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EL - Q1 2013 The Estée Lauder Companies Inc. Earnings Conference Call

EVENT DATE/TIME: NOVEMBER 01, 2012 / 1:30PM GMT

OVERVIEW:

EL reported 1Q13 local currency net sales growth of 6%, net earnings of \$312.1m and diluted EPS of \$0.79. Expects FY13 local currency sales growth to be 6-7% and diluted EPS to be \$2.47-2.56. Expects 2Q13 local currency sales growth to be 6-7% and EPS (including negative currency effect of approx. \$0.02) to be \$0.97-1.03.



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PRESENTATION

Operator

Good day everyone and welcome to the Estee Lauder Companies fiscal 2013 first quarter conference call. Today's call is being recorded and webcast. For opening remarks and introductions, I would like to turn the call over to the Vice President of Investor Relations, Mr. Dennis D'Andrea. Please go ahead, sir.

Dennis D'Andrea - *The Estee Lauder Companies Inc. - VP, IR*

Good morning everyone. On today's call are Fabrizio Freda, President and Chief Executive Officer; Tracey Travis, Executive Vice President and Chief Financial Officer; and Karen Buglisi, Group President of our MAC brand. Karen will discuss the evolution of MAC and its future opportunities.

Since many of our remarks today contain forward looking statements, let me refer to our press release and our reports filed with the SEC, where you'll find factors that could cause actual results to differ materially from these forward looking statements. Except when noted, our discussion of our financial results and our expectations are before restructuring and other charges. You can find a reconciliation between GAAP and non-GAAP figures in our press release and on the investor relations section of our website. I will turn the call over to Fabrizio.

Fabrizio Freda - *The Estee Lauder Companies Inc. - President & CEO*

Thank you, Dennis. Good morning everyone. Before we discuss the quarter, I want to acknowledge how terrific it is to be sitting here and holding this call on schedule given the difficult situation in the New York area this week. I'm proud of the dedication of our employees who have enabled



it to take place. I also appreciate all of you taking the time to hear our discussion where you may have more pressing matters. I hope you and your families are well and safe.

Now I want to officially welcome our new Chief Financial Officer, Tracey Travis, to her first Estée Lauder Companies conference call. Tracy will review the quarter financials in a few minutes.

I am pleased to report that our fiscal '13 first quarter sales in local currency we're on target with our expectation, while diluted earnings per share came in slightly better than we anticipated. Sales grew 6%, a solid performance following a 14% sales gain in last year's first quarter and worse than expected market challenges in Western Europe and Korea.

Sales rose solidly in each of the three biggest brands and increased in our top five markets and American markets in general. In China, our third largest market, sales were again exceptionally strong, even against a tough comparison to last year. Additionally, our North America Department Store business continued to thrive, thanks to well received product launches, effective advertising programs and excellent personalized service.

Many of our brands and channels have been growing rapidly in recent quarters maintained their momentum. Our luxury brands, including La Mer, Jo Malone and Tom Ford, continued strong double digit growth as did channels that tend to attract young consumers, namely online and North America speciality retail. Our reported sales rose 3%, which was higher than we forecasted because currency movements were not as negative as we had expected. EPS rose 12% to \$0.79, demonstrating how our winning business model leverages our sales growth into even greater profitability.

We are encouraged that fiscal 2013 is off to a healthy start and our strategy continues to be successful and resilient. By focusing investment in the fastest growing opportunities across our diverse brands, categories and geographies, we are able to increase sales even when sales with pockets of weakness and lower consumer spending. This quarter we achieved share gains in several emerging markets including China, Turkey and Brazil. Many of our brands gained share in established markets, including some in Western Europe.

Since we have a lot of activity going on around the world, let me provide further details on our business by region. This quarter, our strongest sales growth came from the Americas, lead by the United States, where our business was buoyant. US prestige beauty continued to outperform mass during this quarter by 4 percentage points. La Mer increased its ranking to become the fourth largest prestige skin care brand on the strength of its new moisturizing soft cream, which is expected to be its biggest launch in account for a sizeable amount of its global sales the first year. Our Company's brands now represent three of the top four prestige skin care brands in the United States.

We stepped up our commitment to the Canadian retailers about a year ago and our combined efforts paid off with high single digit sales growth. Higher sales in Latin America were lead by Brazil, due to our initiatives to further establish our prestige presence. Al told, we did well in Asia Pacific, but the region showed a sharp divide, with business rising in some markets and sliding in others. In China, our sales climbed 32%, primarily from reaching new consumers through expansion into Tier 2 and 3 cities.

As we said in our last call, more of our growth will come from broadening our geographic presence. We took our brands into six new cities, bringing the total to 64 and opened 78 counters. We expect the new consumers to also purchase our products in airport shops and international destination when they travel.

We were pleased to see modest growth in Japan, driven by success in foundations, which comprise a large portion of the make up category and leverage our skin care technology. Our biggest challenge in the region was Korea, which we cited as a problematic in our August call. In Korea, prestige beauty has been hit hard by inroads from local mass brand and weak retail environment and our sales declined sharply there. These conditions also negatively impacted our Travel Retail business in that country.

While our sales in Europe, Middle East and Africa region improved overall, markets in Western Europe and the travel retail channel were weaker than we had expected and affected our results. That said, we still grew in certain key markets such as UK, or Germany, backed by the strengths of our innovation and focus on local relevance, as well as strategic brand expansion. We also showed continued success in the Middle East, South Africa and Turkey.



Sales in our travel retail channel increased, but at a lower rate than in recent quarters. Retail sales of our products in China rose nearly 11%, more than twice the 4.5% gain in passenger traffic. But our net sales growth was constrained by select retailer destocking and the weakness in Korea, which is our second largest country in term of sales in travel retail. We expect retail sales to continue at the current base throughout the remainder of the fiscal year.

