shorter term and some are longer term because they require structural changes. One of the things that we are looking at, to your point, is in light of some of the acceleration that we're seeing in channel shifts in some parts of our business, certainly in the U.S., how we might look to accelerate different components of Leading Beauty Forward. We are aggressively pursuing, expanding our digital capabilities in the company. We are aggressively pursuing looking for other cost savings opportunities under the Leading Beauty Forward program as well as other – our other cost saving programs as well.

A

But, Leading Beauty Forward, the reason why we indicated initially when we announced the program that there was no cost savings this year and we would see some next year, but it was included within our guidance for next year was just the timing of some of the longer term items that were planned under Leading Beauty Forward that

required some structural change. But certainly, we are looking as we always do aggressively to accelerate opportunities as we see them.

Fabrizio Freda

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

A

Yeah, and I just to add one [ph] aspect (33:51) that beyond reducing cost and doing of what Tracey is explained, I believe one of the key benefits in the next two, three years of Leading Beauty Forward, to reallocate resources to the fast growing opportunity and the fast growing businesses that we have around the world. So this should further enforce our strengths on top of creating more cost saving and more margin over the long-term.

Operator: Your next question is from the line of Ali Dibadj with Bernstein Research.

Ali Dibadj

Analyst, Sanford C. Bernstein & Co. LLC

Q

Hey, guys. So, I have a couple things. One is from a top line perspective. At least to our math based on your disclosures last quarter of sales and growth rates on your acquisitions, all of your acquisitions together this year, including the growth of those acquisitions, should be adding close to 3 points to your top-line growth. So not just the sales, but the sales and the growth. So does that mean your underlying organic local currency growth is about 3% to 4% for the year? And if yes, how should we think about the, I guess, attainability of your longer term 6% to 8% local currency sales growth target, which I get is only about 5% to 7% excluding typical 1% M&A, that's on a top-line.

And then the second question I had was on your inventory levels. I'm still just shocked that it's not improving. Your own inventory levels look like they're up about 20% year-on-year and I guess I'm kind of disappointed and surprised given SAP is now in place and you should see some more improvement and hopefully it generates more cash flow there. So thanks on those two questions.

Tracey Thomas Travis

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

A

All right. Thanks, Ali. I'll start and perhaps Fabrizio will join in. And the two questions are actually related, right? In terms of why we're not seeing some of the improvement that we had expected to see this year in terms of inventory. So our underlying business, if you exclude Kilian and Too Faced and BECCA, is more in the 4% to 5% range. So you're correct with your math. And that is for the reasons that we shared in our press release and in our prepared remarks. We are seeing some pretty strong challenges here in the U.S. in mid-tier department stores. The Middle East which is a very – has historically been a very strong growth and profit market for us, is challenged and we've talked about Hong Kong now for the last couple of years. So those are the primary drivers.

We expected a bit of a different mix in terms of the business, so that has left us with some higher inventory levels in some of our brands. In other brands, we've actually had to chase inventory because they are growing faster than we expected, like Tom Ford and Jo Malone and some of those brands. And we're managing all of that, obviously, to deliver the results that we shared with you this morning.

We are still committed, certainly, to leveraging SAP. It has helped us tremendously as the portfolio has become broader and more complex to manage in more volatile time. So thank goodness we have SAP and we along with our supply chain and business partners can manage the different flows of inventory as situations change around the globe. But we are still committed to the levels of inventory management that we have shared with you at the end of our year last year as we gave our three year guidance. And we'll certainly update that in August.

Fabrizio Freda

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

A

And I just would like to add one thing on the top-line, which is – yeah, 4% to 5% organic plus acquisition is what we see today. And actually what we are doing in terms of action is to improve the ability of all of these elements to grow faster in the future. Meaning the organic is – the good news is there are so many very strong drivers of growth within the current organic travel retail. China gains, stabilization of Hong Kong, continue of online and they're all accretive in terms of margins. So the organic, with the activity that we are doing and actually, we did decrease of the department store in the U.S., which is at this point the most disappointing performance as part of our portfolio, this part is decreasing as a percentage of business. What is increasing as a percentage of business are all the fast growing channels and fast growing activity.