Our online business again grew strong double digits fueled by new E&M commerce sides and solid growth from our brand and retailer sides, particularly in the European region. Our strategy is focused on channels with the best growth potential in keeping with our brand equity, and we expanded accordingly.

MAC and Clinique, for example, were our first brands to begin E&M commerce in Spain and Smashbox entered both pharmacies in the UK. Also, Aveda opened a shop in the Minneapolis, St. Paul airport, its first foray in the travel retail channel in North America with an eye on further expansion. Estee Lauder began a 24 store test in Sephora in North America and Bobbi Brown opened a temporary pop-up store in New York City Grand Central terminal, which has been very successful.

Each of our product categories rose in constant currency and we were especially pleased with our success in hair care. Driving the growth was Aveda Invati collection for thinning hair, as well as greater salon distribution globally. Aveda began advertising Invati on TV and saw a quick response to its retail and online channels. Bumble and bumble sales increased as it expanded its speciality store distribution into 30 booth stores in the UK. It is also growing in Sephora in the US, and we expect this retailer for us to bring great awareness to the brand and help drive, also, consumers to salons.

Skin care, a key focus of our strategy, grew solidly as we continue to excel in creativity innovation. Clinique North America skin care sales rose 10% driven by the launch of Even Better Eyes. Estee Lauder latest Perfectionist serum was a hit and the brand continues seeing strong skin care growth in Asia. La Mer has been enjoying strong growth in Asia, and this quarter its US also rose significantly, more than 25% on the strength of its new moisturizing self cream.

Many brands have put an increased focus on make-up with good results, especially Estee Lauder and Clinique. We also launched the first make-up line for Aerin in upscale doors in North America and the UK. The luxury beauty brand was created by Aerin Lauder and is receiving great media attention. Smashbox grew double digit as it expanded internationally and is an excellent addition to our portfolio. Also, within make-up, MAC enjoyed solid global growth and did well in the US and in emerging markets. A standout was the Middle East, where it created lipstick shades for consumers there, another terrific example of our commitment to local relevance. Karen will describe MAC and its business more fully in a few minutes.

In fragrance, local sales were essentially flat. On a positive note, Jo Malone and Tom Ford, our high end brands, continue do well but they were offset by lower promotional sales from Estee Lauder and Clinique. This year our heritage and designer fragrances are continuing to improve their business model. Starting in fiscal year '14 we expect to resume greater fragrance launch activity for existing brands and new ones, such as Tory Burch and also Zegna, which will give us the opportunity to expand in the growing Mens Fragrance business.

Fueling our global growth was an increase advertising spending at the end of fiscal '12. We continued to increase our magazine advertising globally and accelerate our TV and digital ads. TV has become an extremely effective way to promote products and bring consumers to our counters. Some brands, like Aveda, have just started using the medium while the others, it is now part of their overall media campaigns. Clinique, for instance, ran commercials in numerous countries in the quarter for several products.

For the remainder of the fiscal 2013, we will continue to pursue the most promising opportunities on a regional and local level, drilling down to appeal to groups of consumers with specific tastes and customs. These opportunities will likely be in the high growth areas driving prestige beauty that we defined in our 10-year compass, digital speciality retailing, emerging market, traveling consumers and local relevant innovation.

There are many exciting developments underway in our second quarter, including the recent launch of our newest brand, Osiao, in Asia. This skin care brand developed over five years in our Shanghai skin institute illustrates our deep commitment to Asia and China in particular. Osiao shows

how we develop products closest to our most demanding consumers. The brand debuted a few weeks ago in two Lane Crawford stores in Hong Kong and we expect to launch it in China in the future.

Heading into the holiday season, we feel positive about the programs and promotion our brands will offer which target consumer from the value conscious to the high end. Aveda will begin selling in 15 Nordstrom stores later this month, which marks its first entry into North America speciality department stores. We expect the Nordstrom test will refer consumers to Aveda large and important network of salons. Aveda remains deeply committed to ongoing success in the salon channel and strengthening its presence within it.

Zegna, one of our newest fragrance brands, will announce a major launch later this month. Marni, another new design fragrance brand, is expected to roll out in February.

Currently we are preparing for the next phase of our strategic modernization initiative, which is planned to take place in January. It will affect ten business units and markets including China, France, and Hong Kong. We anticipate a large shift of orders into the second quarter from the third by retailers to avoid potential business disruptions. To date, all of our SMI implementations have gone relatively smoothly.

We operate in more than 150 countries and territories worldwide and at any given time will be ups and downs, a situation that we see today. This year we expect to see continuing strong demand for prestige beauty in the US and China, offset by weak markets in Korea and certain European countries. We believe the global prestige beauty will climb about 3% this year and we expect to grow at twice the rate or 6% to 7%. At this time we are also raising the lower end of our diluted EPS range for fiscal year 2013.

Throughout our history, we have demonstrated our ability to manage successfully through various economic environments and use the opportunity to strengthen or expand our Business. Our Board of Directors continues to show its confidence in our strategy and our strong fundamentals. This morning we announced we are raising our annual dividends by 37% to \$0.72 per share. We also said that beginning in calendar year 2013 we will transition to paying dividends quarterly instead of annually to deliver value to stockholders throughout the year. In addition, the Board increased our share repurchase authorization by 40 million shares.

The fourth year of our winning long-term strategy is successfully underway and we are confident in our ability to achieve our goals. I want to thank our strong organization and our valued employees for their ability to drive the business and react quickly, even in soft economies, while continuing to build long-term capabilities.

Finally, I want to note that all our employees are safe following the recent storm and our facilities were not damaged. We hope to resume normal business operations shortly and appreciate the efforts of our employees during the fast few days and the difficult circumstances. At this time, we are in the process of estimating the impact of the storm on our Business and will know more in the weeks to come. But we don't expect it to be material.