So the 4% to 5% can become stronger over time and not weaker, plus the acquisition. Now the acquisitions are doing fantastic. We acquired great brands both this concept of artisanal high-end fragrances, which as I said in my prepared remarks, altogether growing more than 30% and the new acquisitions like Too Faced, the BECCA which have high growth brand into high growth channels. So the mix of improving our organics with a new change of mix and adapting to the new reality and the strong acquisition actually aims to reinforce our growth potential rather than dilute it.

Tracey Thomas Travis

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

A

And then the only other thing I'll add, Ali, to Fabrizio's remarks is back to inventory, just remember that in Q2, we also have included the inventory from our new acquisition, mainly Too Faced.

Operator: Your next question is from Bonnie Herzog with Wells Fargo.

Bonnie L. Herzog

Analyst, Wells Fargo Securities LLC

Q

Good morning.

Tracey Thomas Travis

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

A

Good morning.

Fabrizio Freda

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

A

Good morning.

Bonnie L. Herzog

Analyst, Wells Fargo Securities LLC

Q

I have a question on M•A•C. It seems that much of the brand softness in the U.S. has been due to issues that have been outside your control like weak tourist volumes and weak traffic at mid-tier department stores. So, first, would you agree with that point? And then second, in terms of what's in your control, you did mention some success you've had with your social media presence which is great, but curious how effective some of your promotions have been with M•A•C and whether you've had success in attracting new consumers to the brand.

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

A

So, no, I frankly disagree that over what's happening on M•A•C is out of our control. There are two things which is happening on M•A•C One, which is a soft traffic in the distribution where M•A•C is present and we need to correct that over time. And so it's kind of in our control. We can correct that. And second, if M•A•C had to make improvements in the social media activity penetration and we are making these improvements. And this is in our control and it's an area that we could do better. We are doing better as I explained and we'll continue to do even better. And the third part is marketing programs. M•A•C quality of collection, quality of innovation will need to improve and continue to improve in the U.S. and we are working on it and some of the things have been already visible in quarter two and more to come in the next quarter.

So it's not only a distribution adjustment, it's also a consumer engagement opportunity and also an innovation programs opportunities and we are addressing all of these three. Then I want to add that on M•A•C we are also working on new freestanding store formats that will address the ability to have freestanding store also in lower productivity situation while low tourist traffic because they will be smaller, more connected online, more engaging for consumers and more profitable.

Operator: Your next question is from the line of Rupesh Parikh with Oppenheimer.

Rupesh Parikh*Analyst, Oppenheimer & Co., Inc. (Broker)*

Q

Good morning, and thank you for taking my questions. Just I had a question on the gross margin line. The gross margins came in a little bit light compared to our expectations. Can you help us understand the key drivers for the decline and what your expectations are for the back half of the year?

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

A

Sure. So as I indicated in my prepared remarks, gross margin was impacted by some obsolescence. Product mix and in particular some of the programs that we have introduced this year have been a bit higher cost than prior programs so that has impacted our gross margin this year. And then there is some geographic mix in there as well and channel mix, so we have a lot of mix components. And then the last component is currency, so currency in terms of the transaction impact of currency has negatively impacted cost of goods this year and certainly that's what we had anticipated.

In terms of the back half of the year, we still expect to have some gross margin pressure on as it relates to some of the higher cost programs. However, as Fabrizio indicated and as I indicated in my prepared remarks, we do have incremental pricing that we've taken in the second half of the year, so that will help mitigate some of that.

Operator: Your next question is from the line of Steph Wissink with Piper Jaffray.

Stephanie Schiller Wissink*Analyst, Piper Jaffray & Co.*

Q

Thanks. Good morning, everyone. Tracey, just to follow-up on your previous comment regarding price increases, if you could just give us some sense of historically how effective those have been and if we should think about it as an effective mix or if it's like-for-like pricing? And then as a counterbalance, how you're thinking about using

discounts and promotion to drive conversion even on higher pricing if that's the thing we should think about? Does it give you a little bit more flexibility to use some promotional tactics?

Tracey Thomas Travis

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

A

Yeah, no, great question. So our pricing historically has been a combination of mix and like-for-like pricing. I would say probably a little bit more like-for-like than mix although I indicated obviously that we have introduced some higher cost programs which obviously have higher prices in both last year as well as this year. In terms of promotional activity, that's something that we have certain of our brands that have embedded within their operating model, promotions like Estée Lauder and Clinique and the gift with product promotions that they do.