Now I will turn the call over to Karen to tell you what's in store for MAC.

Karen Buglisi - *The Estee Lauder Companies Inc. - Group President MAC Brand*

Thank you, Fabrizio and good morning everyone.

I started in the beauty industry more than 20 years ago and joined MAC in 1998 when Estee Lauder took full (technical difficulties) of it. In 2010 I was honored to become the brand's global president.

MAC was founded in 1984 in Toronto as a professional make-up brand. Staying true to our make-up artistry and fashion heritage has enabled us to achieve great success and enhance brand equity. We are proud to say that MAC is number one in prestige make-up in many countries, such as the US, UK, Canada and Mexico, as well as in emerging markets like Brazil, the Middle East and India.



MAC is the third biggest brand in Estée Lauder Companies' portfolio and one of the most profitable, which is impressive when you consider that about 95% of our Business is done in just make-up. Our strength in this category is even more pronounced given that we trade in less than 2,000 doors in just over 80 countries and territories globally, compared with many competitors that are in at least three times as many doors. This speaks to the fact that MAC's economic model is based on highly productive doors. Over the last ten years, MAC has quadrupled global sales and profits.

Our largest region is North America where MAC is the second largest brand in the Company, growing at an average annual rate of 12% over the past 10 years. By staying true to our brand credo, all ages, all races, all sexes, we have as many consumers under 25 as over 45 years old and we have plenty of consumers in every age in between. Over 40% of our consumers are non-caucasian. Since this is a more established market, we grow by recruiting new consumers into prestige beauty through limited traditional advertising like print and outdoor in tandem with disruptive digital content, as well as through enhancing our unparalleled high touch in store experience.

Currently MAC's International business makes up just over half of our sales, up from 23% 10 years ago. Its average annual growth rate of 25% over the past decade was driven largely by the UK and continental Europe. International will continue to be MAC's growth engine lead by these markets and a growing emphasis on emerging markets, Asia and travel retail.

One of our most important emerging markets is Brazil, where we launched in 2002. MAC was the trailblazer there and continues to be the leader in prestige make-up. However, over 97% of the market is in Mass and Mass-tige, so our growth potential lies in continuing to convert customers to prestige, as well as capturing the growing middle class and traveling consumer.

There are often no high end department stores in emerging markets like Brazil and India, but MAC has been able to introduce the brand through our stand alone stores, an important part of differentiation from many of our competitors. Freestanding stores allow the truest expression of the brand and MAC's retail concept is proven, productive, and profitable. Currently we operate about 300 freestanding stores globally, which represent almost a quarter of our Business.

Freestanding stores bring greater brand awareness and with street locations, mall locations and flagship stores like Times Square in New York, which is now our number one door globally. We are opening our second flagship store in New York City on 5th Avenue this month and our third is planned to open on Champs Elysee in Paris next February during fashion week.

Another point of differentiation is our high touch make-up service model. MAC artists are our number one customers and active brand ambassadors. We employ over 10,000 artists globally, giving our artists a career with MAC which leads to higher loyalty and lower turn over. We have the largest number and most highly skilled make up artists in the world working for us, which allows us to provide advanced artistry and expertise to our consumers. We will continue to prioritize artist recruitment, retention and development to maintain and enhance our superb service offerings.

Another aspect of our unique business model lies in our constant innovation. We launched something new, a product, color story, collaboration or regionally relevant collection every week, making newness our advertising and promotion. This pulls in consumers looking for something new and fresh and provides ample content for buzz building, word of mouth support for the brand. Despite all this activity, only about 15% of our sales come from new launches, although over 75% of our total global editorial coverage is on new collections and collaborations.

Much of this coverage is in digital media. MAC already has a strong digital and social media presence and the brand received the highest digital ranking in beauty from L2 last year. We are number one cosmetic brand on Facebook with 4 million fans and Facebook is the third biggest driver of traffic to our e-commerce site. We are also the number one subscribed luxury brand on YouTube with over 6 million video views. We have over 270,000 followers on Twitter through our MAC brand handle and senior artists. Our Tumblr site is constantly updated with make-up looks from the 850 global fashion shows we support every year.

For us, social media is the evolution of the word of mouth advertising that's built this brand and we plan to continue fostering these online communities through engaging content and consumer participation programs. This fiscal year we are expanding our 11 global e-commerce sites with 5 more and plan to launch in Belgium, Spain, Italy, Poland and Turkey, as well as introduce mobile sites in all e-commerce markets.



Lastly, the heart and soul of MAC is the MAC AIDS fund and Viva Glam. The MAC AIDS fund was established in 1994 to support men, women, and children living with HIV and AIDS and it's financed by the sale of Viva Glam products around the world. 100% of the sales of these products is donated to the fund and since its inception, over \$270 million has been raised which makes MAC the biggest corporate donor for HIV and AIDS in the US. Viva Glam has also proven to be a powerful loyalty driver for MAC artists, MAC consumers, and I can say the MAC President. I'm happy to announce that MAC AIDS fund Board of Directors approved today a Hurricane Sandy relief fund of \$500,000.

We have come a long way from our humble beginnings 28 years ago, and we are committed to sustaining our leadership and prestige make-up category and driving our growth by fostering our core markets, expanding internationally with a focus on Asia, emerging markets and travel retail, growing our free-standing store distribution and retailing expertise, expanding aggressively our E&M commerce business, evolving our high touch artistry experience, launching innovative and regionally relevant products and leveraging our fashion heritage in digital expertise. Given the brands' relatively high profit margins, MAC's future success will also benefit the entire corporation.

Thank you and now I would like to turn the call over to Tracey.