And in certain situations where the environment during certain times of the year becomes more promotional, we have the flexibility within our model to react and respond. And certainly, the U.S. is one of the places where around holiday, it has become more promotional and some of our brands have reacted and responded to that. And then the last place that we will use promotion is in a situation where we do have higher inventory levels with certain brands, and you might see some very short-term promotional activity to liquidate that inventory. So those are primarily the areas we use promotion.

Sets have always been a part of our business, particularly in travel retail, and that's a form of value to the consumer. But by and large, we are not a heavy promotion company, and so we certainly use advertising and digital and social media now to drive traffic with the innovation of our products and the innovation of our marketing campaigns.

Fabrizio Freda

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

A

And the only thing I would like to add is that in a moment of evolution where consumers are really sensitive to innovation and to trying new products, one of the area of promotion where we are investing more is sampling. And we really are learning more and more how to make samplings very effective, also models that we call paid samplings which are very effective way to do sampling. So we are increasing sampling. And thanks to this, we are increasing the trial level of our new innovations.

Operator: Your next question is from Steve Powers with UBS.

Stephen R. Powers

Analyst, UBS Securities LLC

Q

Hey, great. Thanks. So clearly, the 5% to 6% underlying growth that you're guiding to is still impressive versus what we've heard from other companies, but it is below the level you seemed confident in a few months ago, even while Q2 came in more or less along with expectations. So can you just help us better frame where that one muted outlook over the second half of the year is coming from because it doesn't look like your market expectations have changed all that much? You seem muted on department stores in the Middle East coming into the quarter, et cetera.

And then secondly on expense control, which you've talked a little bit about. It looks as though your EPS guidance now reflects the higher FX headwinds that you called out plus the Too Faced solution and nothing else, despite that underlying top-line growth reduction of 200 basis points or so in the back half. So if that's correct, that implies a good deal of expense control to absorb the lower top line. And I know you – probably you alluded this in your

prepared remarks, but could you or Tracey just provide more color on where that – where spending levels have been reduced relative to the October outlook? Thanks.

Fabrizio Freda

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

A

Sure. I will – let me start from the growth. So we see the market 4% to 5%. Our goal – our, say, high-end goal has always been to grow at least 1 point more than market, meaning to continue growing market share. And we are delivering that and we believe we'll continue to deliver that in the long-term.

Now to explain the detail of what happened. In reality, we are taking the estimate down 1%. That's what's happening, and we are obviously still deliver 6% to 7% thanks to Too Faced. But there is 1% less expected growth than there were before Too Faced. Now where this comes from and why we believe will accelerate in the second half. This comes from mid-tier department stores in the U.S. that did less than what we expected originally and comes from the Middle East, emerging markets mainly. Middle East, that was really tough, and Turkey.

Turkey was a super high growth market for us and a very unfortunate event of the quarter two make Turkey grow much less than what we were expecting. And so this is what was the 1% less. But on the other side, there were many things that continue to do well actually that did even better than what we expected. So for example, the improvements in Asia particularly in China are even better than expected. The trend stabilization of Hong Kong is very good news. The continued success of Korea is really amazing, and this has huge implication for travel retail. Frankly, the super high growth of travel retail, which show how our strategy is working is even better than what we could have anticipated.

And the online continue to be very strong. So at the end, the net of this is that many of our engines of growth are getting better and better. Two of the things that took us down in the past, Middle East and Hong Kong are stabilizing, and the issue remains mid-tier department store U.S. where we do not anticipate a lot of improvements in this quarter, and that's what is the result.

Of our estimate, you need to add to this that our acquisitions are very strong and they could do very well and even better, and so that's the other element of strength that we are adding to the second semester in our ability to deliver our goals.

Now, Tracey, on the EPS?

Tracey Thomas Travis

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

A

Yes, and so on the expenses, as I spoke previously, one of the things that we have done certainly is try to ramp up our cost saving programs in light of some of the softness we're seeing in some parts of the business. So some of the planned expenses that we had had in some parts of the business we have certainly pulled back on. We have cut back on travel, we have cut back on some of the consulting projects that we had planned to do this year that have been cancelled, and some of the hiring in certain areas that we had expected to do. So those are the primary areas that we've addressed in terms of expense management.

Operator: Your next question is from the line of Caroline Levy with CLSA.

Caroline Levy

Analyst, CLSA Americas LLC

Q

Good morning, and thank you. I'm wondering what your advertising and marketing spend looked like year-over-year and as a percentage of sales, and if you can just help us think through the third and fourth quarter as to how that might flow? And do you see year-over-year maybe a decline in the fourth quarter?

And the other question is around this gross margin, just the risk that has peaked given that a lot of your growth is coming from more extensive input and that you're driving sampling and so on. I'm just wondering if – we seem to have been missing margin goals for a number of reasons. I don't know how much of that is currency and how much is just the change in portfolio?

Tracey Thomas Travis

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

Okay.

A

Fabrizio Freda

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

So [ph] probably I could (52:06) start and say our absolute advertising spending is going to be more or less stable across the year and will be – is assumed to be a bit stronger actually in the second six months, so in the six months we have in front of us, particularly in the third quarter because of innovation launches and activities.

In terms of percentage of sales, so we'll slightly down in the year and this percentage is driven also by mix, meaning our advertised – or more advertised brands, I should say our traditionally advertised brands are becoming a lower percentage of our total business and our brands which are supported by different tools from social media to sampling and to others like in store activities are becoming a bigger percentage of the business. Because of that, you should assume an overall stability for the next months of our absolute investment and a slight reduction of percentage of sales.

In gross margin, Tracey, do you want to comment on that?

Tracey Thomas Travis

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

Yeah, so in terms of gross margin, Caroline, as you know, and clearly we talked about some of the factors that are driving it this year, but you're right, the last couple of years, it's been relatively flat. That happens to correspond with a mix shift in terms of the significant growth of makeup and fragrance and the slowdown in skin care. So we do have different gross profit margins depending on the category.

We do also have certain of our cost activities that are targeted against cost of goods and we do expect that that will continue over the next couple of years. And again, clearly, if the skin care mix picks up, that will also help gross profit margin. So I do think we can see and we do expect to see some increase in gross profit margin, but as long as makeup and fragrance are driving the best gross from a category standpoint, it will be somewhat suppressed.

Operator: Your next question is from Jason English with Goldman Sachs.

Jason English

Analyst, Goldman Sachs & Co.

Hey. Good morning, folks. Thank you for – thanks for the question. I'm going to jam two in here. First through a follow-up to the margin questions, or maybe it's a follow-up to Steve Powers' sort of flow through question.

Q

Fabrizio, in your answer to Steve's question, it's sounded to me like you were saying there's also a mix shift by channel happening, so while you're getting slower growth, your slower growth is in lower margin channels, your faster growth is in higher margin channels and this is helping to mitigate the bottom line impact of the slower top-line growth. So question one, is that a reasonable interpretation? And then second question, back to sustainability of top-line, 4% to 5%, we hear you on that sort of underlying. You've done 3.5% in the first half on average. Your guidance is 3.5% to 4% in the third quarter and your full year guide implies something in the 6% to 8% range by the time we get to the fourth quarter. So how do we get comfort in the pace of acceleration and should we view even the slightly lowered guide as still carrying a degree of risk? Thank you.

Fabrizio Freda

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

A

So on the first question, the answer is yes. The evolution of our channel mix is accretive. But not only to margin, it's also accretive to growth potential because we are swinging a bigger percentage of our business into higher growth channels from what we see. So there is a positive margin and positive growth. And to your point, to your second question, I think – I believe I already explained. The key thing is that the key area of acceleration are pricing. We had pricing in January, which had about 2 points of acceleration. We had a lot of new – particularly for new brands, new distribution opportunities which are planned to start being impacting the business in the second semester and there are 2, 3 points that will come out of new distribution.

And this new distribution I do mean – new distribution for example, Tom Ford, Jo Malone in new countries, new cities. So it's not cannibalizing distribution, it's really coverage of consumer. That's why we call it consumer coverage opportunities. Plus, this includes some of the mix acceleration, meaning the moment Estée Lauder brand successfully built doors in ULTA, and they were very well, these automatically create more distribution which grows better. So there is more of this in the second semester. Then there is strong organic growth, the innovation that is working as we have explained in our prepared remarks, will now continue to impact and grow in multiple areas.