Tracey Travis - *The Estee Lauder Companies Inc. - EVP & CFO*

Thank you, Karen, and good morning everyone.

As a quick reminder, my commentary on the quarter and the outlook excludes restructuring and other charges which is consistent with the way we have reported results in prior quarters. As Fabrizio noted in his remarks, we delivered sales in the quarter in line on with our expectations, while managing increasingly challenging economic environments in some of the markets where we operate and while anniversary strong sales growth results in our prior year quarter.

In local currency, net sales rose 6% with all regions and product categories contributing to growth. Net earnings for the quarter increased 11% to \$312.1 million, compared with \$281.5 million in the prior year and diluted EPS came in above the top end of our expectations at \$0.79.

Sales of skin care products rose 7% in local currency and we generated growth in all of our regions. New product launches from Estee Lauder, Clinique and La Mer, combined with continued strength in China, helped category grow this quarter on top of the 20% local currency growth we experienced in the prior year quarter. In make-up, local currency sales rose 6%. Results were driven by solid gains primarily from new and existing products at Clinique and MAC.

Our Fragrance business rose very slightly in local currency. Double digit growth from our luxury brands was offset by lower promotional sales from Estee Lauder and Clinique. In hair care, sales rose 12% in local currency. Aveda benefited from the success of the new Invati product line and other product launches. All three of our hair care brands expanded distribution, including Aveda and Bumble and bumble, adding new salon customers to their network.

Geographically in the quarter, sales in our Americas region increased 8% in local currency. Within the Americas, the United States, Latin America and Canada each rose 8%. From a channel perspective, our North American sales to department stores and in our own free-standing retail stores grew 6%, while sales in multi-brand beauty stores, online, and salons rose double digits. In Latin America sales in Brazil grew 25% driven by the strength of the MAC sales and expansion that Karen just shared with you.

In the Europe, Middle East, and Africa regions sales increased 2% in local currency. Our travel retail sales, which are represented within the EMEA region, also grew by 2% as double digit retail sales growth in the channel was mostly offset by trade destocking, as well as challenging business conditions in the Korea travel retail channel. Several Western European countries, including the UK, Germany, and Austria, grew mid single digits, while Turkey, the Middle East, South Africa and our Nordic markets all grew double digits. This growth was partially offset by continued softness in other parts of Europe, primarily Spain, France, and Greece.



Our Business in Russia also remained difficult in the quarter. However, our comparison should begin to ease next quarter as we anniversary the deceleration of shipments in Russia that began last year. Switzerland also remains weak as the relative strength of the Swiss Franc compared to the Euro encourages some cross border shopping.

Asia Pacific region sales rose 7% in local currency. China grew sharply, primarily from the expansion of brands, doors and new cities. Our Business was also strong in Thailand and Hong Kong, and we were pleased that Japan was up 2%. We experienced weakness across all channels of distribution in Korea, as challenging economic conditions impacted retail sales and some consumers traded down to lower-priced local brands.

Our gross margin increased 50 basis points to 78.9%. The increase came from favorable mix and pricing of 90 basis points and favorable currency of 10 basis points, partially offset by a foreign transactional tax provision, manufacturing variances and obsolescence of 60 basis points. We leveraged operating expenses in the quarter as they declined 90 basis points as a percent of sales to 60%, primarily due to a 70-basis point drop in general and administrative cost and a 40-basis point drop from favorable currency.

Both marketing and selling costs were lower by 20 basis points each, and our previously discussed cost savings initiatives reduced expenses by \$17 million in the quarter. These improvements were partially offset by higher stock based compensation costs and higher IT investments of 30 basis points each. Operating income rose 11% to \$482.4 million and operating margin rose 140 basis points to 18.9%.

In August we issued \$500 million of long-term senior notes at very favorable rates. In September we used \$230 million of the proceeds to redeem 7.75% senior notes that were due next year. Net interest expense was essentially flat in the quarter. We recorded a pre-tax expense on the extinguishment of debt of \$19.1 million, equal to \$0.03 per share. Charges associated with restructuring were negligible in the quarter. The effective tax rate for the quarter was 33.3%.

We used \$125 million of operating cash flow this quarter, which is typically when we are seasonally constrained by working capital requirements ahead of the peak selling holiday season. Day sales outstanding increased to 57, compared to 50 days at the end of the quarter last year due to the timing of collections. Inventory days to sell rose to 177, compared with 163 days last year. This inventory level has been adjusted for approximately 18 days of promotional material such as samples and testers whose costs flow through operating expenses rather than cost of goods.

The increase in inventory reflects the anticipated inventory support to support near term sales growth, as well as additional inventory to maintain service levels in advance of the SMI go live in January. For the year, we expect inventory days to remain in line with fiscal 2012 at approximately 165 days post SMI implementation.

We spent \$96 million for capital projects this quarter as we continued to invest in counters, information technology, and retail stores. During the quarter we repurchased approximately 3 million shares of our stock for \$165 million and this morning, we announced that our Board of Directors has increased our buy back authorization by 40 million shares, which brings our total outstanding authorization remaining to purchase to 52 million shares.

We are overall pleased with our first quarter results. I would like to now share with you our outlook for the second quarter and for the fiscal year. As we have stated previously, our stated goal is to grow our top line at least 1% faster than the growth in global prestige beauty, which we believe will be 3% in fiscal 2013. Our full year sales are forecasted to grow 6% to 7% in local currency, or double the prestige beauty rate, including approximately 2 percentage points from pricing.

Based on current exchange rates and the forecasted strengthening of the dollar over the course of our fiscal year, we now anticipate a negative currency translation impact of about 2 percentage points on our full year sales growth. Our estimate includes weighted average rates of 125 for the Euro, 155 for the pound and 80 for the yen.