I believe the good news is that skin care is growing again and is adding this engine – and the other good news is that the engine we just created with these fragrances – high-end fragrances continue to go very well and we continue accelerate growth on a higher base.

Plus, as I explained, Middle East and Hong Kong have been two negatives in the first six months, should be better in the second six months. And finally, the base is lower frankly particularly in quarter four. The base is lower and so we believe that the combination of these things will bring our organic growth to the level that we are estimating. On top of that, the new acquisitions, Too Faced and BECCA are doing very well, so – and we believe they will add the very significant sense of the comfort to the ability to deliver the right growth and by the way, this will continue into next fiscal year.

Operator: We have time for one more question from Wendy Nicholson with Citi Research.

Wendy C. Nicholson

Analyst, Citigroup Global Markets, Inc.

Q

Hi. Just following up on that, I mean I think this is two quarters in a row where you've come in at the low end of your guidance and yet some of your peers are saying the market's improved. And so I'm wondering, number one, what your commentary is on that. Do you think you have the right forecasting ability et cetera, et cetera, just to boost our confidence, if you will, in terms of the guide for the back half?

The other question I had, Tracey, you've talked in the past about the point of as you expand into specialty-multi, there is a risk that the productivity of your doors or you counters in department stores will drop and I'm wondering if in the U.S. you are seeing that as you expand distribution, as you open up more of your own freestanding stores. Are you facing a problem at some of the mid-tier department stores and is that putting pressure on your growth? Thanks.

Tracey Thomas Travis

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

A

So let me start with the second question, Wendy. One of the things that our team is very careful about is the doors that we do open in specialty-multi and the distance they are from certain department stores. So we do look at the impact of cannibalization of doors and we haven't seen it. When we look at whether it's Clinique's performance or whether we look at Estée Lauder, which is now starting to perform or expand in ULTA as Fabrizio said. We're not seeing that cannibalization. The net of the double points of distribution if you will are accretive and are growth for the brands.

One of the things that and we have talked about in the past, Wendy, is that there is a shift in the retail landscape obviously in the U.S. where there is space being taken out of department stores that are closing doors and obviously we are working with them and managing to try to shift that business to online or to other department store doors. But then our specialty customers like Sephora and ULTA are adding doors every year and so we are adding our brands in those doors as well as they expand. And that's a shift I think we'll see for the next couple of years in the U.S. It's driven by consumer and consumer traffic patterns. It's certainly not driven by any of the actions that we're taking with respect to our business.

If anything, we're trying to be where our consumers are shopping and they're shopping in multiple points of distribution. So I think what we're seeing and how we're managing it is the right way to go for both parts of our business. But, painful at least here in the near-term this year.

Fabrizio Freda

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

A

Yeah. And going back to the first part of the question is, yeah, we came at the low end of the guidance, but the guidance has a high end and a low end, so I would now conclude is that we have issues forecasting. The issue is the one I explained. The issue is that versus our competition. We are absolutely overexposed to mid-tier department stores in the U.S. particularly. And this very high exposure and we have been obviously hit harder than others on the soft traffic that this channel has experienced in the last year. And that's why we are trying to react to. We are trying to continue to diversify our business globally in order to be able not to be over-dependent by any channel, any country, any brand.

And to have such a well diversified portfolio that we can deliver our 1 point ahead of market or more growth independently from any other area of the business or any specific area of the business. So frankly I'm very proud how we are pivoting the company in terms of online, TR, specialty-multi distribution, how we are pivoting the company in terms of social media versus historical or traditional way to engage the consumers, how we are pivoting the company to penetrate the makeup boom in a very aggressive way, how we are pivoting the company to split up and change our innovation models. We are pivoting and we are pivoting while continue to be one of the fastest growth companies in the consumer industry.

I personally am very proud of my team in the way we are managing this. although we do recognize that we were at the low end of our estimate and we are overexposed to the soft and usual mid-tier department store in the US.

Operator: That concludes today's question-and-answer session. If you are unable to join for the entire call, a playback will be available at 1:00 PM Eastern Time today through February 16. To hear a recording of the call, please dial 855-859-2056 passcode 56814785. 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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