Our cost saving initiatives are expected to save between \$50 million and \$75 million for the full year. We will continue to increase investment in advertising, merchandising, and sampling efforts, as well as to build capabilities within our organization to enable our strategic initiatives. That said, we continue to expect operating margin expansion of about 70 to 90 basis points for the full year. Our fiscal 2013 effective tax rate is estimated at 31% to 33%.



We are raising the low end of our guidance for fiscal 2013 and now expect diluted EPS to be between \$2.47 and \$2.56, an increase of between 9% and 13% compared to prior year. Excluding a \$0.06 impact of foreign exchange, our EPS is expected to increase by a strong 11% to 15%. Both of these EPS ranges exclude the one time charge of \$0.03 related to the repurchase of debt, as well as \$0.01 for restructuring charges. For the fiscal year, we expect to record restructuring charges of approximately \$5 million, equal to the \$0.01 per share.

Our second quarter sales are planned to grow 6% to 7% in local currency. Currency translation could negatively impact our reported growth by approximately 1.5 percentage points. As part of our SMI program, we plan to go live with SAP at our next wave of affiliates in January, and as a result we expect retailers will advance some of their orders into our second quarter. While the timing is consistent with last year, we expect the potential shift in orders to be much higher, ranging from \$70 million to \$90 million, versus the \$30 million we experienced last year.

Additionally, we are increasing our marketing investments in the second quarter in support of both our launch calendar and to support our strong existing products in certain markets. Our cost saving initiatives are expected to generate \$15 million to \$20 million in savings for the second quarter and EPS for the quarter is estimated to come in between \$0.97 and \$1.03, which includes a negative currency effected of approximately \$0.02.

As Fabrizio mentioned, I want to note that our current expectations do not take into account the possible impact of this week's storm that passed through New York metropolitan area. Thankfully, and mindful of the considerable damage experienced in the region and with the tremendous commitment of our employees to resume normal business operations, none of our facilities have experienced property damage and despite some power disruption, we do not, at this time, anticipate the impact to be material in our Business results.

That concludes my prepared remarks on the quarter and the guidance for the balance of the year. Before I turn the call back to the operator, let me say that I am pleased to join the Estee Lauder call this morning as we report our fiscal 2013 first quarter results. I have been warmly welcomed by the organization and am proud to join a team that has built both an outstanding portfolio of brands and has demonstrated its ability to leverage opportunities and create significant value for its stockholders and its customers.

I do look forward to continuing to build on the strong efforts of the team by working closely with Fabrizio, the entire leadership team and my finance and other teams to focus our resources to support the strategic growth initiatives that have been developed, take a fresh look at our strategic modernization initiative, SMI program, and the next potential areas of profit enhancing initiatives; and partner with the brands and the supply chain on inventory optimization and the disciplines necessary to accelerate further cash flow generation and further margin improvement.

In addition to Fabrizio's acknowledgment of the extraordinary events and efforts that occurred this week, I would like to particularly thank the finance and investor relations teams for their commitment this week to reporting results this morning as many of them were personally impacted by Hurricane Sandy.

That does officially conclude my prepared remarks. At this point in the call, we'll be happy to take your questions. Operator, can you assist us with that?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Neely Tamminga, Piper Jaffray.

Neely Tamminga - Piper Jaffray & Co. - Analyst

Good morning and congratulations you guys. Good quarter. Just want to dig a little bit in, now that we have Karen on the call this morning, on MAC and some of the opportunities for MAC. Could you talk about Brazil and dot com for us? Could you offer some insights has to how Sephora,



assuming you go through some of the Sephora doors down in Brazil, what maybe their expansion plans are down in that region or how far penetrated you are with Sephora down in Brazil? From a dot com perspective, I'm trying to size up the dot com relevancy to the MAC brand and maybe how that index is relative to Estee as well as Clinique. Thank you so much.

Fabrizio Freda - *The Estee Lauder Companies Inc. - President & CEO*

This is Fabrizio. Before giving the call to Karen, I just want to say that we are not in Sephora Brazil with MAC at this point in time, but I'd like Karen to answer the questions.

Karen Buglisi - *The Estee Lauder Companies Inc. - Group President MAC Brand*

Certainly. I would love to talk a little bit about Brazil because it's probably the most important emerging market that we have. Currently, as I stated, we are the leader in prestige make-up there. We have about 30 points of distribution, we plan to double, we are in 11 cities. We plan to double our distribution in the next three to four years and double the number of cities that we're in, so we will continue to trail blaze for the prestige beauty market there and recruit customers into beauty into the prestige market. Secondly, dot com offers a great opportunity for us, especially Mcommerce now. Our M commerce is 12% of our overall E&M commerce, so we think there is a great opportunity for us to continue to maximize those channels.

Operator

Nik Modi, UBS.

Nik Modi - *UBS - Analyst*

Hi. Good morning everyone.

Fabrizio Freda - *The Estee Lauder Companies Inc. - President & CEO*

Good morning.

Nik Modi - *UBS - Analyst*

Fabrizio, can you frame the longer opportunity in China, just trying to understand as a percentage of the total distribution you could potentially have, where are you today and how do you see that investment and that strategy playing out over the next couple of years? Thank you.

Fabrizio Freda - *The Estee Lauder Companies Inc. - President & CEO*

As we said, we are today in 68 cities in China. We believe there are at least 100 or 120 cities that already now would be rated for the distribution. If, from a consumer standpoint, if the distribution network would be available. Our plan is to continue expanding to two or three cities and continue expand, particularly our most successful brands, the brands which are more ready for the expansion. Our plan is to continue to advertise and build awareness for your brands in China and basically to continue expansion in this way. To be clear, if you look at what's happening in China at this moment, is that the market in tier 1 cities in our industry is growing less aggressively than in the past in terms of comp growth particularly. But the potentials of continue expanding into new city and attracting new consumers is enormous. That's why this quarter we grew 32% in the situation.

The other thing that is part of the plan is to continue working on what we call the traveling corridors for China's consumers. We know today that there are a lot of consumers that are traveling and these consumers traveling are coming actually from these tier 2 and 3 cities where we are just launched recently or where we are not yet in, which means that the expansion in tier 2 or 3 cities in turn drives also the expansion in travel retail



and what they buy when they travel. And the other thing we know is today 70% of our online sales in China come from cities in which we are not distributed, indicating that the consumer demand is already there and we adjust to continue accelerating the distribution. So that's it.

Operator

Chris Ferrara, Bank of America.

Chris Ferrara - *BofA Merrill Lynch - Analyst*

Tracey, maybe this is an unfair question given that you've only be there -- this is your first quarter. Can you talk about your view on the balance sheet? The dividend increase is great. But can you talk about, in general, the status of the unlevered balance sheet and how you feel about that? Do you think there is a path to more aggressive use of it and what do you see for M&A opportunities? Thank you.

Tracey Travis - *The Estee Lauder Companies Inc. - EVP & CFO*

David, that is an unfair question after two months, but I'll do my best to respond. I think obviously our capital structure is something that we discuss on a regular basis with our Board of Directors. That includes our dividend issuance, our share repurchase activity and the amount of debt that we hold as a company. I think right now, given the increase that we announced this morning, as well as the additional share repurchase activity, we are certainly and the Board is certainly committed to returning cash to shareholders that we deem to be excess at this point in time and increase shareholder value.

In terms of debt, we obviously did most recently take on some additional debt. Some of that was to retire old debt but we do have a slightly higher debt than we had previously on our balance sheet. I think we're very comfortable with that at this point in time. It has been discussed previously that we certainly are open to appropriate acquisitions to enhance our portfolio. And I think we'll make those judgments at that time with respect to how we fund those acquisitions. But at this point in time, I think we're pretty comfortable with our capital structure.

Operator

Alice Longley, Buckingham.

Alice Longley - *Buckingham Research Group - Analyst*

Hi, good morning. My question is about your guidance for organic sales growth year at 6% to 7%. It was 6% the first quarter. And then if you take out the accelerated shipments in Asia above and beyond what you had last year, it looks like your organic sales growth in the second quarter is 4% to 5%. So that means it sounds like you're expecting accelerating organic sales adjusted for these timing issues in the second half. Can you explain why that's the case?

Fabrizio Freda - *The Estee Lauder Companies Inc. - President & CEO*

Yes. As we said before, we believe we will grow 6% to 7%, which is double the market. In this moment the market, our estimate is we grow about 3%. Just to be clear, this is different what we felt in August. In August we felt 3% to 4% would have been the market growth. The reality of what we have seen, particularly in south and European markets, which are now on the negative market trend, and in Korea which is fluctuant was a very strong growth market in the past. We had to re-adjust our point of view on the global market for the fiscal year.



Then in terms of our plan, we continue to grow market share and to grow in great markets like China and North America this moment. Frankly, we continue to grow and grow market share in many of the weak markets that we are seeing, for example, in places like Italy we continue to grow well ahead of the market trend. The same in France. So it's good results.

The reason why we believe we will accelerate as of January are twofold. First of all, we have an initiative plan and an innovation plan which is very strong there. Second, we have a strong innovation plan supported by extra advertising in the second quarter this year. We will spend \$80 million more advertising in the second quarter of the year versus last year, which we believe will have good strong inference on the third quarter end results and obviously also on the fourth quarter.

So this year, because of the of current (Inaudible) of our innovation and because of our intention to push our best opportunities as soon as possible in the fiscal year, we have an anticipated increase of advertise to the second quarter. As you remember, this was happening mainly in the fourth quarter in our previous year. And I think this will be beneficial to the further acceleration in the last six months. So in a nutshell, is coming innovation of initiatives, key opportunities by market to end the input of our advertising behind us in the innovation plan that we believe will further accelerate the sales growth. Lastly, keep in mind that we have a very high base in the first six months of the fiscal year from last year, and we have an easier base to beat the second six months of this fiscal year.

Operator

Ali Dibadj, Bernstein.

Ali Dibadj - *Sanford C. Bernstein & Company, Inc. - Analyst*

I just have one follow up from a previous question and then another one. Just to get underneath this kind of spending and impact on margins, one of the clear stories that has been very positive about Estee Lauder is the margin expansion. As we look at gross margins, as we look at SG&A opportunities this quarter and going forward, still a little bit more detail -- I know you try every once in a while -- but just a little bit more detail about where the opportunities lie going forward. And how much of the investment has to be increased investments to just grow the way it used to grow? Then tied to that a little bit, but a part of the other question, is if you could give a little bit more detail about Europe and how that may figure into it. So how much of the European issues we are hearing are really impacting the consumer versus just retailers and inventory and how should we think about that going forward? I apologize for two questions. Hopefully it can help.

Fabrizio Freda - *The Estee Lauder Companies Inc. - President & CEO*

I will try to answer both and allow Tracey to add onto what I say on this question. Let me start with Europe. What we see in Europe is that the markets are Italy, in Spain, in Greece, in Portugal and now also in France are starting negative, frankly, more than what we expected. The markets, we are doing well in this market but the markets are very, very tough. And there is less consumers buying than what we originally expected, which is understandable given the very tough economic situation. What happens in this case, when you have a worsening of the market in Europe, is that trade starts destocking as well. This happens because, as you know, the retail stocks in Europe are pretty high.

So Europe is a market where when we see a deceleration, deceleration is actually increased by the combined trade of stocking. At the same time, when we see an acceleration, the acceleration is increased by the trade restocking. So that's why you should expect in Europe, that's why you see the variation. What we expect in Europe for the future, our estimate in this moment is that the negative market base in south Europe will continue for the fiscal year. Then I believe they will stabilize and then probably start bouncing back in the '14 and '15 years. For the moment, we assume they will stay that for the remaining of the fiscal year.

To answer your second question, we are continuing at capping costs and we are continuing improving gross margin. We are continuing reducing promotions. And particularly we are continuing to drive our mix of initiative very strongly toward the most profitable and the most important and the most potential. Thanks to these leverage points, we are generating the possibility of advertising more and also you should know in the Company we have developed what I believe is the best innovation program that we probably have had for the next three years. So we want to be



able to finance these innovation launch to exploit best, the great asset of this company which is our great brands, our great innovation program for the next years. So what that means is we will continue to increase advertising spending in absolute term. This doesn't mean that we will continue year after year to increase the percentage of advertising, so in total AP spending. Also, we deem the AP spending total we will continue to look for ways to make it more efficient and to make it more efficient will include winning more money from promotion and promotion activities into brilliant pool activities in the key markets.

The last thing I want to add on this, we do this with enormous agility. It is a key part of our way to work today is that when we act like now, markets like China, US having a particularly strong opportunity, we are able to move funds and push our wins in this market with much more agility than what we could do in the first, which in turn makes our advertising spending more effective. And then we are trying to drive our more profitable mix channels. The reason why we have been introducing in this call, travel retail some time ago, then online, today MAC is basically to make you more familiar with what are the strong volume and profit drivers in our organization at this point.

Tracey Travis - *The Estée Lauder Companies Inc. - EVP & CFO*

I think Fabrizio summed it up well. The only thing that I would add to it is the Company has laid out a number of cost savings initiatives and expense leverage initiatives, which I think you are all familiar with, that have really helped and support a lot of the things that Fabrizio laid out over the last few years, helping to increase advertising expenditures in a very strategic way while increasing or expanding our margin. We are certainly focused on continuing to identify projects and programs within the organization that allow us to better leverage expenses. One of the things that I know has been discussed quite a bit on these calls has been the strategic modernization initiative and the SAP implementation, which will certainly allow us to improve some of the areas like inventory optimization which will have tremendous benefits with respect to cash flow improvement, as well as expense in margin improvement as well. So we're pretty excited about the next few years with all of the capability building that's happened in the last couple of years to be able to continue to leverage expenses and continue to grow with the innovation that Fabrizio indicated.

Operator

Caroline Levy, CLSA.

Caroline Levy - *CLSA Limited - Analyst*

Good morning everybody. Question on the SAP impact to sales and earnings in the second quarter, if there is anyway you can quantify that and how that would compare to the SAP impact from the year before? Is it adding more to sales growth and earnings than it did a year ago? Then also if you could elaborate a little bit on the trade destocking and travel retail in particular. So the difference between retail take away up 12 and the up 2 that you reported and when you expect that might normalize. Thank you.

Tracey Travis - *The Estée Lauder Companies Inc. - EVP & CFO*

Why don't I answer the SAP shift and then Fabrizio can answer the second part of your question. As I said in my prepared remarks, you are absolutely correct, the impact this year given the number of affiliates that we have rolling out in January is greater than it was in the prior year's quarter. So this year we're expecting approximately \$70 million to \$90 million in sales to shift between the third quarter into the second quarter. That compares to about \$30 million last year. That's what the impact will be in the quarter.

Fabrizio Freda - *The Estée Lauder Companies Inc. - President & CEO*

Yes. Travel retail -- the stocking has been mainly in Asia and in the Americas and was the result of a change of rate of increased traffic in July particularly, and then just in August. And some of the retailers decided to destock. We believe this will continue. We believe that the overall net sales will gradually align to the retail sales in the remaining of the fiscal year. And as I explained in my prepared remarks, the retail sales increasing in travel retail globally has been about 11% despite a tough quarter in Korea, which is 15% of our total global travel retail business.



Operator

Bill Schmitz, Deutsche Bank.

Bill Schmitz - *Deutsche Bank - Analyst*

Hi, guys. Good morning.

Tracey Travis - *The Estee Lauder Companies Inc. - EVP & CFO*

Good morning.

Bill Schmitz - *Deutsche Bank - Analyst*

Just to follow up on the SAP pre-buy, I think in years past it was like a 70% to 80% operating margin on those sales pulled forward. When we model it, should we assume those same kind of margin levels? My real question is as things start to get dicey out there, do you guys have a contingency plan in place that can preserve earnings? Are there some investments you can pull back on or are you just going to invest straight through because it's better for the long-term health of the business?

Tracey Travis - *The Estee Lauder Companies Inc. - EVP & CFO*

To answer the first part of your question, yes, you can assume the same type of margin on that sales shift in the quarter.

Fabrizio Freda - *The Estee Lauder Companies Inc. - President & CEO*

The second question, yes, we have a pretty sophisticated contingency system as you have probably seen in the last two years, where every brand has an element of contingency and flexible spending. In the course of our year, this contingency of flexible spending is then flexed to profit protection or to further investment on our winners depending how the markets in our fiscal year goes. So we have the opportunity in case things would get worse in some markets to protect our plans. To be clear, the way we protect our plans is not necessarily protecting on the profit, but the best way in which we protect our plans is to be to agile enough to move resources to our winners and to be able anyway to protect also our top line growth in the course of the year wherever we can. So when things get tough we can protect profit but most importantly, we can direct our resources where things are not tough, actually are good. To be clear, the strength of our portfolio is that our many brands, many channels, many countries, our broad approach to the world offer always, frankly, a possibility to find areas which are growing fast which are solid and which is worth investing in. So it's a balance of being able to protect and agile enough to be able to leverage what is working.

Operator

Mark Astrachan, Stifel Nicolaus.

Mark Astrachan - *Stifel Nicolaus - Analyst*

Good morning everybody. On advertising, we're just trying to get a better handle on the incremental spend. Is the absolute amount that you are planning to spend for fiscal '13 the same as pulling forward some of that into this December quarter? And then more broadly, I know you have talked a little bit before about AMS spending moderating as percentage of sales over time. Maybe give us a bit of an update in terms of how you



are thinking about that now, particularly as it may seem like -- there seems to be an increase in correlation between that spend and your sales growth.

Tracey Travis - *The Estée Lauder Companies Inc. - EVP & CFO*

Okay. So our advertising full year dollar expenditures are expected to increase this year. As Fabrizio noted, the calendarization of the spend is a bit different this year than last year. So we're seeing a fairly heavy spike in the second quarter, which will be offset by a decline in the fourth quarter as it relates to our plans this year. But full year we are expecting to increase advertising spending. We have, as we had mentioned before, a tremendous launch program this year that we certainly want to be able to support. We are, however, this year expecting to leverage advertising and promotion expense. So it will not be deleveraging on our margin.

Operator

Linda Bolton-Weiser, Caris and Company.

Linda Bolton-Weiser - *Caris & Company - Analyst*

Hi. I know you made some comments about Russia but maybe you could give a little bit more color. Oriflame, on their call the other day, mentioned that they felt that the traditional retail channels were gaining share from direct selling in beauty in Russia and they said they thought there was a very high level of promotion in the regular retail channels. Could you comment, is that more mass cosmetics or is that prestige too? And can you give a little bit more about the market dynamics in Russia and also can you give us some ideas to what size it is for you guys, what percentage of sales roughly? Thanks.

Fabrizio Freda - *The Estée Lauder Companies Inc. - President & CEO*

Yes. Russia is more percentage, there is more percent of our sales is around 2% of our sales. What's happening in Russia, the market is growing double digits over the prestige market in Russia. We are growing double digit or more with most of the retailers we were with in Russia. There is a retailer we wish we don't have in agreement for the plan forward and we are discussing with them. So the reason why we, in this moment in time, we are not fully exploiting the growth of the Russian market and we are delivering results in Russia which are below market growth, which is unique because in all the other emerging markets of the world in this moment is just the opposite is happening, meaning we are growing much faster than the market. In this market, the reason why it's happening is because we don't have, yet, a final agreement with one of the retailers. So we are evaluating what will be the right strategy in the future to continue growing in Russia at this point in time.

Operator

John Faucher, JPMorgan.

John Faucher - *JPMorgan Chase & Co. - Analyst*

Yes. Good morning. Thank you. I was wondering if you could take your category growth comments and then your targets and sort of put them in the context of what you're seeing from a competitive standpoint? It seems as though the incremental spending is just about trying to get more out of your marketing budget for fiscal 2013 as opposed to an increase in spending. So do you think that just simply moving the support forward is enough to -- I don't know whether you are accelerating your market share gains or at least sort of maintaining your market share gains. Can you walk through the incremental spending in the context of what you are seeing out there competitively? Thanks.



Fabrizio Freda - *The Estee Lauder Companies Inc. - President & CEO*

We are definitely growing at double the industry. We are growing market share globally. Our estimate is the market will grow about 3% and we are growing -- we will grow 6% to 7% in our estimate. So we will definitely continue to accelerate global market share.

In terms of our main biggest competitors, we have been growing stronger than them ever year and the most of the quarters. If you look to our history in the last three years, there will be only few quarters where some of our competitors have been growing faster than us. This is normally associated with calendarization of events rather than with a strategic change. So we are a fast growth company.

We have defined fast growth as at least 1% ahead of market every year. When the market grow 4% to 6%, we will grow 6% to 8%. In the year where the market seems to grow 3%, particularly because there are some big markets in the world, like the south of Europe that we show negative, when this happens we may grow 6%, 7% like we are seeing this year. Anyway, it's always the same logic as growing double than the market, much better than the industry and normally, again with exception of few quarters, we believe we will be ahead of competition in terms of growth.

Tracey Travis - *The Estee Lauder Companies Inc. - EVP & CFO*

And the only thing I would add to what Fabrizio is saying in terms of our spend this year and the reason we can get a little bit more leverage out of it, we are far more targeted in the spend this year in terms of the products that we're supporting and the markets that we're supporting as well, which is allowing us to get tremendous leverage on the dollars.

Operator

Victoria Collin, Atlantic Equities.

Victoria Collin - *Atlantic Equities - Analyst*

Hi, good morning. Fabrizio, I apologize if you said it already, but I wonder if you could give the same door sales figure for China please. And also maybe a little bit of color on the Q2 guidance, particularly in your key markets? What are you expecting for the holidays, something more buoyant than last year presumably for the US and maybe the detail on whereabouts in the market you expect to see that? Thank you.

Fabrizio Freda - *The Estee Lauder Companies Inc. - President & CEO*

The same door sales in China has been 2% in the quarter. In terms of the holiday, we frankly have early indication of a very solid holiday season. We have great programs out there. Some of our programs appeal to value consumer, consumers which are interested in value. Some of our programs appeal to the high end consumer. We believe we have very balanced programs and very promising.

The first indications, that should be good. We get these indications from online. We have a very strong beginning of online activity linked to holiday. So we are pleased with the first reaction to our programs and we are encouraged by what we see for the holidays.

Operator

That concludes today's question and answer session. If you were unable to join the entire call, a play back will be available at 1.00 PM Eastern time today through November 15. To hear a recording of the call, please dial 855-859-2056 and then enter pass code 53701080. Again, please dial 855-859-2056 then enter the pass code 53701080. That concludes today's Estee Lauder conference call. I would like to thank you all for your participation and wish you all a good day.



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